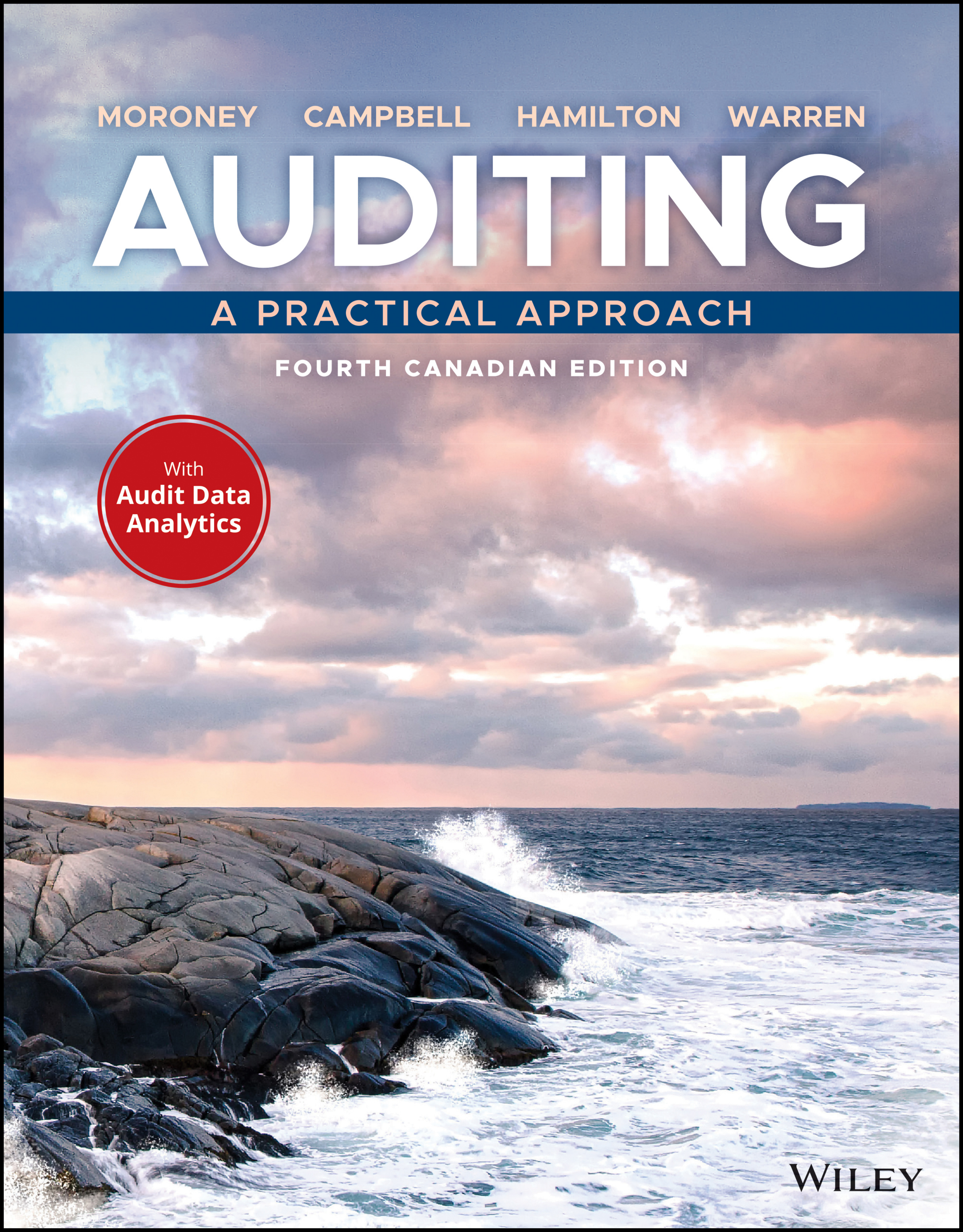
MORONEY CAMPBELL HAMILTON WARREN

AUDITING

A PRACTICAL APPROACH

FOURTH CANADIAN EDITION

With **Audit Data Analytics**



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Auditing

A Practical Approach

with Data Analytics

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Fourth Canadian Edition

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Preface

Welcome to the fourth Canadian edition of *Auditing: A Practical Approach*. This is not just another auditing text. As the title suggests, the textbook focuses on how audits are conducted in practice. As authors, we bring our diverse experiences to this book to provide a very different approach to teaching and studying auditing. In addition to covering the essential topics of auditing, the text provides greater insight into how an audit is conducted and the issues that are of greatest concern to practising auditors.

As each chapter unfolds, students are introduced to the various stages of an audit. Key auditing concepts are addressed in a succinct manner, making them easily understandable. To underpin this approach, each chapter begins with a diagrammatic representation of the stages of an audit, with the current stage highlighted as we progress through the text. The diagram provides a useful reference point to ground the discussion in each chapter to the relevant stage in the audit process. To underpin our discussion of how an audit is conducted, we use a case study of a hypothetical client, Cloud 9. The discussion in each chapter is kept general, with our case study providing an example of how the general principles behind each audit may be applied in practice. By using this approach, students are provided with a continuing example of how the concepts discussed may apply in practice.

The Cloud 9 case study provides a flexible learning tool to be used within an auditing and assurance course. Details about Cloud 9 and its audit are provided in each chapter to give an insight into how an audit is conducted, the issues that auditors face at each stage of an audit, and the processes used to gather evidence and arrive at conclusions. The Cloud 9 case materials can form the basis of class discussions, student role plays, or online exchanges between students. At the end of each chapter, a case-study problem is provided using Cloud 9 as a basis.

To reinforce the practical approach of the text, students can also conduct audit procedures using the Alpine Bags case, formerly the Cloud 9 casebook now updated to a backpack business and revised, which is available in the online course. In this independent case study, the student plays the role of a recent graduate working for an accounting firm with a new audit engagement. Assignments that accompany this case include documentation of the knowledge of the entity, materiality, audit data analytics, and tests of controls. A random Excel generator accompanying the Alpine Bags case is included in the course. The Excel generator can randomize numbers and business documents, so no two assignments are the same. These problems can be used as part of a weekly tutorial or as an assignment for students to work on individually or in groups (or some combination of the two).

This updated edition of the text includes enhanced content on professional scepticism, auditing estimates, and a new chapter on data analytics. The text also reflects recent changes to assurance standards, including the revised CAS 315 *Identifying and Assessing the Risks of Material Misstatements*, and CSRS 4200 *Compilation Engagements*.

New to This Edition

New Emphasis on Data Analytics

A new chapter on the emerging area of audit data analytics (ADAs) has been developed for this edition. Students are provided with common terminology, available techniques, and data considerations when performing ADAs. Examples of ADA using a variety of popular software and various visualizations are included in this chapter. Related end-of-chapter material, in the form of questions and critical thinking problems, has also been created for faculty wanting to expand the discussion of this material. Questions include both the interpretation of visualizations and the manipulation of data using popular ADA software. Furthermore, audit data analytics and the impact of using software at every stage of the audit is considered throughout the textbook.

To encourage students to develop their analytic skills, **PowerBI** and **Tableau Homework** questions accompanied by visualizations are available with most chapters. Students are required to interpret visualizations and think critically about data.

An **IDEA Workbook** and accompanying data sets, provided by Audimation Services and CaseWare IDEA, are also available in the online course accompanying this text.

A new **accounting-specific data analytics module** with interactive lessons, case studies, and videos is part of the course. The module has been prepared using industry-validated content to help students develop the professional competencies needed for the Common Final Examination and the changing workforce.

Currency and Accuracy

As in past editions, we have endeavoured to make this edition the most current and accurate available.

The following list outlines the key revisions and improvements made to the chapters.

Chapter 1 Introduction and Overview of Audit and Assurance

- We have revised the wording on auditor reporting with respect to key audit matters and the requirements in the new CAS 701 *Communicating Key Audit Matters in the Independent Auditor's Report*.
- We have revised the discussion of a compilation engagement to reflect the new standard CSRS 4200 *Compilation Engagements*, and added the new review engagement

report and a new end-of-chapter problem about engagement reports.

Chapter 2 Ethics, Legal Liability, and Client Acceptance

- We have added a new learning objective and end-of-chapter material on professional judgement and professional scepticism.
- We have updated the Professional Environment 2.2 feature box on quality control to discuss proposed changes to CSQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance Engagements*.

Chapter 3 Audit Planning I

- We have added a new learning objective and end-of-chapter material on how auditing estimates can impact risk.

Chapter 4 Audit Planning II and Chapter 7 Understanding and Testing the Client's System of Internal Controls

- We have updated the discussions of risk assessment to reflect the revisions to CAS 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment*.

Chapter 8 Execution of the Audit—Performing Substantive Procedures

- We have added a new learning objective and end-of-chapter material on auditing accounting estimates to reflect the new requirements in CAS 540 *Auditing Accounting Estimates and Related Disclosures.*

Chapter 9 Audit Data Analytics

- As detailed above, we have added an entire chapter on the emerging field of audit data analytics.

Chapter 14 Completing and Reporting on the Audit

- We have updated the discussion on auditor reporting to reflect the requirements on key audit matters in the new CAS 701 *Communicating Key Audit Matters in the Independent Auditor's Report*.
- We revised the appendix in this chapter to expand coverage of review engagements and to reflect the new assurance standards on special reports where applicable.

Digital Resources for Students and Instructors

Auditing: A Practical Approach, fourth Canadian edition, is completely integrated with the online course, featuring a suite of teaching and learning resources. The accompanying online course allows students to create a personalized study plan, assess their progress along the way, and access the content and resources needed to master the material. It provides immediate insight into students' strengths and problem areas with visual reports that highlight what's most important for both the instructor and the student. Many dynamic resources are integrated into the course to help students build knowledge and understanding, stay motivated, and prepare for decision-making in a real-world context.

Additional features of the course include resources for students and instructors.

For Instructors

We offer several useful supplements in the online course. Instructors will find the Solutions Manual, PowerPoint presentations, Test Bank, Computerized Test Bank, a data set library, data analysis and visualization questions, and other valuable teaching resources. Instructors also have a selection of autogradable end-of-chapter questions that they can assign to students. These are multi-solution multiple-choice questions based on chapter content and adapted professional application questions.

The supplements are prepared by subject matter experts and contributors who are often users of the text and are rigorously checked to ensure accuracy.

For Students

Students will find support materials in the course that will help them develop their conceptual understanding of class material and increase their ability to solve problems. Students will find the Material Matters Video Series, Excel Function Videos, and PowerPoint presentations. The course includes a variety of practice questions that include matching activities as well as multiple-choice questions and dropdown questions to keep students engaged.

Overview of the Text

Chapter 1: Introduction and overview of audit and assurance. This chapter begins with a definition of assurance engagements, which leads into a discussion of the source of the historical and ongoing demand for audit services. This is then followed by assurance services, an explanation of how they can differ, and the different levels of assurance and opinions that can be provided by auditors. The role of the financial statement preparer is also contrasted with that of the auditor. The regulations surrounding the provision of assurance services are outlined and the expectation gap is explained. This chapter provides the background that underpins the remainder of the text.

Chapter 2: Ethics, legal liability, and client acceptance. This chapter provides an overview of the fundamental principles of professional ethics that apply to all accountants. A discussion on professional scepticism and professional judgement follows. Attention is then given to auditor independence, including threats and safeguards. The auditor's legal liability to their client and third parties is explained, together with the concept of contributory negligence. This chapter ends with a discussion of the factors to consider in the client acceptance or continuance decision, which marks the commencement of our discussion of how an audit is conducted.

Chapter 3: Audit planning I. The first stage of every audit involves planning. This important topic is covered in two chapters. Chapter 3 begins with a discussion of the different phases of an audit. The key components of the risk assessment phase are gaining an understanding of a client, identifying the risk of fraud, assessing the extent of related party transactions, evaluating the client's going concern assumption, understanding the impact of any estimation uncertainty, gaining an understanding of the client's corporate governance structure, and evaluating how a client's information technology can affect risk. These components of audit planning are described in detail in this chapter, along with a discussion of how client financial reporting requirements and closing procedures can impact reported results.

Chapter 4: Audit planning II. This chapter continues our discussion of audit planning. Specifically, this chapter includes a definition of audit risk and describes its components. The concept of materiality, the development of planning materiality, and how it is used when conducting an audit is then described. The process used by auditors in arriving at their audit strategy, which provides a blueprint for the remainder of the audit, is explained. The chapter concludes with an overview of the use of analytical procedures during the risk assessment phase of an audit.

Chapter 5: Audit evidence. This chapter contains an overview of the different types of audit evidence and the processes used by auditors to gather that evidence throughout the audit, including audit data analytics. The audit assertions, which aid in risk identification and the design of audit procedures, are defined. The concept of sufficient appropriate audit evidence is explained. The procedures when using the work of an expert or another auditor are described. This chapter concludes with a discussion of how auditors document the details of evidence gathered in their working papers.

Chapter 6: Sampling and overview of the risk response phase of the audit. This chapter begins with a discussion of how an auditor determines whether to use sampling or to test the entire population using an audit data analytic. The chapter then focuses on audit sampling. Sampling and non-sampling risk are explained and contrasted and then followed by a discussion of the difference between statistical and non-statistical sampling. Various sampling methods used in practice are then described. The factors that impact sample sizes when testing controls and conducting substantive tests are then outlined. Tests of controls and substantive procedures are then described. The difference between tests of controls and substantive procedures and the factors that impact the nature, timing, and extent of audit testing are explained.

Chapter 7: Understanding and testing the client's system of internal controls. This chapter provides an overview of internal controls. The system of internal control is defined and the seven generally accepted objectives of internal control activities are outlined. Internal controls at the entity level are explained and contrasted. This chapter discusses how an auditor determines when to conduct their tests, how they identify different types of controls, how they select the techniques to use when testing controls, how they select controls to test, and how they design their tests of controls. The chapter demonstrates that once controls testing is completed, an auditor must interpret the results of their testing and the implications of the findings for the remainder of the audit. A description is provided of how an auditor documents their understanding of their client's system of internal controls. Based upon that understanding, an auditor will then identify strengths and weaknesses in their client's system of internal controls and communicate their findings to those charged with governance in the organization.

Chapter 8: Execution of the audit—performing substantive procedures. This chapter provides an overview of the substantive procedures used by auditors when testing the details of their client's transactions and account balances. This chapter includes a discussion of the link between audit risk and the nature, timing, and extent of substantive procedures conducted by the auditor. An overview is provided of common substantive audit procedures used in practice and the level of audit evidence obtained when conducting different tests, including performing substantive tests using technology. This chapter concludes with a description of the documentation of the conclusions reached by auditors as a result of their substantive procedures.

Chapter 9: Audit data analytics. This chapter begins by defining audit data analytics (ADAs) and when an auditor can use ADAs during an audit. Approaches for performing ADAs are presented. The various data and documentation issues the auditor should consider are discussed. The chapter provides several examples of ADAs. These examples demonstrate how an auditor deals with exceptions and anomolies and presents a variety of visualizations. The chapter ends with what an auditor should consider when preparing visualizations. Feature boxes include how ADAs are used in practice in Canada and some of the different technologies available to conduct ADAs.

Chapter 10: Auditing sales and receivables. This chapter begins with a discussion of the audit objectives when auditing sales and receivables. It identifies the functions and control procedures normally found in the processing of sales, cash receipts, and sales adjustment transactions. The audit strategy, including the risk of material misstatement and tests of controls for these accounts, is discussed. The chapter ends with an overview of the substantive audit procedures used to audit the sales and receivables cycle, including the confirmation of accounts receivable.

Chapter 11: Auditing purchases, payables, and payroll: This chapter begins with a discussion of the audit objectives applicable to purchases, payables, and payroll. It identifies the functions and control procedures normally found in the processing of purchase, payment, and purchase adjustment transactions.

The audit strategy, including the risk of material misstatement and tests of controls for these accounts, is discussed. The chapter ends with an overview of the substantive audit procedures used to audit purchases, payables, and payroll.

Chapter 12: Auditing inventories and property, plant, and equipment: This chapter describes the audit objectives applicable to inventory and property, plant, and equipment. Record-keeping for these accounts is discussed. This is followed by the considerations in determining the audit strategy for inventory and property, plant, and equipment. Substantive audit procedures are discussed, including procedures relating to the client's inventory count.

Chapter 13: Auditing cash and investments: This chapter includes the audit objectives applicable to cash and investments. The audit strategy for cash and investments is discussed, as well as substantive procedures for these accounts. The fraud known as lapping and how an auditor can detect it are described.

Chapter 14: Completing and reporting on the audit: This final chapter of the text marks the conclusion of the audit. An explanation of the procedures performed by an auditor as part of their wrap-up, including gathering and evaluating audit evidence, is provided. The going concern concept is revisited in the context of finalizing the audit. Subsequent event testing is explained. The procedures auditors use when evaluating material misstatements uncovered during their audit are outlined. A description is provided of how auditors evaluate the conclusions drawn throughout the audit in relation to evidence gathered and its impact on the overall opinion formed on the financial statements. The form and content of the audit report are outlined. Finally, a description is provided of the types of reports an auditor will provide to the client's management and those charged with governance at the conclusion of the audit. This chapter is followed by an appendix that discusses the various types of special engagements and reports that an auditor may be asked to complete.

Structure of Each Chapter

Each chapter commences with a diagram of the *overview of the audit process*. This figure aids in understanding the structure of the textbook, which mirrors the process generally used when conducting an audit. The diagram highlights the phase of the audit to be covered in the current chapter, which aids in understanding what has come before and what is still to come. It supports the development of a holistic understanding of the audit process.

Following the audit process visual, an overview of the *learning objectives* addressed in the chapter is provided. Each learning objective is linked to the applicable assurance standards. The standards are incorporated in the discussions within the textbook, and other pronouncements and guidance statements are also listed and discussed where applicable. The learning objectives are also highlighted throughout the chapter as the discussion unfolds. After each learning objective is covered in the text, three *before you go on* questions are set for students to confirm they recall the main issues covered. As these questions come directly from the text, it is straightforward for students to check their understanding of the key concepts covered before progressing to the next learning objective (section) in the chapter. Specific learning objectives are also linked to end-of-chapter professional application questions. This approach means that tutorial questions can be set to ensure coverage of the learning objectives considered most important.

Students are then introduced to *Cloud 9* at the start of each chapter; the case study continues throughout each chapter. The case provides continual practical insight into how the topics discussed can be applied in an audit, from a junior auditor perspective. Students can choose to incorporate Cloud 9 in their reading of each chapter or to go back and read through the case study after reading the main text. As Cloud 9 is easily distinguishable from the main text, either approach can be adopted when studying a chapter.

The introduction to the Cloud 9 case is followed by a brief overview and outline of the chapter. As *key terms* appear in the text, their definitions appear in the margin, which aids studying and revision.

Descriptions of the *professional environment* in which auditors operate appear in each chapter. These vignettes provide some details of the auditing profession and various challenges faced by auditors. Thought-provoking questions related to each topic are provided for further contemplation.

Each chapter concludes with a summary, list of key terms used, and end-of-chapter questions. The *summary* provides a brief recap of each learning objective covered in a chapter. The end-of-chapter questions include multiple-choice questions, review questions, professional application questions, a Cloud 9 case-study question, and a research question.

Solutions to *multiple-choice questions* appear in the course, so students can use them as part of their independent study. The *review questions* test student understanding of the key concepts covered in the chapter. The *professional application questions* are problems designed around the learning objectives set for the chapter. Each question is graded as basic, moderate, or challenging and indicates the learning objective(s) covered. A selection of the professional application questions is based upon problems published by professional bodies such as CPA Canada in their various publications and exams. Several professional application questions are also based on Audit and Assurance exams administered by Chartered Accountants Australia and New Zealand. The inclusion of these problems in the text helps build familiarity with the types of problems that students will encounter in their professional exams.

The Cloud 9 *case study* builds from one chapter to the next and is based on the information provided in each chapter, in the case study at the end of each chapter, and in the appendix to the textbook. The use of a case study in this text aids in the appreciation of how each topic covered fits in to the context of an audit as a whole. Together with the practical approach used in the body of the text, this allows a deeper understanding of how audits are conducted in practice.

Research questions provide an opportunity for students to gain a deeper appreciation of the role of academic research in providing greater insights into audit practice. Sample documents and forms are included in the text and provide students with useful examples of the forms and templates that they would encounter during an audit.

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We have tried to produce a text that is error-free and that meets your requirements. Suggestions and comments from users are always welcome.

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Brief Contents

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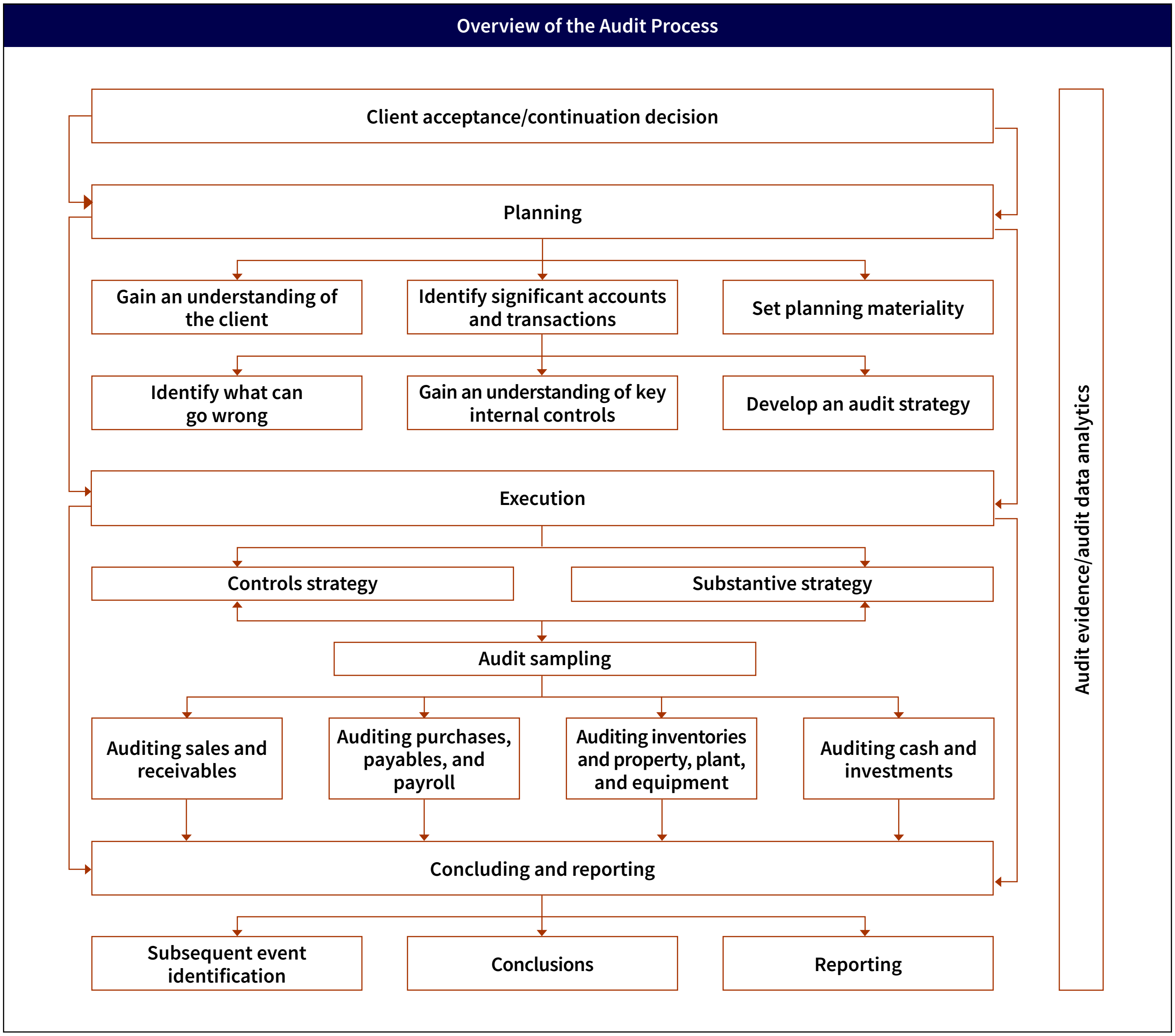
Introduction and Overview of Audit and Assurance



LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
After studying this chapter, you should be able to:		Standards addressed in each learning objective are as follows:
1 Define an assurance engagement	**1.1** Auditing and Assurance Defined	CSAE 3000 *Attestation Engagements Other than Audits or Reviews of Historical Financial Information*
2 Explain why there is a demand for audit and assurance services	**1.2** Demand for Audit and Assurance Services **1.2.1** Financial statement users **1.2.2** Sources of demand for audit and assurance services **1.2.3** Theoretical frameworks **1.2.4** Demand in a voluntary setting	
3 Differentiate between types of assurance services	**1.3** Different Assurance Services **1.3.1** Financial statement audits **1.3.2** Compliance audits **1.3.3** Performance audits **1.3.4** Comprehensive audits **1.3.5** Internal audits **1.3.6** Corporate social responsibility (CSR) assurance	CAS 200 *Overall Objectives of the Independent Auditor, and the Conduct of an Audit in Accordance with Canadian Auditing Standards* CAS 610 *Using the Work of Internal Auditors* CSAE 3000 *Attestation Engagements Other than Audits or Reviews of Historical Financial Information* CSAE 3001 *Direct Engagements*
4 Explain the different levels of assurance	**1.4** Different Levels of Assurance **1.4.1** Reasonable assurance **1.4.2** Limited assurance **1.4.3** No assurance	CAS 200 *Overall Objectives of the Independent Auditor, and the Conduct of an Audit in Accordance with Canadian Auditing Standards* CSRE 2400 *Engagements to Review Historical Financial Statements* CSRS 4200 *Compilation Engagements* CAS 700 *Forming an Opinion and Reporting on Financial Statements* CAS 701 *Communicating Key Audit Matters in the Independent Auditor's Report*
5 Outline different audit opinions	**1.5** Different Audit Opinions	CAS 700 *Forming an Opinion and Reporting on Financial Statements* CAS 705 *Modifications to the Opinion in the Independent Auditor's Report*

LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
		CAS 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*
6 Differentiate between the roles of the preparer and the auditor, and discuss the different firms that provide assurance services	**1.6** Preparers and Auditors **1.6.1** Preparer responsibility **1.6.2** Auditor responsibility **1.6.3** Assurance providers	CAS 200 *Overall Objectives of the Independent Auditor, and the Conduct of an Audit in Accordance with Canadian Auditing Standards*
7 Identify the different regulators, legislation, and regulations surrounding the assurance process	**1.7** The Role of Regulators and Regulations **1.7.1** Regulators, standard setters, and other bodies **1.7.2** Legislation **1.7.3** Regulation	CAS 220 *Quality Control for an Audit of Financial Statements* CSQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance Engagements*
8 Describe the audit expectation gap	**1.8** The Audit Expectation Gap	CAS 200 *Overall Objectives of the Independent Auditor, and the Conduct of an Audit in Accordance with Canadian Auditing Standards* CAS 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

Cloud 9 Integrated Case

This book is designed to provide students with the opportunity to learn about auditing by using a practical, problem-based approach. Each chapter begins with some information about an audit client—Cloud 9 Ltd. (Cloud 9). The chapter then provides the underlying concepts and background information needed to deal with this client's situation and the problems facing its auditor. As students work through the chapters, they gradually build up their knowledge of auditing by studying how the contents of each chapter are applied to Cloud 9. The end-of-chapter exercises and problems also provide students with the opportunity to study other aspects of Cloud 9's audit, in addition to applying the knowledge gained in the chapter to other practical examples.

Cloud 9 Inc., a listed company in Canada, is looking to expand. McLellan's Shoes is seen as a potential target.

In 2000, Ron McLellan starts a business to manufacture and retail customized basketball shoes. Ron calls his business McLellan's Shoes. Ron borrows from the bank to start the business, using his house as security, and over the years he works very hard to establish a profitable niche in the highly competitive sport shoe market. Ron is able to repay the bank in 2005, before a recession hit. As he watches retail businesses struggle to stay open, he is glad to have the extra cash available to invest in creative marketing and product development to maintain solid sales.

As the business grows, Ron's wife and three adult children start to work for him, with responsibility for administration, marketing and sales, production, and distribution. By the early 2010s, Ron's business employs 20 people full-time, most of whom work in production. There are also several casual employees and part-time staff in the retail outlet, particularly during busy periods.

In February 2012, Ron receives a call from Chip Masters, the senior vice-president of Cloud 9 Inc. Chip expresses an interest in buying McLellan's Shoes. Ron is getting tired, and his children are starting to fight among themselves about who is going to take over from their father. Ron has had enough, but he does not want Chip to know that. He asks if Chip is ready to talk about the price. Chip says he is, but first he needs to see the audited financial statements for McLellan's Shoes.

Ron asks for some time. He tells Chip that he needs to talk to his family and will get back to him. When Ron puts the phone down he immediately rings his friend from the golf club, Ernie Black, who is a professional accountant. For years, Ernie has been quietly suggesting to Ron that his business affairs need attention. Ron is skilled at making deals and working hard, but he has never bothered with sophisticated financial arrangements. He has never had a formal set of financial statements prepared for McLellan's Shoes. Ron is in a panic—he wants to sell McLellan's Shoes, but what is he going to do about Chip's request for audited financial statements?

Chapter Preview

The purpose of this chapter is to provide an overview of audit and assurance services. We begin by defining assurance and audit engagements. We discuss the reasons why there is a demand for audit and assurance services. We also introduce some of the assurance and audit terms that will be used throughout the text. We then go on to differentiate between the various types of assurance services a practitioner may provide. The assurance engagements explained in this chapter include financial statement audits, compliance audits, performance audits, comprehensive audits, and internal audits. We also discuss the emerging area of assurance of corporate social responsibility disclosures. We then provide an overview of the different levels of assurance that can be provided when conducting assurance procedures. The levels of assurance discussed in the chapter include reasonable, limited, and no assurance engagements.

Next, we provide a brief overview of the different audit opinions that an auditor can arrive at after completing an audit. An auditor can provide either an unmodified or a modified audit opinion. Unmodified or modified opinions can include an emphasis of matter paragraph, which is intended to draw the reader's attention to a specific matter. They can also include key audit matters, where auditors communicate issues that were important during the audit. If a modified opinion is used, the auditor has the choice of three types of modifications: qualified, adverse, or a disclaimer of opinion. These concepts are explained further in this chapter.

The roles of the financial statement preparer and auditor are explained and contrasted. An overview of the different firms that provide assurance services is then given. That section contains details about both accounting and consulting firms and the different services they provide. An overview of assurance regulators and their regulations is provided. The audit expectation gap is explained in the last section of the chapter.

1.1 Auditing and Assurance Defined

LEARNING OBJECTIVE 1

Define an assurance engagement.

assurance engagement an engagement performed by an auditor or consultant to enhance the reliability of the subject matter

An assurance engagement is 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 of the intended users other than the responsible party about the outcome of the measurement or evaluation of an underlying subject matter against criteria" (CSAE 3000 C12). Thus, an **assurance engagement** is an engagement where a practitioner, such as a financial statement auditor, is engaged to issue a written conclusion on a subject matter for which a responsible party is accountable to intended users. Intended users are the people for whom the assurance provider prepares the report (for example, the shareholders). The responsible party is the person or organization (for example, the company) responsible for the preparation of the subject matter (for example, the financial statements). The triangle in **figure 1.1** illustrates the three parties needed for an assurance engagement.

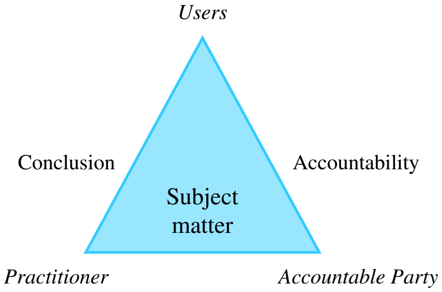


FIGURE 1.1 Parties involved in an assurance engagement

As illustrated in the triangle in figure 1.1, there must be an accountability relationship where a person or organization is responsible to the users for the subject matter. The practitioner gathers evidence and assesses the subject matter against criteria or benchmarks, and then provides a written report that concludes on the subject matter.

While the audit of a company's financial statements is one of the most common types of assurance engagements, it is not the only type of assurance engagement. Later in this chapter, section 1.3 provides a description of some of the different types of assurance services.

Cloud 9 Integrated Case

Chip Masters has asked Ron McLellan for audited financial statements of McLellan's Shoes. Ron has heard about tax audits, efficiency audits, and financial statement audits. Are they all the same thing? Ernie explains to Ron that there are several services that people call "audits" that are different from financial statement audits. However, all these services, including financial statement audits, can be defined as assurance engagements.

When you are acquiring a new skill, it is often necessary to become familiar with new terminology. **Table 1.1** presents a number of key assurance and audit terms to introduce you to the language of auditing.

TABLE 1.1 **Key assurance and audit terms**

Term	Definition
applicable financial reporting framework	The financial framework chosen by management to prepare a company's financial statements. For example, an applicable framework for a reporting issuer would be International Financial Reporting Standards (IFRS). An applicable framework for a private enterprise could be Accounting Standards for Private Enterprises (ASPE), or it could be IFRS.
assertions	Statements made by management regarding the recognition, measurement, and presentation and disclosure of items in the financial statements.
audit evidence	Information used by the auditor to support the audit opinion.
audit file	The file where the evidence and documentation of the work performed are kept as a permanent record to support the opinion issued.
audit plan	The list or description of audit procedures to be performed.
audit risk	The risk that the auditor may express an inappropriate opinion. This means the auditor may indicate that the financial statements are not materially misstated when in fact they are.
financial statements	A structured representation of historical financial information, including the required disclosures.
independent auditor's report	The auditor's formal expression of opinion on whether the financial statements are in accordance with the applicable financial reporting framework.
internal control	The processes implemented and maintained by management to help the entity achieve its objectives.
material	An amount or disclosure that is significant enough to make a difference to a user. For example, if a company reports a profit of $100,000 and the auditor finds an error resulting in an overstatement of net income by $10, this probably wouldn't affect an investor's decision. However, if the auditor finds an error overstating revenue by $50,000, or 50 percent of the profit, this likely would affect the user's decision and would therefore be considered material.
sufficient and appropriate evidence	The quantity (sufficiency) and quality (appropriateness) of the evidence collected by the auditor.

(*continued*)

TABLE 1.1 Key assurance and audit terms (*continued*)

Term	Definition
unmodified opinion	The auditor's opinion concluding that the financial statements are fairly presented. (Also called an "unqualified opinion.")
working papers	Paper or electronic documentation of the audit created by the audit team as evidence of the work completed.

Before You Go On

1.1.1 Who are the three parties involved in an assurance engagement?

1.1.2 What might an assurance provider express a conclusion about?

1.1.3 What is an assurance engagement?

1.2 Demand for Audit and Assurance Services

LEARNING OBJECTIVE 2

Explain why there is a demand for audit and assurance services.

In this section, we will provide an overview of the key financial statement users and their requirements. This is followed by a description of why these users may demand an audit of the financial statements. Next, three theoretical frameworks that have been used to encapsulate these sources of demand are described. Finally, the demand for assurance services in a voluntary setting is explored.

1.2.1 Financial Statement Users

Financial statement users include current and potential investors (shareholders if the entity is a company), suppliers, customers, lenders, employees, governments, and the general public. Each of these groups will read the financial statements for a slightly different reason. Each group of users and their reasons for reading a company's financial statement is described below, and is illustrated in figure 1.2.

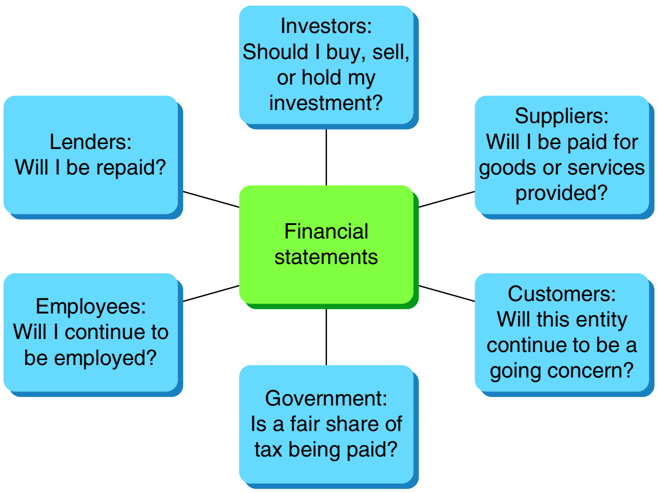


FIGURE 1.2 Financial statement users

Investors

In the case of a company, investors generally read the financial statements to determine whether they should invest in or buy, hold, or sell shares in the entity being reported on. They are interested in the return on their investment and are concerned that the entity will remain a going concern into the foreseeable future. Investors may also be interested in the capacity of the entity to pay a dividend. Prospective investors read financial statements to determine whether they should buy shares in the entity.

Suppliers

Suppliers may read the financial statements to determine whether the entity can pay them for goods supplied. They are also interested in whether the entity is likely to remain a going concern (that is, it is likely to continue to be a customer of the supplier) and continue to be able to pay its debts as and when they fall due.

Customers

If customers rely on the entity for their business, they may read the financial statements to determine whether the entity is likely to remain a going concern.

Lenders

Lenders may read the financial statements to determine whether the entity can pay the interest and principal on their loans as and when they fall due.

Employees

Employees may read the financial statements to determine whether the entity can pay their wages or salaries and other benefits (for example, vacation pay). They may also be interested in assessing the future stability and profitability of the entity, as this affects their job security.

Governments

Governments may read the financial statements to determine whether the entity is complying with regulations and paying a fair amount of taxation given its reported earnings, and to gain a better understanding of the entity's activities. An entity in receipt of government grants may provide a copy of its financial statements when applying for a grant and when reporting on how grant funds have been spent.

The General Public

The general public may read the financial statements to determine whether they should associate with the entity (for example, as a future employee, customer, or supplier) and to gain a better understanding of the entity, what it does, and its plans for the future.

1.2.2 Sources of Demand for Audit and Assurance Services

Financial statement users and their needs, as outlined in the previous section, are many and varied. There are a number of reasons why some or all of these users would demand audited financial statements. The primary reason is to reduce **information risk**, which is the risk that users will rely on incorrect information to make a decision. The causes of information risk include remoteness, complexity, competing incentives, and reliability. Each of these concepts is now explained.

information risk the risk that users will rely on incorrect information to make a decision

Remoteness

Most financial statement users do not have access to the entity under review. This makes it difficult to determine whether the information contained in the financial statements is a fair presentation of the entity and its activities for the relevant period.

Complexity

Most financial statement users do not have the accounting and legal knowledge to enable them to assess the complex accounting and disclosure choices being made by the entity.

Competing Incentives

Management has an incentive to disclose the information contained in the financial statements in a way that helps them achieve their own objectives—for example, to present their performance in the best possible light. Users may find it difficult to identify when management is presenting biased information.

Reliability

Financial statement users are concerned with the reliability of the information contained in the financial statements. As they use that information to make decisions that have real consequences (financial and otherwise, such as assessing the future viability of the company), it is very important that users are able to rely on the facts contained in the financial statements.

An independent third-party review of the information contained in the financial statements by a team of auditors, who have the knowledge and expertise to assess the fair presentation of the information being presented by the preparers, aids users with all of these issues. Auditors have access to entity records, so they are not remote. They are trained accountants and have detailed knowledge about the complex technical accounting and disclosure issues required to assess the choices made by the financial statement preparers. Independent auditors have no incentives to aid the entity in presenting its results in the best possible light. They are concerned with ensuring that the information contained in the financial statements is reliable and free from any significant (material) misstatements (error or fraud).

Cloud 9 Integrated Case

Ron tells Ernie that he has no remote users, such as shareholders or lenders, and his business is not very complex. He is the owner and the manager of McLellan's Shoes and therefore has no competing incentives. For all these reasons, he has never felt the need to purchase an audit to assure users of the reliability of his business's financial information. Ernie agrees, but points out that there is now a user who is very interested in the reliability of the financial information—Chip Masters.

1.2.3 Theoretical Frameworks

The reasons for demanding audit and assurance services outlined in the previous section have led to the development of three theoretical frameworks that have been used to explain why audits occurred prior to regulations requiring that they be done, why users may demand an audit from a certain type of firm (for example, an international or an industry specialist firm), and why users may demand assurance of voluntarily disclosed information (for example, environmental reports). The three theories are agency theory, the information hypothesis, and the insurance hypothesis. Each is described in turn.

Agency Theory

When an individual is an owner-manager of their own business, there are no competing incentives. The owner (principal) and manager (agent) are one. When an owner hires a manager to run the business on their behalf, potential conflicts arise. The manager has an incentive to provide favourable results. If there is one owner, they can easily monitor the activities of the manager. When there are several owners (such as shareholders of a large company), it is difficult for the owners to monitor the activities of the management. Agency theory tells us that, due to the remoteness of the owners from the entity, the complexity of items included in the financial statements, and competing incentives between the owners and managers, the owners (principals) have an incentive to hire an auditor (incur a monitoring cost) to assess the fair presentation of the information contained in the financial statements prepared by their managers (agents).

Information Hypothesis

Financial statement users require access to high-quality information to make a variety of decisions. That information is used to determine whether to hold or sell shares in the entity, whether to lend money to the entity, what rate of interest to charge the entity on money lent, and so on. The greater the perceived quality of the information contained in the financial statements, the more likely it will be relied upon by the users of that information. The information hypothesis tells us that, due to the demand for reliable, high-quality information, various user groups, including shareholders, banks, and other lenders, will demand that financial statements be audited to aid their decision-making.

Insurance Hypothesis

Investors take on a risk when buying shares. If the entity fails, investors could lose the money invested. According to the insurance hypothesis, an audit is one way for investors to insure against at least part of their loss should the company they invest in fail. As auditors are required to take out professional indemnity insurance policies, they are seen as having "deep pockets" (that is, access to money), should an investor be able to prove that audit failure was to blame, at least in part, for a loss. The insurance hypothesis tells us that investors will demand that financial statements be audited as a way of insuring against some of their loss should their investment fail.

Cloud 9 Integrated Case

Cloud 9 is considering buying McLellan's Shoes from Ron. In effect, it is considering investing in the business. If the business fails, the shareholders of Cloud 9 will lose their money. The new investors have incentives that are in competition with Ron's. If Ron purchases an audit, he is providing assurance to the potential new investors about the fair presentation of the financial statements. The audit also increases the perceived reliability of the information in the financial statements. For example, the outsiders know that Ron will have to convince an auditor of the appropriateness of the reporting decisions he is making.

Purchasing an audit is also a way of taking insurance against any possible loss by creating the opportunity for investors to recover their investment from the auditor. In reality, the auditor is not guaranteeing the success of the business, only providing reasonable assurance that the financial statements comply with the relevant laws and standards and give a fair presentation of the business's financial position and performance. There is little chance of a successful legal action against an auditor unless it can be established that the auditor failed to perform to a reasonable standard.

1.2.4 Demand in a Voluntary Setting

In addition to the audit of company financial statements, assurance providers (including auditors and consultants) provide other assurance services (as outlined in section 1.3). The theories outlined above are now being used to understand more about the demand for assurance of corporate social responsibility (CSR) disclosures, including environmental, sustainability, and carbon emissions reports.

It is becoming more common for companies to voluntarily disclose CSR information in their annual reports, on their websites, and in separate stand-alone reports. This trend toward increased disclosures has been in response to stakeholder (shareholder, lender, employee, customer, supplier, and public) demand that companies be more accountable for their impact on the environment and on society. Stakeholders are concerned about more than just profits and returns on shareholder funds. They want to know what impact companies are having on our environment and what actions are being taken by those companies to reduce that impact.

Stakeholders are concerned about the reliability of environmental and other CSR disclosures. Just as the provision of these disclosures is voluntary, so is the assurance. Companies are not required to have their environmental and other CSR disclosures assured, yet several companies do. Assurance is provided to meet user demands for high-quality, reliable information and to demonstrate a high level of corporate responsibility.

Before You Go On

1.2.1 Who are the main users of company financial statements?

1.2.2 Why might financial statement users demand an audit?

1.2.3 What are the three most common theories used to explain the origins of the demand for audit and assurance services?

1.3 Different Assurance Services

LEARNING OBJECTIVE 3

Differentiate between types of assurance services.

In this section, we provide an overview of the different types of assurance services that an assurance practitioner can provide. Common types of assurance engagements are financial statement audits, compliance audits, performance audits, comprehensive audits, and internal audits. We will also briefly consider assurance on corporate social responsibility (CSR) disclosures. Each will now be explained in turn.

1.3.1 Financial Statement Audits

financial statement audit an audit that provides reasonable assurance about whether the financial statements are prepared in all material respects in accordance with the financial reporting framework

According to CAS 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Canadian Auditing Standards,* the objective of a **financial statement audit** is for the auditor to express an opinion about whether the financial statements are prepared in all material respects in accordance with a financial reporting framework (CAS 200, para. 11). Within a Canadian context, this means that the financial statements have been prepared in accordance with Canadian generally accepted accounting principles (GAAP) and any relevant legislation, such as the Canada Business Corporations Act.

This means that, when a set of financial statements has been audited, the information presented has been verified by an independent auditor. To do this, the auditor methodically gathers evidence to corroborate the financial information presented by management. At the end of an audit engagement, the auditor issues a report indicating whether the financial information is fairly presented in accordance with the financial reporting framework. This lends credibility to the information.

listed entity an entity whose shares or debt are listed on a stock exchange

fair presentation the consistent and faithful application of accounting standards when preparing the financial statements

The Canadian Securities Administrators (CSA) requires **listed entities** to publish audited financial statements annually. It is the auditor's responsibility to form an opinion on the fair presentation of the financial statements. **Fair presentation** refers to the consistent and faithful application of the accounting standards. In fulfilling their role, the auditor must be independent of the company audited and exercise due professional care.

Cloud 9 Integrated Case

Ron believes that his business has good, reliable financial records. Ron's wife helps him keep tight control of the cash and other assets, and together they prepare some simple reports on a regular basis. Ron believes he knows exactly what is happening in the business and monitors the business's cash flow and profit very closely. However, he has not prepared financial statements that comply with Canadian generally accepted accounting principles (GAAP). Is this a problem? Ernie explains to Ron that some businesses must apply the accounting standards. For example, if a company requires audited financial statements to meet regulatory requirements or as a condition of a loan agreement, then the financial statements must comply with Canadian GAAP.

Process of a Financial Statement Audit

An audit is a systematic process. It involves the gathering of evidence in a logical fashion to substantiate the balances and disclosures in the financial statements. All audits should follow the same process to ensure that professional standards are met. Regardless of the size or complexity of the entity, auditing principles remain the same. Some engagements may be riskier than others, so the amount of work performed and the time spent may vary, but the sequence to be followed is the same for all audits.

The first step in this sequence is the risk assessment phase. This involves performing an overall risk assessment. The auditor documents an understanding of the business, its environment, and its processes to determine where the greatest risks may be. The auditor then devises an overall audit strategy, taking these risks into consideration. This allows the auditor to plan when to perform the "fieldwork" (the work to be done at the client's premises), who will do it, and what exactly needs to be done. Tasks are usually divided by business cycle or financial statement groupings (for example, purchasing cycle; cash; property, plant, and equipment). The financial statement accounts related to each cycle are divided into sections. For each section, there should be an "audit working paper program" that lists the procedures to be performed for that area.

During the risk response phase, the auditor typically works at the client's premises. When the auditor is not a sole practitioner, and carries out the engagement as part of a team, staff members are assigned sections to complete, which generally involves obtaining information, assessing it, and having discussions with the client's staff regarding systems, procedures, and clarification as required. As the work is done, it is documented in the audit working paper file (which may be electronic or paper). The documentation is done through the use of narrative, memos, or schedules with audit "ticks" (common conventions used by auditors to indicate the work performed). The audit programs are "signed off" or initialled by audit members once completed. Each completed section is then reviewed by a more senior auditor, as work must be properly supervised.

Once the fieldwork has been completed, the auditor leaves the client's premises; however, there remain a number of completion procedures to be done. Once all of the required procedures have been performed, the completed file and financial statements go to the partner responsible for the audit for review. If the partner believes there is sufficient and appropriate evidence in the audit file, and the financial statements appear fairly stated, they will approve and issue an unmodified audit opinion on the financial statements.

Limitations of a Financial Statement Audit

An audit is an assurance engagement performed to increase the confidence of financial statement users. Therefore, an audit is conducted to enhance the reliability and credibility of the information in the financial statements. However, it is not a guarantee that the financial statements are free from fraud and error.

The limitations of an audit result from the nature of financial reporting, the nature of audit procedures, and the need for the audit to be conducted within a reasonable period of time and at a reasonable cost (CAS 200).

"The nature of financial reporting" refers to the use of judgement when preparing financial statements, because of the subjectivity required when arriving at accounting estimates. Judgement is also required when selecting and applying accounting methods. For example, judgements and estimates are used when determining whether to use FIFO (first-in, first-out) or weighted average for inventory costing, as well as when assessing inventory obsolescence.

"The nature of audit procedures" refers to the reliance on evidence provided by the client and its management. If an auditor does not have access to all the information relevant to the audit, there is a limitation in the scope of the audit. If the auditor is unaware of this situation, they may arrive at an inappropriate conclusion based on incomplete facts. Evidence may be withheld or modified by perpetrators of fraud. It can be difficult for an auditor to determine whether fraud has occurred and documents altered, as those committing fraud generally hide evidence. Sampling may be used when testing transactions and account balances. If a sample is not representative of all items available for testing, an auditor may arrive at an invalid conclusion.

"The timeliness and cost of a financial statement audit" refers to the pressure an auditor faces to complete the audit within a certain time frame at a reasonable cost. While it is important that auditors do not omit procedures in an effort to meet time and cost constraints, they may be under some pressure to do so. This pressure will come from clients wanting to issue their financial statements by a certain date, from clients refusing to pay additional fees for additional audit effort, and from within the audit firm, where there are pressures to complete all audits on a timely basis to avoid incurring costs that may not be recovered. By taking the time to plan the audit properly, an auditor can ensure that adequate time is spent where the risks of a significant error or fraud are greatest.

1.3.2 Compliance Audits

compliance audit an audit to determine whether the entity has conformed with regulations, rules, or processes

A **compliance audit** involves gathering evidence to ascertain whether the person or entity under review has followed the applicable rules, policies, procedures, laws, and regulations. There are a number of examples of compliance audits. A tax audit is used to determine whether an individual or company has completed a tax return in accordance with the Income Tax Act. Within an organization, management may specify that certain processes be followed when completing a function. For example, a company may have policies and procedures for the hiring of new staff. In that case, the organization's internal auditors may be called upon to determine whether employees are following the specified processes appropriately.

1.3.3 Performance Audits

performance audit an assessment of the economy, efficiency, and effectiveness of an organization's operations

Performance audits are concerned with the economy, efficiency, and effectiveness of an organization's activities. Economy refers to the cost of inputs, including wages and materials. Efficiency refers to the relationship between inputs and outputs; specifically, efficiency refers to the use of the minimum amount of inputs to achieve a given output. Finally, effectiveness refers to the achievement of certain goals or the production of a certain level of outputs. From an organization's perspective, it is important to perform well across all three dimensions and not allow one to dominate. For example, if buying cheap inputs results in an inefficient production process, efficiency may be seen to be sacrificed to achieve economic goals.

Performance audits are generally conducted by an organization's internal auditors, or they may be outsourced to an external audit firm. Performance audits are sometimes referred to as value for money audits, operational audits, or efficiency audits. Professional Environment 1.1 explains how the Office of the Auditor General of Canada carries out performance audits of various federal government programs and agencies.

1.1 Professional Environment — Performance Audits as a Public Service

The Office of the Auditor General of Canada (OAG) is the internal auditor of the Canadian government. It is responsible for performing financial and performance audits for federal government departments and agencies, most Crown corporations, and many other federal organizations.

The OAG performs between 25 to 30 performance audits a year. While the OAG reports to Parliament, the reports issued are available to the public. The OAG states that "a performance audit is an independent, objective and systematic assessment of how well government is managing its activities, responsibilities and resources. Performance audits contribute to a public service that is effective and a government that is accountable to Parliament and Canadians." Audits are selected based on a risk analysis performed by the OAG. High-risk areas are those that use significant taxpayer dollars or threaten the health and safety of Canadians.

In 2016, one performance audit report issued was related to preventing and detecting fraud in the Canadian citizenship program. "This audit examined whether Immigration, Refugees and Citizenship Canada detected and prevented fraud in adult citizenship applications to ensure that only applicants who met selected eligibility requirements were granted Canadian citizenship." This program was selected for audit because citizenship fraud is very costly to Canadian taxpayers as it results in people fraudulently receiving the benefits of citizenship.

The audit report concluded that the responsible government department did not adequately ensure that the citizenship criteria were met. It was found that processes were not being applied consistently and information was not being shared between government departments to ensure that informed decisions were being made. The performance audit report included several recommendations as to how the citizenship criteria should be better applied. For each recommendation, the government department issued a written response, indicating how the recommendations would be implemented. Through this process, the OAG contributes to the economy and effectiveness of the Canadian government.

Q: Audits are not only limited to audits of financial information. How important is it to have performance audits within government agencies and why?

Sources: Office of the Auditor General of Canada, "What We Do," www.oag-bvg.gc.ca/internet/English/au_fs_e_371.html; Office of the Auditor General of Canada, 2016 Spring Reports, "Report 2—Detecting and Preventing Fraud in the Citizenship Program."

1.3.4 Comprehensive Audits

A **comprehensive audit** may encompass elements of a financial statement audit, a compliance audit, and a performance audit. For example, an auditor may report on whether an entity has met its efficiency targets. Comprehensive audits most commonly occur in the public sector, where compliance with various regulations is examined as part of the financial statement audit.

comprehensive audit an audit that encompasses a range of audit and audit-related activities, such as a financial statement audit, performance audit, and compliance audit

1.3.5 Internal Audits

Internal audits are conducted to provide assurance about various aspects of an organization's activities. The internal audit function is typically conducted by employees of the organization being audited, but can be outsourced to an external audit firm. As such, the function of internal audit is determined by **those charged with governance** and management within the organization. While the functions of internal audits vary widely from one organization to another, they are often concerned with evaluating and improving risk management, internal control procedures, and elements of the governance process. The internal audit function often conducts performance audits, compliance audits, internal control assessments, and reviews. Many internal auditors are members of the Institute of Internal Auditors (IIA), an international organization that provides guidance and standards to aid internal auditors in their work. When conducting a financial statement audit, the external auditor may consider the work done by the internal auditors (CAS 610 *Using the Work of Internal Auditors*).

internal audit an independent service within an entity that generally evaluates and improves risk management, internal control procedures, and elements of the governance process

those charged with governance generally the board of directors, and may include management of an entity, concerned with evaluating and improving risk management, internal control procedures, and elements of the governance process

1.3.6 Corporate Social Responsibility (CSR) Assurance

Corporate social responsibility (CSR) reporting is voluntary. However, it is becoming more widespread. CSR disclosures include environmental, employee, and social reporting. Some organizations choose to have their CSR disclosures assured by an independent assurance provider. The assurance of CSR disclosures can be carried out by both auditors and specialist **consulting firms**. As these disclosures include non-financial as well as financial information, the skill set required to conduct these assurance services is quite broad.

Whether a company chooses to provide additional voluntary environmental disclosures or not, an auditor must still consider the impact of environmental issues on a client's financial statements when conducting the financial statement audit. However, as investors demand more relevant information in this area, further guidance is expected.

corporate social responsibility (CSR) a range of activities undertaken voluntarily by a corporation; CSR disclosures include environmental, employee, and social reporting

consulting firms non-audit firms that provide assurance services on non-financial information, such as corporate social responsibility and environmental disclosures

Cloud 9 Integrated Case

Ron is not concerned about internal audits—his business is too small for a separate internal audit function. He is also not worried about CSR reporting or compliance and performance audits. His priority at the moment is to close the deal with Chip Masters, and he still does not know what he has to do about the audit.

Before You Go On

1.3.1 What are the three elements of a performance audit?

1.3.2 What is the objective of a financial statement audit?

1.3.3 What are the most common tasks of the internal audit function?

1.4 Different Levels of Assurance

LEARNING OBJECTIVE 4

Explain the different levels of assurance.

In this section, we describe the different levels of assurance that a practitioner can provide when conducting assurance procedures. An assurance practitioner can provide reasonable assurance, limited assurance, or no assurance. When providing reasonable and limited assurance, the practitioner's report is addressed to the party requesting assurance (for example, a company's shareholders). When an assurance practitioner performs a non-assurance engagement, a report on the findings is addressed to management or to those charged with governance. The differences between reasonable, limited, and no assurance are now explained.

1.4.1 Reasonable Assurance

reasonable assurance assurance that provides high but not absolute assurance on the reliability of the subject matter

The objective of a **reasonable assurance** engagement is to gather sufficient evidence upon which to form a positive expression of an opinion regarding whether the information being assured is presented fairly. This means that the auditor has done adequate work to report with reasonable certainty that the information being assured is, or is not, reliable. This does not reflect absolute assurance, as an auditor can never be 100 percent certain that there are no errors or omissions. For example, an auditor is in the position to say whether in their opinion the financial statements are in accordance with relevant laws and accounting standards and they present fairly the financial position of the reporting entity. Auditors can make such a positive statement only if they are reasonably sure that the evidence gathered is sufficient and appropriate. The audit opinion will depend upon the auditor's findings while conducting the audit. A brief overview of the different opinions that an auditor may form when conducting a financial statement audit is provided in the next section of this chapter. Reasonable assurance is the highest level of assurance provided; again, note that it is high but not absolute assurance. The audit of a company's financial statements is one example of a reasonable assurance engagement. CAS 700 *Forming an Opinion and Reporting on Financial Statements* provides guidance on the form and elements of the audit report.

As illustrated in **figure 1.3**, the audit report includes the following:

- The report begins with the audit opinion and an identification of the financial statements that have been audited.
- It is followed by a basis of opinion, which provides an explicit statement about the auditor independence and ethical requirements.
- The audit report may include "key audit matters," where auditors communicate issues that were important in the current audit. According to CAS 701, key audit matters include areas of higher assessed risk of material misstatement, areas that involve significant judgement where there is high uncertainty around estimations, and the effect of significant events on the audit (CAS 701, para. 9). The reporting of key audit matters is mandatory only if required by law or regulation. After December 15, 2020, key audit matters are required for audits for entities listed on the Toronto Stock Exchange, except for certain investment funds.
- Where clients include other information with their audit report, such as an MD&A (management's discussion and analysis), the auditor is required to make a statement in the audit report regarding this information.

FIGURE 1.3 **Example of an audit report**

W&S PARTNERS

1200-90 Eglinton Avenue East,
Toronto, ON M4P 2Y3.
Phone number: (416) 236-8743.

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of Skyward Inc.,

Report on the Audit of the Consolidated Financial Statements

Opinion

We have audited the consolidated financial statements of Skyward Inc. and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 2023, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Group as at December 31, 2023, and its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

> Provides the opinion and identifies the entity and the title of the financial statements under audit, including the disclosures and accounting policies.

Basis for Opinion

We conducted our audit in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in Canada, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

> Indicates the audit was conducted in accordance with auditing standards, and makes an explicit statement about the auditor's independence and compliance with ethical standards.

Key Audit Matters

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

> For listed entities, key matters of significance.

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

Other Information

Management is responsible for the other information. The other information comprises the information, other than the financial statements and our auditor's report thereon, in the Annual Report.

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

> Other Information explains the auditor responsibilities when the audited financial statements are included with other documents, such as the MD&A.

In connection with our audit of the financial statements, our responsibility is to read the other information identified above and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated.

We obtained the Annual Report prior to the date of this auditor's report. If, based on the work we have performed on this other information, we conclude that there is a material misstatement of this other information, we are required to report that fact in this auditor's report. We have nothing to report in this regard.

Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements

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

> Management's responsibility for the financial statements and internal control.

(continued)

In preparing the consolidated financial statements, management is responsible for assessing the Group'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 Group or to cease operations, or has no realistic alternative but to do so.

Statement that those responsible for governance are responsible for overseeing financial reporting.

Those charged with governance are responsible for overseeing the Group's financial reporting process.

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Summarizes that an audit provides reasonable, not absolute, assurance whether the financial statements are free from fraud or error.

Our objectives are to obtain reasonable assurance about whether the consolidated 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 Canadian generally accepted auditing standards 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 consolidated financial statements.

Auditor's responsibility to: assess risk of material misstatement, understand internal controls, evaluate the overall financial statements including accounting policies and estimates, and conclude on management's appropriateness of going concern.

As part of an audit in accordance with Canadian generally accepted auditing standards, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated 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 Group'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 Group'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 consolidated 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 Group to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the Group audit. We remain solely responsible for our audit opinion.

Highlights the auditor's requirement to communicate with those responsible for governance regarding scope and timing of audit, significant audit findings, and independence.

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 consolidated 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.

The engagement partner on the audit resulting in this independent auditor's report is Nicholas Summers.

Toronto, Canada

March X, 2024

"W&S Partners, LLP"
Chartered Professional Accountants
Licensed Public Accountants

FIGURE 1.3 **Example of an audit report (*continued*)**

- This is followed by a paragraph summarizing management's responsibilities for the financial statements, internal control, and for the assessment of the going concern assumption. It also indicates that those responsible for governance are responsible for overseeing financial reporting.
- The report then concludes with the auditor's responsibilities, which includes assessing the risk of material misstatement, understanding internal controls, assessing the overall financial statements including estimates, and concluding on the appropriateness of management's use of the going concern assumption.

Note that in figure 1.3, part of the auditor's responsibilities is shaded. This shaded wording may instead be reported in an appendix to the report, as long as the report includes a reference to the location of the appendix. It may also be reported on a website, as long as a description of the website is provided in the report, and this is permitted by law, regulation, or national auditing standards.

1.4.2 Limited Assurance

The objective of a **limited assurance** engagement is to perform sufficient procedures and gather sufficient evidence to support the practitioner's conclusion. This means that the practitioner has done adequate work to report whether or not anything came to their attention that would lead them to believe that the information is not prepared in accordance with the applicable financial framework. The practitioner is not required to conduct detailed testing when undertaking a limited assurance engagement. The practitioner is required to at least do enough work so that the report enhances the user's confidence about the information. This means that practitioners do not need to obtain as much evidence or perform as many procedures as when they make a positive statement.

limited assurance the level of assurance obtained where engagement risk is reduced to an acceptable level and the evidence gathered is at least sufficient for the practitioner to conclude and provide a level of assurance that is likely to enhance the intended users' confidence about the financial statements

The limited assurance engagement for a company's historical financial statements is called a **review engagement**. A review engagement may be requested when the client requires some assurance over the financial statements but does not require an audit level of assurance. For example, a lender of a small business may not want to approve a loan based on financial statements with no assurance, but it may not require the same level of assurance that an audit would provide.

review engagement engagement in which the practitioner does adequate work to provide limited assurance

When conducting a review engagement, a practitioner obtains an understanding of the entity and identifies where material misstatements are likely. The practitioner then performs primarily inquiry and analytical procedures on material financial statement items and items where a risk of material misstatement has been determined to exist.

Guidance on the form and elements of the review engagement report is provided in CSRE 2400 *Engagements to Review Historical Financial Statements*. An example of a review engagement report is provided in **figure 1.4**. The report explicitly states that management is responsible for the preparation and fair presentation of the financial statements, and the practitioner is responsible for complying with generally accepted standards for review engagements. The report also states that the procedures performed are less than that of an audit and therefore an audit opinion is not expressed. Finally, the review engagement report concludes that the practitioner was not aware of any matter that made them believe that the financial statements were not fairly stated.

1.4.3 No Assurance

no assurance what results when a practitioner completes a set of tasks requested by the client and reports factually on the results of that work to the client

compilation engagement engagement that provides no assurance, where the practitioner compiles the financial information in accordance with a basis of accounting disclosed in the financial statements

An assurance provider may perform other services for clients for which **no assurance** is provided. In such circumstances, an assurance provider must ensure when reporting to users that they make clear that they are merely reporting the activities that they have performed (and in some engagements, their findings) and are not providing assurance. An example of an engagement where no assurance is provided is a **compilation engagement**, where a practitioner compiles the financial information provided by the client and arranges it into a set of financial statements. The financial statements must include disclosure with respect

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INDEPENDENT PRACTITIONER'S REVIEW ENGAGEMENT REPORT

To the Board of Directors of Janeway Ltd.

We have reviewed the accompanying financial statements of Janeway Ltd. that comprise the balance sheet as at December 31, 2023, and the statements of income, retained earnings and cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian accounting standards for private enterprises, 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.

Practitioner's Responsibility

Our responsibility is to express a conclusion on the accompanying financial statements based on our review. We conducted our review in accordance with Canadian generally accepted standards for review engagements, which require us to comply with relevant ethical requirements.

A review of financial statements in accordance with Canadian generally accepted standards for review engagements is a limited assurance engagement. The practitioner performs procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained.

The procedures performed in a review are substantially less in extent than, and vary in nature from, those performed in an audit conducted in accordance with Canadian generally accepted auditing standards. Accordingly, we do not express an audit opinion on these financial statements.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the financial statements do not present fairly, in all material respects, the financial position of Janeway Ltd. as at December 31, 2023, and the results of its operations and its cash flows for the year then ended in accordance with Canadian accounting standards for private enterprises.

Toronto, Canada

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March X, 2024

FIGURE 1.4 **Example of a review engagement report**

Source: CPA Canada, CPA Handbook, CSRE 2400

to the basis of accounting used to prepare the financial statements. For example, an entity is required to disclose if the financial information is prepared on a cash or on an accrual basis. When accepting the engagement, if a compilation engagement is to be provided to a third-party user, then CSRS 4200, *Compilation Engagements*, requires the practitioner to ensure that the third-party user is able to obtain additional information from the entity and has agreed to the basis of accounting to be used in preparing the financial statements. If these two conditions are not met, the practitioner should not accept or conduct the engagement.

After accepting an engagement, CSRS 4200 requires the practitioner to obtain an understanding of the business, its operations, and its accounting system to the level needed to conduct the engagement. The practitioner should ensure management understands any assumptions made so management is able to accept responsibility for the financial statements.

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COMPILATION ENGAGEMENT REPORT

To Management of StyleWear Inc.

On the basis of information provided by management, we have compiled the balance sheet of StyleWear Inc. as at December 31, 2023, the statement of income and retained earnings for the year then ended, and Note 1, which describes the basis of accounting applied in the preparation of the compiled financial information, and other explanatory information ("financial information").

Management is responsible for the accompanying financial information, including the accuracy and completeness of the underlying information used to compile it and the selection of the basis of accounting.

We performed this engagement in accordance with Canadian Standard on Related Services (CSRS) 4200, *Compilation Engagements*, which requires us to comply with relevant ethical requirements. Our responsibility is to assist management in the preparation of the financial information.

We did not perform an audit engagement or a review engagement, nor were we required to perform procedures to verify the accuracy or completeness of the information provided by management. Accordingly, we do not express an audit opinion or a review conclusion, or provide any form of assurance on the financial information.

Readers are cautioned that the financial information may not be appropriate for their purposes.

Toronto, Canada
February X, 2024.

"W&S Partners, LLP"
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FIGURE 1.5 **Example of a Compilation Engagement Report**

Source: CPA Canada Handbook – Assurance, 2020, Chartered Professional Accountants of Canada

The practitioner should also format the financial statements, check them for mathematical accuracy, and read them to ensure they are not misleading.

The report issued for a compilation engagement is called a **Compilation Engagement Report** and it includes a description of both management's and the practitioner's responsibilities. The Compilation Engagement Report explicitly states that no assurance is being provided. An example of the report for a fictional company is in **figure 1.5**.

Compilation Engagement Report the communication issued when the practitioner performs a compilation engagement

Table 1.2 summarizes the differences among the three types of engagements.

Cloud 9 Integrated Case

As Ernie explains the differences between reasonable and limited assurance, Ron wonders if Chip will accept a review, rather than an audit, of the financial statements. If he will, it will be much easier and cheaper for Ron. However, Ron also realizes that Chip would not get as much assurance from a review as he would get from an audit. Ron thinks Chip would know the difference between an audit and a review; because he asked for an audit, Chip must need the additional assurance it provides.

TABLE 1.2 Types of engagements

Characteristic	Audit	Review	Compilation
Objective	To reduce the assurance engagement risk to an acceptably low level so that a positive opinion can be provided. Reasonable assurance means a high, but not absolute, level of assurance.	To reduce the assurance engagement risk to an acceptable level to allow the practitioner to conclude and express limited assurance in that nothing has come to their attention.	To compile a set of financial statements based on information provided, including disclosure with respect to the basis of accounting used to prepare the financial statements.
Procedures	Sufficient appropriate evidence is obtained as part of a systematic process that includes: • obtaining an understanding of the assurance engagement circumstances • assessing risks • responding to assessed risks • performing further evidence-gathering procedures using a combination of inspection, observation, confirmation, recalculation, re-performance, analytical procedures, and inquiry	Sufficient appropriate evidence is obtained by: • obtaining an understanding of the entity and identifying where material misstatements are likely • performing primarily inquiry and analytic procedures to address high-risk areas and to address all material items in the financial statements	Performance requirements include: • obtaining a knowledge of the business, the accounting systems, and the policies used to prepare the financial statements as needed to conduct the engagement • discussing with management the assumptions the auditor helped make in preparing the financial statements • reading the financial statements to consider if they are misleading • formatting the financial statements and checking the mathematical accuracy
Financial reporting framework	Must be in accordance with Canadian GAAP or other appropriate financial reporting framework.	Must be in accordance with Canadian GAAP or other appropriate financial reporting framework.	GAAP not required but must include a note to disclose the basis of accounting used to prepare the financial statements.
Level of assurance	High assurance	Limited assurance	No assurance
Report	Independent Auditor's Report	Independent Practitioner's Review Engagement Report	Compilation Engagement Report
Cost and time	Most time-consuming, highest cost	May take less time, as less work required; lower cost	Least amount of work, lowest cost

Before You Go On

1.4.1 What are the main differences between reasonable and limited assurance engagements?

1.4.2 What is the level of assurance required for an annual financial statement for a reporting issuer?

1.4.3 What level of assurance does a compilation engagement provide?

1.5 Different Audit Opinions

LEARNING OBJECTIVE 5

Outline different audit opinions.

unmodified opinion a clean audit opinion; the auditor concludes that the financial statements are fairly presented

emphasis of matter what results when an auditor issues an unmodified audit opinion when there is a significant issue that is adequately disclosed and there is a need to draw the attention of the user to it in the audit report

The purpose of this section is to present a very brief overview of the different types of audit opinions an auditor can arrive at when completing an audit.

The most common audit report includes an unmodified opinion. An **unmodified opinion** is also known as a clean opinion. The audit report in figure 1.3 is an example of such a report. Auditors arrive at this type of opinion when they believe that the financial statements are not materially misstated and that they present fairly the financial position of the company, and that the information provided is in accordance with Canadian GAAP.

An audit report may have an unmodified opinion and include an **emphasis of matter** paragraph. An emphasis of matter paragraph draws the attention of the reader to an issue that

TABLE 1.3 Audit opinion modifications

Nature of the 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

Source: CAS 705 *Modifications to the Opinion in the Independent Auditor's Report*, para. Al.

the auditor believes has been adequately and accurately explained in a note to the financial statements. The purpose of the paragraph is to ensure that the reader pays appropriate attention to the issue when reading the financial statements. The audit report remains unmodified and users of the financial statements can still rely on the information contained in the financial statements (CAS 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*).

All other audit reports are modified. There are three types of modifications, shown in **table 1.3** (CAS 705 *Modifications to the Opinion in the Independent Auditor's Report*).

The first is called a **qualified opinion** and is issued when the auditor believes that "except for" the effects of a matter that is explained in the audit report, the financial statements can be relied upon by the reader. A qualified opinion is used when the matter of concern can be identified, quantified, and explained in the audit report. In this case, the matter of concern is material but not pervasive to the financial statements. In this context, "pervasive" refers to misstatements that are not confined to individual accounts or elements of the financial statements, or, if confined, the misstatements affect an extensive portion of the financial statements or there are missing disclosures that are vital to a user's understanding of the financial statements.

More serious matters require either an **adverse opinion** or a **disclaimer of opinion**. An adverse opinion is appropriate if the auditor has evidence that identified misstatements, individually or in the aggregate, are material and pervasive to the financial statements. A disclaimer of opinion is used when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and concludes that the possible effects on the financial statements could be material and pervasive. Although these opinions are used in different circumstances, in both instances the matter or matters of concern are so material and pervasive to the financial statements that the auditor cannot issue a qualified, "except for" opinion.

qualified opinion an "except for" opinion provided where there is a material scope limitation or a material (significant) misstatement not pervasive to the overall financial statements

adverse opinion opinion provided when the auditor concludes that there is a pervasive material misstatement in the financial statements

disclaimer of opinion opinion provided when the impact of a scope limitation is so extreme that an auditor is unable to obtain sufficient appropriate evidence to base an opinion

Cloud 9 Integrated Case

Ron worries that an auditor might not be able to give an unmodified opinion on his business's financial statements. The whole point of getting an audit would be to give Chip sufficient assurance that the financial statements give a true and fair view of his business's financial position and performance, and thus agree to pay a good price for the business. If the auditor gives a disclaimer of opinion or an adverse opinion, Chip could either change his mind about the business or offer only a very low price because he can't be sure that the business is as profitable and as solvent as Ron claims. Even getting a qualified opinion would be serious. Ernie assures Ron that disclaimers are extremely rare; in fact, he has never seen one. Adverse opinions are also rare, and if Ron's belief about his good financial records and tight control over assets is well founded, then there should not be any major problems.

Before You Go On

1.5.1 What are the different types of unmodified audit opinions?

1.5.2 What are the different types of modified audit opinions?

1.5.3 What type of audit opinion is unmodified and modified?

1.6 Preparers and Auditors

LEARNING OBJECTIVE 6

Differentiate between the roles of the preparer and the auditor, and discuss the different firms that provide assurance services.

In this section, we explain and contrast the different responsibilities of financial statement preparers and auditors. We provide details of the role that each group plays in ensuring that the financial statements are a fair representation of the company in question. Following this discussion, there is an overview of the different firms that provide assurance services.

A complete set of financial statements includes the balance sheet (statement of financial position), income statement (statement of comprehensive income), statement of cash flows, statement of changes in equity, and the required disclosures. It is the responsibility of those charged with governance (generally the board of directors and management) to prepare the financial statements. They must ensure that the information included in the financial statements is fairly presented and complies with Canadian accounting standards and interpretations. According to CAS 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Canadian Auditing Standards*, those charged with governance are responsible for:

- identifying the financial reporting framework to be used in the preparation and presentation of their financial statements
- reporting, establishing, and maintaining internal controls that are effective in preventing and detecting material misstatements finding their way into the financial statements
- selecting and applying appropriate accounting policies and making reasonable accounting estimates

1.6.1 Preparer Responsibility

It is the responsibility of those charged with governance to ensure that the information contained in their financial statements is relevant, reliable, comparable, understandable, and fairly presented. Each of these concepts is now discussed.

Relevant

The information included in the financial statements should be relevant to the users of that report. Information is relevant if it has an impact on the decisions made by users regarding the performance of the entity. Users require information that helps them evaluate past, present, and future events relating to the entity. They are interested in evaluating past decisions made by management and predicting whether the entity will remain viable (that is, a going concern) into the future. Users can use current information to estimate future share price movements, like dividend payments, and the ability of the entity to meet its immediate obligations.

Reliable

The information included in the financial statements should be reliable to the users of those statements. Information is reliable when it is free from material misstatements (errors or fraud). If users perceive that the information presented is unreliable, for whatever reason, the financial statements cannot be used to make the types of decisions outlined above. The information must be unbiased; it must not be presented in such a way as to influence the user's decision-making process. An independent audit of the financial statements is one method of improving the reliability of the financial statements.

Comparable

The information included in the financial statements should be comparable through time. Users need to be able to trace an entity's performance to identify any trends that may influence their perception of how well the entity is doing. Users also need to be able to benchmark the performance of the entity against other similar organizations to assess its relative performance. To enable such comparisons, information must be presented consistently across time and across entities. Any changes in accounting policies must be clearly disclosed so that appropriate adjustments can be made. Consistent application of Canadian generally accepted accounting principles by all entities over time aids these comparisons.

Understandable

The information included in the financial statements should be understandable. Users need to understand the information presented in order to make appropriate decisions. The financial statement disclosures should provide additional details to aid in the interpretation of the accounting information provided and they should be appropriately placed based on their significance. The disclosures must be clear and concise, and phrased in such a way as to impartially inform users to aid their decision-making.

Fairly Presented

The information included in the financial statements should be fairly presented. "Presented fairly" or "truth and fairness" refers to the consistent and faithful application of the accounting standards or an applicable framework when preparing the financial statements.

It is the responsibility of the auditor to form an opinion on the fair presentation or the truth and fairness of the financial statements. In doing so, the auditor will assess the accounting policies selected by those charged with governance of the entity. Specifically, the auditor will evaluate whether those accounting policies are consistent with the financial reporting framework used by the entity. The auditor will also consider the accounting estimates made by management and those charged with governance to determine whether the estimates are reasonable. The auditor will assess the relevance, reliability, comparability, and understandability of the information presented in the financial statements and the adequacy of the disclosures.

1.6.2 Auditor Responsibility

When undertaking an audit, the auditor should use professional scepticism, professional judgement, and due care. Each of these concepts is now defined and explained.

Professional Scepticism

Professional scepticism is an attitude adopted by the auditor when conducting the audit. It means that the auditor remains independent of the entity, its management, and its staff when completing the audit work. In a practical sense, it means that the auditor maintains a questioning mind and thoroughly investigates all evidence presented by the client. The auditor must seek independent evidence to corroborate information provided by the client and must be suspicious when evidence contradicts documents held by the client or inquiries made of client personnel (including management and those charged with governance). It means the auditor should assess evidence critically and remain alert for fraud.

Professional Judgement

Professional judgement relates to the level of expertise, knowledge, and training that an auditor uses while conducting an audit. An auditor must utilize their judgement throughout the audit. For example, an auditor must determine the reliability of an information source and decide on the sufficiency and appropriateness of evidence gathered, the procedures to be used in testing, and an appropriate sample size.

Due Care

Due care refers to being diligent while conducting an audit, applying technical and statute-backed standards, and documenting each stage in the audit process.

1.6.3 Assurance Providers

Assurance services are provided by accounting and other consulting firms. The largest accounting firms in Canada are known collectively as the "Big-4." The firms that make up the Big-4 are Deloitte, EY, KPMG, and PricewaterhouseCoopers (PwC). These four firms operate internationally and dominate the assurance market throughout the world. There were once eight international firms, but after a series of mergers and the collapse of Arthur Andersen, the Big-8 became the Big-4. These four firms dominate the audits of Canada's largest companies.

The next tier of accounting firms is known as the national accounting firms. The firms in this tier have a significant presence nationally and most have international affiliations. National firms in Canada include BDO, Grant Thornton, and MNP. These firms service medium-sized and smaller clients.

The next tier of accounting firms is made up of regional and local accounting firms. These firms service clients in their local areas and range in size from single-partner firms to several-partner firms with professionally qualified and trained staff.

Most of these accounting firms provide non-assurance (or non-audit) services as well as assurance (or audit) services. Non-assurance services include management consulting, mergers and acquisitions, insolvency, tax, and accounting services. The code of professional conduct specifies a number of requirements that restrict an accounting firm from providing non-audit services to its audit clients. These rules were established to increase the transparency of the extent of services being provided by an accounting firm to its audit clients after the collapse of several high-profile companies, including Enron and WorldCom (in the United States). The collapse of Arthur Andersen (previously an international accounting firm) raised concerns that the provision of non-audit services to an audit client could affect the auditor's independence and objectivity.

Accounting firms are not the only providers of assurance services. A number of consulting firms provide assurance services primarily in areas of corporate social responsibility, including some combination of environmental issues, carbon emissions, community engagement, charitable activities, and employee welfare as well as disclosures in other areas. Consulting firms employ staff with a range of expertise, including engineers, accountants, sociologists, scientists, and economists.

Cloud 9 Integrated Case

Ernie stresses to Ron that any financial statements prepared for McLellan's Shoes are Ron's responsibility, even if they are audited. The auditor has to be sceptical about the claims made by Ron in the financial statements. These claims include, for example, that the assets shown on the balance sheet exist and are valued correctly, and that the balance sheet contains a complete list of the business's liabilities. In other words, the auditor is not just going to believe whatever Ron tells him or her. Auditors must gather evidence about the financial statements before they can give an audit opinion. Ernie also explains to Ron that, because his business is relatively small, he has a choice between large and small audit firms. Very large companies would be expected to select a larger audit firm because often smaller firms may be too small to maintain their independence effectively. If a small audit firm audits a large company, it is open to the criticism that it will not be sufficiently sceptical because it does not want to lose the fees from that client. A large audit firm has many other clients, so the fees from any one client are a relatively small part of its revenue. Ron likes the idea that the smaller audit firms may be less costly.

Before You Go On

1.6.1 A financial statement must be relevant and reliable. What do these terms mean in this context?

1.6.2 What three characteristics should an auditor have when conducting an audit?

1.6.3 What are non-audit services?

1.7 The Role of Regulators and Regulations

LEARNING OBJECTIVE 7

Identify the different regulators, legislation, and regulations surrounding the assurance process.

In this section, we discuss the regulators and regulations that have an impact on the audit process.

1.7.1 Regulators, Standard Setters, and Other Bodies

The accounting profession in Canada is primarily self-regulated; however, it does rely on legislation to some extent. Currently, a number of organizations have an impact on the auditing profession, either directly or indirectly. They include the Auditing and Assurance Standards Board (AASB), the Canadian Securities Administrators (CSA) and the various provincial securities commissions, the Canadian Public Accountability Board (CPAB), and the Chartered Professional Accountants of Canada or CPA Canada (which integrated the former Canadian Institute of Chartered Accountants, Certified General Accountants Association of Canada, and, Society of Management Accountants of Canada).

Auditing and Assurance Standards Board (AASB)

The purpose of the Canadian AASB is to serve the public interest by setting high-quality auditing and assurance standards.[1] To accomplish this, the AASB adopted the International Standards on Auditing (ISAs), which are issued by the International Auditing and Assurance Standards Board (IAASB). The ISAs have been redrafted by the IAASB and placed in a "clarity" format to improve the consistency of application worldwide. The Canadian version of the ISAs is now referred to as the Canadian Auditing Standards (CASs). In addition to issuing the CASs, the AASB is responsible for issuing the Canadian Standards for Assurance Engagements (CSAEs), as well as the Canadian review engagement and compilation engagement standards. Some CSAEs cover assurance related to non-financial issues, as discussed in Professional Environment 1.2.

1.2 Professional Environment **Assurance Engagements on Carbon Emissions Information**

Many companies now present CSR information in their annual reports or in separate corporate sustainability reports. In some cases, the reports include information about carbon emissions. However, the reporting and assurance of these reports is voluntary and largely unregulated, raising concerns about the quality of the information. One of these concerns is that the information being provided in CSR reports is not sufficiently quantitative, particularly with respect to carbon emissions data.

To address some of these concerns, Canada issued a Canadian Standard on Assurance Engagements, CSAE 3410 *Assurance Engagements on Greenhouse Gas Statements*, based on the international assurance standard, ISAE 3410 *Assurance Engagements of Greenhouse Gas Statements.* The standard stipulates an auditor's responsibilities in identifying, assessing, and responding to the risks of material misstatement when engaged to report on greenhouse gas (GHG) statements. It sets out requirements and guidance on the work to be performed and the reporting responsibilities for both reasonable and limited assurance engagements. Unlike in financial statement audits, the standard does not mandate certain types of procedures (such as inquiry and analytical procedures) as the primary means of obtaining evidence. This requirement recognizes that GHG information is not capable of being subject to the rigour of a double-entry bookkeeping system and is susceptible to different risks than historical financial information. In addition, the nature of assurance engagements on GHG statements can vary greatly. Auditing carbon emissions information creates new challenges for auditors and has the potential to change what it means to be an "auditor" in the twenty-first century.

Q: What concerns should an auditor have when approached to audit information other than financial information?

Canadian Securities Administrators (CSA)

In Canada, securities regulation falls under provincial jurisdiction. However, securities regulators from across the provinces and territories have joined together to form the CSA. The CSA is a voluntary umbrella organization with the objective of improving, coordinating, and harmonizing regulation of the Canadian capital markets.[2] Part of its mandate is to regulate listed entity disclosure requirements. As such, it requires the annual filing of audited financial statements in accordance with Canadian GAAP, which in Canada is now IFRS for listed entities. It also requires that the CEOs and CFOs of reporting issuers certify that the annual financial statements are fairly presented. In addition, the CSA issues staff notices to provide reporting issuers with guidance on various issues, such as environmental disclosures.

Canadian Public Accountability Board (CPAB)

CPAB was incorporated in 2003 under the Canada Corporations Act. It was formed by the CSA, Canadian Institute of Chartered Accountants, and Office of the Superintendent of Financial Institutions with the objective of promoting high-quality audits. The CSA requires that auditors of reporting issuers register and be members in good standing with CPAB. To be a member in good standing, a firm must pass a CPAB inspection, which includes a review of the firm's compliance with its quality control policies and a sample of engagement files for compliance with professional standards.

Toronto Stock Exchange (TSX)

The TSX is the largest stock exchange in Canada. It aims to help listed companies raise funds, provide opportunities for investors to build wealth, and enable buyers and sellers to transact with confidence. In order to remain listed on the TSX, a company must meet the requirements of the Securities Act of Ontario, the relevant provincial securities acts, and the CSA. Companies listed on the TSX must file all required documents through the SEDAR (System for Electronic Document Analysis and Retrieval) electronic filing system.

Chartered Professional Accountants of Canada (CPA Canada)

CPA Canada is the national body of the accounting profession in Canada, with members working in public practice, industry, academia, and government.

Becoming a CPA requires completion of an extensive training program, which combines study and mentored work experience with a focus on technical competence and skills. The successful completion of a rigorous professional exam is required before a CPA designation is conferred.

1.7.2 Legislation

In Canada, a company can be incorporated under either federal or provincial jurisdiction. If a company is incorporated federally, then it must follow the statutes of the Canada Business Corporations Act (CBCA) (excluding banks and insurance and trust companies). The CBCA calls for audited financial statements for federally incorporated companies that are listed on Canadian stock exchanges. The CBCA statutes also require that these financial statements be in accordance with Canadian generally accepted accounting principles, and audits must be conducted in accordance with Canadian generally accepted auditing standards as defined by the CPA Canada Handbook. In addition, the CBCA regulates auditor independence, auditor appointment, and auditor access to information and company records.

1.7.3 Regulation

Auditing standards are issued by the Auditing and Assurance Standards Board (AASB) in Canada. The standards provide minimum requirements and guidance for auditing and assurance engagements. These standards, comprising the Canadian Auditing Standards (CASs), constitute Canadian generally accepted auditing standards (GAAS), and apply to all audits of historical financial information where audit assurance is provided. They are based on the International Standards for Auditing (ISAs); however, they may be modified to comply with Canadian legal or regulatory environments. As noted earlier in the chapter, review engagements of financial statements and other historical financial information are guided by Other Canadian Standards—Review Engagements. The Other Canadian Standards—Assurance Engagements other than Audits or Reviews of Financial Statements and Other Historical Financial Information (CSAEs) are the engagement standards that apply to other assurance engagements not related to historical financial information, such as compliance engagements. These standards provide general and specific guidance for assurance engagements other than audits and reviews of historical financial information, such as the effectiveness of internal controls, where either reasonable or limited assurance is provided. Assurance engagements that comply with the CSAEs are also in compliance with Canadian GAAS. The Canadian Standard on Quality Control (CSQC 1) applies to audits and reviews of financial statements and other assurance engagements. This standard specifies quality control requirements for firms providing audit, review, and assurance services. Other Canadian Standards—Related Services provide guidance on related services, including compilation engagements.[3] **Figure 1.6** provides an overview of the CPA Canada Handbook – Assurance.

Cloud 9 Integrated Case

Ernie explains that, in general, the regulators and regulations that apply to companies are not relevant to McLellan's Shoes. However, any auditor Ron engages would be also performing company audits and would be a member of a professional accounting body. The auditor would apply the auditing and accounting standards that are relevant to an audit engagement when auditing a small business. The auditor would apply strict professional standards to Ron's audit and should perform the audit to a reasonable standard.

Before You Go On

1.7.1 What is CPA Canada?

1.7.2 What is the AASB and what is its role?

1.7.3 What are the main functions of the CSA?

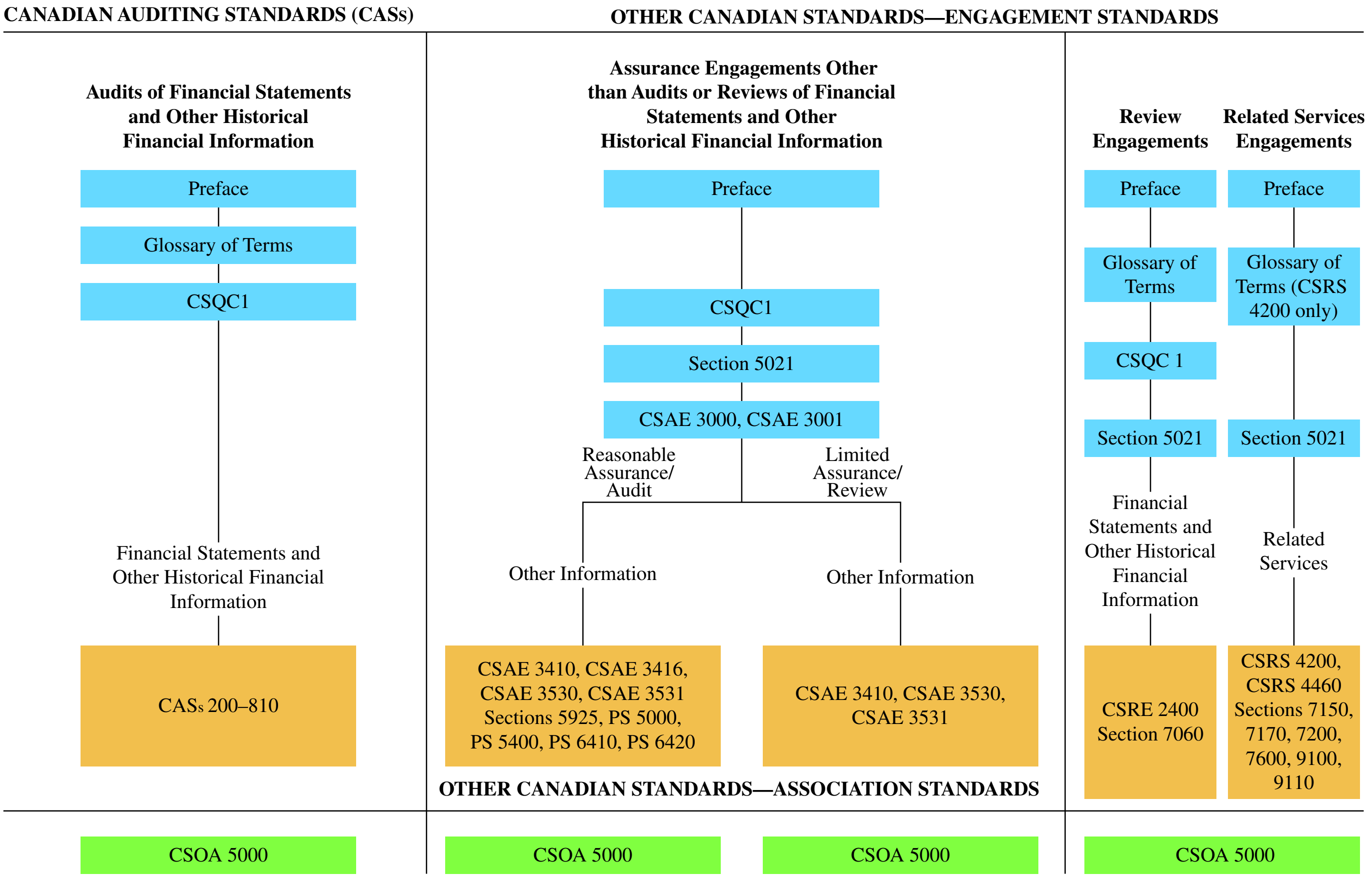

FIGURE 1.6 **Overview of the Assurance Handbook, Appendix 4**

Source: Chartered Professional Accountants of Canada. "Overview of the Assurance Handbook." *CPA Canada Handbook – Assurance*, Part I, *Preface to the CPA Canada Handbook – Assurance*, Copyright © 2020, Chartered Professional Accountants of Canada. References to the CPA Canada Handbook are reprinted with permission from the Chartered Professional Accountants of Canada, Toronto, Canada. Any changes to the original material are the sole responsibility of the author and/or publisher and have not been reviewed or endorsed by the Chartered Professional Accountants of Canada.

1.8 The Audit Expectation Gap

LEARNING OBJECTIVE 8

Describe the audit expectation gap.

The audit expectation gap occurs when there is a difference between the expectations of assurance providers and financial statement users. The gap occurs when user beliefs do not align with what an auditor has actually done. In particular, the gap is caused by unrealistic user expectations, such as:

- The auditor is providing complete assurance.
- The auditor is guaranteeing the future viability of the entity.
- An unqualified (clean) audit opinion is an indicator of complete accuracy.
- The auditor will definitely find any fraud.
- The auditor has checked all transactions.

The reality is that:

- An auditor provides reasonable assurance.
- The audit does not guarantee the future viability of the entity.
- An unqualified opinion indicates that the auditor believes that there are no material (significant) misstatements (errors or fraud) in the financial statements.
- The auditor will assess the risk of fraud and conduct tests to try to uncover any fraud, but there is no guarantee that they will find fraud, should it have occurred.
- The auditor tests a sample of transactions.

The audit expectation gap is represented in **figure 1.7**.

The audit expectation gap can be reduced by:

- auditors performing their duties appropriately, complying with auditing standards, and meeting the minimum standards of performance that should be expected of all auditors
- peer reviews of audits to ensure that auditing standards have been applied correctly
- auditing standards being reviewed and updated on a regular basis to enhance the work being done by auditors
- education of the public

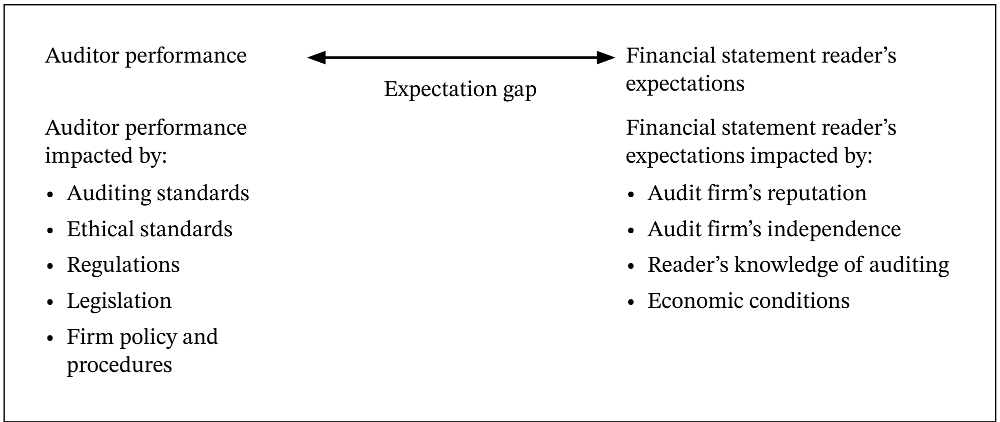

FIGURE 1.7 **Audit expectation gap**

- enhanced reporting to explain what processes have been followed in arriving at an audit (reasonable assurance) or a review (limited assurance) opinion (significant improvements have been introduced by standard setters improving assurance reporting)
- assurance providers reporting accurately the level of assurance being provided (reasonable, limited, or none)

As described in this chapter, financial statement users rely on audited financial statements to make a variety of decisions. They use the statements to assess the performance of the company, the appropriateness of the remuneration paid to management, the adequacy of dividends declared, and the likely future viability of the company. Following the corporate collapses of the early 2000s (for example, Enron and WorldCom), user confidence in auditors and audited financial statements hit a low. In Canada and the United States, increased regulation was imposed on the auditing profession. The United States passed the Sarbanes-Oxley Act (SOX) and created the Public Company Accounting Oversight Board (PCAOB). These organizations focus on corporate governance and accounting and audit regulations. In Canada, increased regulation resulted in the creation of the Canadian Public Accountability Board (CPAB). The standard setters have also responded to public demands that auditors pay greater attention to the risk that a material fraud may occur. CAS 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* requires that auditors consider the risk of material fraud in every audit. The auditor must assess the risk that a material fraud could occur and gauge the adequacy of the client's system of internal control to prevent or detect such a fraud. If the auditor is not satisfied with the client's system of internal control, its audit procedures must be designed to aid in the detection of any material suspected frauds.

While highlighting the importance of considering fraud in every audit, standard setters also point out that the primary responsibility for fraud prevention and detection remains with management and those charged with governance (CAS 240, para. 4). They also emphasize the inherent limitation of any audit, making fraud detection less than certain (CAS 240, para. 5).

Cloud 9 Integrated Case

Ron believes that Chip Masters would know what an audit can provide and what it cannot, because Chip is an experienced vice-president of a large international company. He would deal with auditors on a regular basis. Ron thanks Ernie for his time. Ernie has helped him to understand that preparing more detailed financial statements and engaging an auditor to perform a financial statement audit would not be as bad as he first thought. Ron now understands why Ernie thinks audits are valuable, and not just another business expense. If Chip thinks that Ron's financial statements are more credible with an audit, then it is likely that he will be prepared to pay a higher price for Ron's business.

Before You Go On

1.8.1 Define the audit expectation gap.

1.8.2 What causes the audit expectation gap?

1.8.3 What can be done to reduce the audit expectation gap?

Summary

1 Define an assurance engagement.

An assurance engagement involves an assurance provider arriving at an opinion about some information being provided by their client to a third party. A financial statement audit is one type of assurance engagement. This engagement involves an auditor arriving at an opinion about the fair presentation of the financial statements. The audit report is addressed to the shareholders of the company being audited, but other users may read the financial statements. Learning about auditing and assurance requires an understanding of auditing and assurance terminology, including terms such as audit risk, materiality, internal controls, listed entity, and assertions.

2 Explain why there is a demand for audit and assurance services.

Financial statement users include investors (shareholders), suppliers, customers, lenders, employees, governments, and the general public. These groups of users demand audited financial statements because of their remoteness from the entity, accounting complexity, their incentives competing with those of the entity's managers, and their need for reliable information on which to base decisions. The theories used to describe the demand for audit and assurance services are agency theory, the information hypothesis, and the insurance hypothesis.

3 Differentiate between types of assurance services.

Assurance services include financial statement audits, compliance audits, performance audits, comprehensive audits, internal audits, and assurance on corporate social responsibility (CSR) disclosures.

4 Explain the different levels of assurance.

The different levels of assurance include reasonable assurance, which is the highest level of assurance, limited assurance, and no assurance. Reasonable assurance is provided in an audit of a company's financial statements. Limited assurance is provided in a review of a company's financial statements. No assurance is provided in a compilation engagement.

5 Outline different audit opinions.

An auditor can issue an unmodified opinion, also known as a clean report, or an unmodified opinion with an emphasis of matter paragraph. Alternatively, a modified opinion may be issued as a qualified, an adverse, or a disclaimer of opinion.

6 Differentiate between the roles of the preparer and the auditor, and discuss the different firms that provide assurance services.

It is the responsibility of a company's governing body to ensure that its financial statements are relevant, reliable, comparable, understandable, and true and fair. It is the responsibility of the auditor to form an opinion on the fair presentation of the financial statements. In doing so, the auditor must maintain professional scepticism and utilize professional judgement and due care.

The firms that provide assurance services include the Big-4 international firms, the national firms (with international links), local and regional firms, and consulting firms that tend to specialize in assurance of CSR and environmental disclosures.

7 Identify the different regulators, legislation, and regulations surrounding the assurance process.

Regulators of the assurance process include the Auditing and Assurance Standards Board (AASB), Canadian Securities Administrators (CSA) and the various provincial securities commissions, and the Canadian Public Accountability Board (CPAB). Relevant legislation includes the Canada Business Corporations Act (CBCA). CPA Canada is the professional accounting body in Canada, responsible for the Chartered Professional Accountant (CPA) designation.

8 Describe the audit expectation gap.

The audit expectation gap occurs when there is a difference between the expectations of assurance providers and financial statement or other users. The gap occurs when user beliefs do not align with what an auditor has actually done.

Key Terms

Adverse opinion 1-21
Applicable financial reporting framework 1-5
Assertions 1-5
Assurance engagement 1-4
Audit evidence 1-5
Audit file 1-5
Audit plan 1-5
Audit risk 1-5
Compilation engagement 1-17
Compilation Engagement Report 1-19
Compliance audit 1-12
Comprehensive audit 1-13
Consulting firms 1-13
Corporate social responsibility (CSR) 1-13
Disclaimer of opinion 1-21
Emphasis of matter 1-20
Fair presentation 1-10
Financial statement audit 1-10
Financial statements 1-5
Independent auditor's report 1-5
Information risk 1-7
Internal audit 1-13
Internal control 1-5
Limited assurance 1-17
Listed entity 1-10
Material 1-5
No assurance 1-17
Performance audit 1-12
Qualified opinion 1-21
Reasonable assurance 1-14
Review engagement 1-17
Sufficient and appropriate evidence 1-5
Those charged with governance 1-13
Unmodified opinion 1-6, 1-20
Working papers 1-6

Self-Test Questions

Answers can be found in *WileyPLUS*.

1.1 The parties relevant to an assurance engagement are:

a. assurance practitioner, users, responsible party.

b. assurance practitioner, responsible party, subject matter.

c. assurance practitioner, users, criteria.

d. assurance practitioner, subject matter, criteria.

1.2 Agency theory explains that audits are demanded because conflicts can arise between:

a. managers and owners.

b. managers and agents.

c. owners and principals.

d. auditors and owners.

1.3 The insurance hypothesis means:

a. managers must take insurance.

b. owners must take insurance.

c. an audit acts as insurance.

d. none of the above.

1.4 Performance audits are useful because:

a. they include an internal audit.

b. they are concerned with the economy, efficiency, and effectiveness of an organization's activities.

c. they involve gathering evidence to ascertain whether the entity under review has followed the rules, policies, procedures, laws, or regulations with which it must conform.

d. none of the above.

1.5 The function of internal audit is determined by:

a. the external auditor.

b. the Institute of Internal Auditors.

c. those charged with governance and management.

d. the government.

1.6 Reasonable assurance means:

a. the auditor disclaims responsibility for the audit opinion.

b. an adverse audit report.

c. the auditor has done adequate work to report whether or not anything came to their attention that would lead them to believe that the information being assured is not fairly presented.

d. the auditor has gathered sufficient and appropriate evidence to form a positive expression of opinion regarding the financial statements.

1.7 An auditor disclaims responsibility when:

a. the users cannot rely on the financial statements.

b. the audit opinion is unqualified and unmodified.

c. the auditor is unable to obtain sufficient evidence about a potentially material and pervasive matter.

d. the audit opinion is unqualified and the auditor includes a paragraph in the audit report to emphasize something important.

1.8 Those charged with governance have a responsibility to ensure that the information in financial statements is:

a. relevant and reliable.

b. comparable and understandable.

c. fairly presented.

d. all of the above.

1.9 The purpose of the Auditing and Assurance Standards Board is:

a. to set high-quality auditing and assurance standards.

b. to regulate capital markets.

c. to promote high-quality audits.

d. to set the educational requirements for the Chartered Professional Accountant designation.

1.10 The audit expectation gap occurs when:

a. auditors perform their duties appropriately and satisfy users' demands.

b. user beliefs do not align with what an auditor has actually done.

c. peer reviews of audits ensure that auditing standards have been applied correctly and the standards are at the level that satisfies users' demands.

d. the public is well educated about auditing.

Review Questions

1.1 What does "assurance" mean in the financial reporting context? What qualities must an "assurer" have in order for you to feel that their statement has high credibility?

1.2 Compare the financial statement users and their needs for a large listed public company with those of a sports team (for example, a football team).

1.3 What are the limitations of an audit?

1.4 Who would request a performance audit? Why?

1.5 Are internal auditors independent? Which internal auditor would be more independent: an internal auditor who reports to the chief financial officer (CFO) of the company, or an internal auditor who reports to the audit committee?

1.6 What does reasonable assurance mean?

1.7 What is an emphasis of matter paragraph? When do you think an auditor would use it?

1.8 What are the auditor's responsibilities?

1.9 Describe the audit expectation gap. What causes the gap?

1.10 Explain the system of reviewing the quality of audits performed by listed company auditors.

Professional Application Questions

Basic Moderate Challenging

1.1 Assurance engagement Basic LO 1

Bravo Bags is a luggage retailer that operates out of a shopping mall. As required by the landlord, Bravo Bags has hired Brad Pope, CPA, to provide a report to the landlord as to whether Bravo Bags has met the requirements of its lease agreement in terms of reporting the store's sales information.

Required

Discuss how this engagement meets the requirements of an assurance engagement.

1.2 Demand for assurance Basic LO 2

In 2002 the audit firm Arthur Andersen collapsed following charges brought against it in the United States relating to the failure of its client, Enron. Some other clients announced that they would be dismissing Arthur Andersen as their auditor before it was clear that Arthur Andersen would not continue.

Required

Using the theories outlined in this chapter on the demand for audits, give some reasons why these clients took this action.

1.3 Assurance providers Basic LO 2, 6

Most audit firms maintain a website that explains the services offered by the firm and provides resources to their clients and other interested parties. The services offered by most firms include both audit and non-audit services.

Required

a. Find the websites for (1) a Big-4 audit firm and (2) a national audit firm. Compare them on:
   - **i.** the range of services provided
   - **ii.** geographic coverage (that is, where their offices are located)
   - **iii.** staff numbers and special skills offered
   - **iv.** industries in which they claim specialization
   - **v.** publications and other materials provided to their clients or the general public
   - **vi.** marketing message

b. In times of economic recession, would you expect the demand for audits to increase or decrease? Would you expect clients to shift from large (Big-4) auditors to national auditors or from national auditors to Big-4 auditors? Why or why not?

Questions 1.4 and 1.5 are based on the following case.

Securimax Limited has been an audit client of KFP Partners for the past 15 years. Securimax is based in Waterloo, Ontario, where it manufactures high-tech armour-plated personnel carriers. Securimax often has to go through a competitive market tender process to win large government contracts. Its main product, the small but powerful Terrain Master, is highly specialized, and Securimax does business only with nations that have a recognized, democratically elected government. Securimax maintains a highly secure environment, given the sensitive and confidential nature of its vehicle designs and its clients.

Clarke Field has been the engagement partner on the Securimax audit for the past five years.

The board of Securimax is considering changing from an audit engagement to a review engagement and has approached Clarke to discuss the implications of this change. Clarke suggests that KFP could perform the review engagement.

Securimax's financial year end is December 31.

1.4 Types of assurance engagements Moderate LO 1

Required

What is a review engagement? Why would a review be appropriate for a set of financial statements for Securimax?

1.5 Audit expectation gap **Moderate** **LO 8**

Required

Discuss the expectation gap that could exist for the audit of Securimax. Consider the existence of any special interests of the users of Securimax's financial statements.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, May 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

1.6 Performance and compliance audits **Challenging** **LO 3**

Fellowes and Associates Chartered Professional Accountants is a successful mid-tier accounting firm with a large range of clients across Canada. In April 2023, Fellowes and Associates gained a new client, Health Care Holdings Group (HCHG), which owns 100 percent of the following entities:

- Shady Oaks Centre, a private treatment centre
- Gardens Nursing Home Ltd., a private nursing home
- Total Laser Care Limited (TLCL), a private clinic that specializes in the laser treatment of skin defects

The year end for all HCHG entities is June 30.

TLCL owns two relatively old laser machines used in therapy. Recently, staff using these machines have raised concerns that they have adverse impacts on patients.

TLCL wishes to purchase a new, more technologically advanced machine. The Ministry of Health has agreed to fund half the purchase price on the basis that TLCL follows the ministry's "Guidelines for Procurement of Medical Equipment" when purchasing the machine. The Ministry of Health has engaged the provincial Auditor General to check that TLCL has met the terms of the funding agreement.

Required

Discuss the relevant criteria against which the Auditor General will check TLCL's compliance with the terms of the funding agreement.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, December 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

1.7 Types of engagements and reports **Moderate** **LO 1, 4**

Building-On-Line (BOL) is an online retailer that has been selling high-end home building products to construction contractors for several years. It was started by Jack Tosic, once a contractor himself, who wanted to find a way to supply home building products to the construction market at lower costs. Jack started BOL and began selling home building products over the Internet. Because it did not have any retail locations, BOL was able to charge its customers lower prices for higher-end products than its competitors.

In recent years, Jack has tried to diversify and expand the business by taking advantage of the technology structure it has had in place. BOL expanded into the consumer retail market with the goal of becoming a home remodelling marketplace, offering a wider variety of products to a wider range of customers. In order to enter this market, the company had to further lower its prices, squeezing already low margins. This resulted in declining profitability and, at times, cash flow issues.

To help with its cash flow problems, BOL has recently asked the bank for a loan. The loan would be used to support the day-to-day operations of the business and to allow BOL to continue to invest in its IT infrastructure. After speaking with the bank manager, Jack has learned the bank appears to have some reservations in lending BOL any money. The bank is aware of BOL's declining profitability and in order to approve the loan, the bank will require a set of financial statements from a CPA. The bank has not indicated the type of engagement it might require. While Jack has seen financial statements before, the bank has suggested it may require some type of report to be attached to the financial statements. Jack wonders what type of reports might be available and what they might say.

Required

a. Compare and contrast the three common types of engagements a CPA may perform in this case.

b. Explain to Jack the various report options and what is included in each report.

c. What type of report do you think would be most appropriate in this case?

d. If the bank requires an audit, discuss how this meets the definition of an assurance engagement.

[1]**1.8** Types of assurance engagements **Moderate** **LO 4**

DDD Motor Sales Inc. is privately owned. It wants to expand its business and has approached its bank for a loan. DDD wants the funds to purchase additional inventory and will be able to provide excellent security to the bank. The bank has agreed that, since DDD can provide good security for the loan, an external audit will not be required. The bank manager has insisted that DDD hire a firm of professional accountants to examine DDD's financial records and provide some level of assurance.

Required

- **a.** What type of engagement is required? Explain your answer.
- **b.** Assume that DDD contracts with Cicak & Jones, CPAs, to perform the required services. What is the title of the report or communication that Cicak & Jones will prepare?
- **c.** Identify the types of procedures Cicak & Jones will be required to conduct.

1.9 Audit opinions **Moderate** **LO 1, 5**

Required

What type of audit report would be appropriate in each of the following scenarios? Explain.

- **a.** There is uncertainty relating to a pending exceptional litigation matter that is adequately disclosed in the notes.
- **b.** The client's records are inadequate and the auditor is unable to obtain sufficient appropriate evidence.
- **c.** There is a GAAP departure concerning a highly material item.
- **d.** The client will not allow the auditor to contact the client's legal counsel.
- **e.** The client's accounting records have been destroyed.
- **f.** There is a material misstatement in the client's inventory account. The misstatement is deemed to be material but not pervasive to the financial statements.
- **g.** Inventories are misstated. The misstatement is deemed to be material and pervasive to the financial statements.

[2]**1.10** Types of audit opinions **Moderate** **LO 5**

Situation 1

The accounting firm of Aschari and Di Tomaso was engaged to perform an audit of the financial statements of Pammenter Inc. During the audit, Pammenter's senior managers refused to give the auditors the information they needed to confirm any of the accounts receivable. As a result, Aschari and Di Tomaso were not able to confirm the accounts receivable balance. However, they did not encounter any other problems during the audit.

Situation 2

The accounting firm of Jovanovic and St. Pierre has discovered, during its audit of Robson Chemicals Inc., that the client is being sued for $3 million. Allegedly, one of its products exploded and severely injured a customer. In the firm's discussion with Robson's lawyers, Jovanovic and St. Pierre ascertained that it is very likely that Robson will indeed have to pay this entire amount when the lawsuit is resolved. To provide for this, Robson's chief financial officer has included information relating to the lawsuit in the notes to its financial statements, but did not otherwise reflect it in its financial statements.

Required

For each of the independent situations presented above:

- **a.** state what type of audit opinion should be issued
- **b.** explain your reasoning

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1.11 Different audit opinions **Basic** **LO 5, 6**

C. D. Hodgson and Associates Chartered Professional Accountants audited the financial statements of Tallender Company, a sporting goods retailer. As with all of his firm's audits, Carl Hodgson conducted the Tallender audit in accordance with generally accepted auditing standards, and, therefore, wrote a standard unqualified opinion in his audit report.

On Saturday afternoon, just as he was about to write the audit opinion relating to this audit, Carl received an emergency telephone call from his wife regarding an accident involving their only child. He had to leave the office immediately and was not sure when he would be able to return. Since the only other person in the office at the time was a junior accountant, Khaled Nersesian, who had also worked on the audit, Carl handed him the completed financial statements and working papers and asked him to make sure it was appropriate to issue an unqualified opinion.

Required

What should Khaled Nersesian take into consideration in deciding whether an unqualified opinion is appropriate for Tallender Company?

1.12 The audit expectation gap **Moderate** **LO 1, 2, 8**

Certek Technologies Inc. is a biotechnology company whose shares traded on a major Canadian stock exchange. Over the 22 months following its initial public offering in May 2009, Certek's share price rose an astounding 1,350 percent. In mid-March 2011, Certek's share price began to decline. Then, in April 2011, the share price plummeted when it was announced that Certek had stopped all research activities on its major projects due to unsatisfactory scientific results. You, a CPA, are sitting with some friends who make the following comments:

Ruby: I lost a bundle on the Certek shares. The price went up with every press release. It seemed like the company was going to solve every medical problem in the world. I thought the auditors had a responsibility to investors and the capital markets for information released to the public.

Omid: I don't understand how audited financial statements are the least bit useful. Certek was investing huge amounts of money in researching new pharmaceutical products, yet the financial statements provided no information on whether its research would develop into viable products. Couldn't the auditors take some responsibility for evaluating the research that companies are doing?

Required

a. What is the auditor's responsibility for information released to the public?

b. Discuss Omid's comment with reference to the expectation gap.

c. What can auditors do to reduce the expectation gap?

Source: Adapted from the Uniform Final Exam (UFE), CPA Canada, Paper 2, 2000.

1.13 Audit reports **Basic** **LO 3, 4, 5, 6, 8**

A sample audit report is provided in figure 1.3 in this chapter. A sample review engagement report is provided in figure 1.4.

Required

a. What is the auditor's responsibility as determined in the audit report?

b. Find the lines in the audit report that express the auditor's opinion. Is it an unqualified or modified audit opinion?

c. Find the lines in the review report that express the auditor's conclusion. Is it an audit opinion? Is it a positive or negative statement?

d. Make a list of the other differences between the audit report and the review report.

1.14 Being an auditor **Basic** **LO 4, 5, 8**

You have recently graduated from university and have started work with an audit firm. You meet an old school friend, Kim, for dinner—you haven't seen each other for several years. Kim is surprised that you are now working as an auditor, because your childhood dream was to be a ballet dancer. Unfortunately, your knees were damaged in a fall and you can no longer dance. The conversation turns to your work and Kim wants to know how you do your job. Kim cannot understand why an audit is not a guarantee that the company will succeed. Kim also thinks that company managers will lie to you in order to protect themselves, and as an auditor, you would have to assume that you cannot believe anything a company manager says to you.

Required

a. Write a letter to Kim explaining the concept of reasonable assurance, and how reasonable assurance is determined. Explain why an auditor cannot offer absolute assurance.

b. Explain in the letter to Kim the concept of "professional scepticism" and how it is not the same as assuming that managers are always trying to deceive auditors.

Case Study—Cloud 9

Ron McLellan established his business, McLellan's Shoes, in 2000. Ron keeps records and his wife helps him prepare basic accounting records. As McLellan's Shoes has no outside owners, Ron has never seen the need to have his books audited.

When Chip Masters from Cloud 9 Inc. expressed an interest in buying McLellan's Shoes in 2012, Ron was asked to provide audited financial statements. Ron discussed his concerns about having an audit with his friend Ernie Black. Ernie is concerned that Ron may forget their conversations and has asked you to prepare a summary of the issues listed below for Ron.

Required

a. What are the main differences between a financial statement audit, a review engagement, and a compilation engagement?

b. What is the difference between reasonable assurance and limited assurance?

c. Why would Chip ask Ron to have the financial statements for McLellan's Shoes audited rather than reviewed?

d. What factors should Ron consider when selecting an accounting firm to complete the McLellan's Shoes audit?

Research Question 1.1

Chong and Pflugrath conducted a study of different audit report formats and their effects on the audit expectation gap. They investigated whether report length (long or short), the location of the audit opinion (at the start or the end), and plain language (instead of technical language) affect shareholders' and auditors' perceptions of the audit. They surveyed a sample of shareholders and auditors and concluded that the responses indicate that different report formats have only minor effects on the audit expectation gap.[4]

Required

a. In your view, what should be contained in an audit report that conveys realistic explanations of the auditor's role and the assurance provided by the audit report?

b. Do you believe that auditors are correct in dismissing users' expectations as "unrealistic"? Should auditors be trying to meet these expectations by rethinking their role and changing their approach?

Research Question 1.2

Required

Access the CPA Canada Handbook and locate the following:

a. What number is the CAS for audit documentation?

b. How many sections are there to each CAS?

c. What is the name of CSAE 3000?

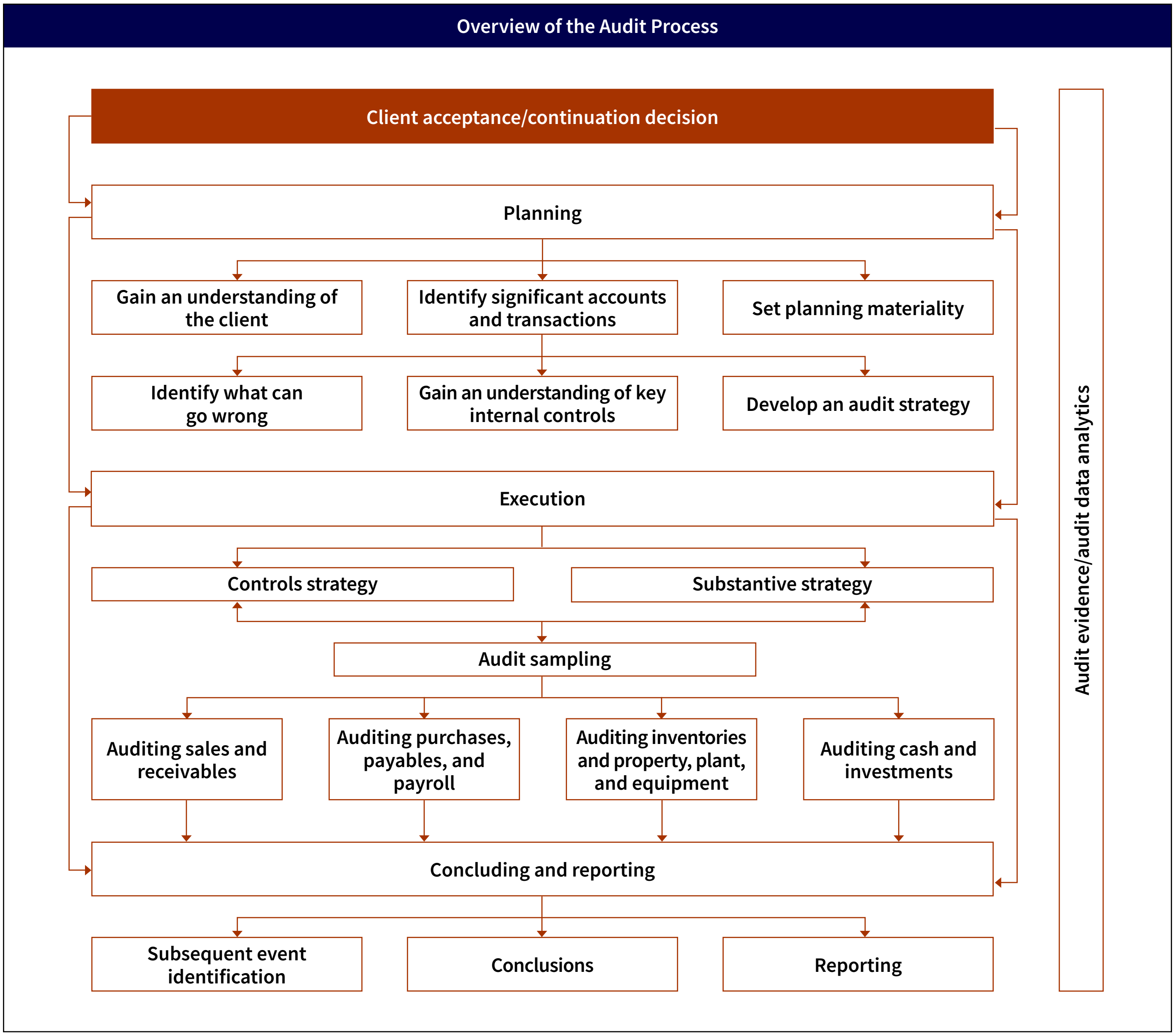
d. What numbers relate to review engagements?

e. Where specifically can the required wording for the Compilation Engagement Report be found?

Notes

1. Financial Reporting & Assurance Standards Canada, "Auditing and Assurance Standards Board." Accessed June 2, 2014. www.frascanada.ca/auditing-and-assurance-standards-board/.
2. Canadian Securities Administrators, "Who We Are." Accessed June 2011. www.securitiesadministrators.ca.
3. Ethical standards are also important regulations concerning auditors. These are discussed in detail in chapter 2 of this book.
4. K. M. Chong and G. Pflugrath, "Do Different Audit Report Formats Affect Shareholders' and Auditors' Perceptions?" *International Journal of Auditing* 12, 2008, pp. 221–41.

Ethics, Legal Liability, and Client Acceptance



LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
After studying this chapter you should be able to:		Standards addressed in each learning objective are as follows:
1 Describe the fundamental principles of professional ethics	**2.1** The Fundamental Principles of Professional Ethics **2.1.1** The fundamental ethical principles **2.1.2** Specific rules incorporating the principles of professional ethics **2.1.3** Framework for ethical dilemmas	CPA Code of Professional Conduct
2 Describe professional judgement and professional scepticism	**2.2** Professional Judgement and Professional Scepticism **2.2.1** A decision-making framework for applying professional judgement **2.2.2** Improving professional scepticism	CAS 200 *Overall Objectives of the Independent Auditor, and the Conduct of an Audit in Accordance with Canadian Auditing Standards*
3 Define and assess auditor independence	**2.3** Independence **2.3.1** Threats to independence **2.3.2** Safeguards to independence	CSQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance Engagements* CAS 220 *Quality Control for an Audit of Financial Statements* CPA Code of Professional Conduct
4 Explain the relationship between an auditor and key groups they have a professional link with during the audit engagement	**2.4** The Auditor's Relationships with Others **2.4.1** Auditors and shareholders **2.4.2** Auditors and the board of directors **2.4.3** Auditors and the audit committee **2.4.4** Auditors and internal auditors	CAS 610 *Using the Work of Internal Auditors*
5 Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties	**2.5** Legal Liability **2.5.1** Legal liability to clients **2.5.2** Contributory negligence **2.5.3** Legal liability to third parties **2.5.4** Avoidance of litigation	
6 Identify the factors to consider in the client acceptance or continuance decision	**2.6** Client Acceptance and Continuance Decisions	CPA Code of Professional Conduct CSQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance Engagements* CAS 210 *Agreeing the Terms of Audit Engagements*

Cloud 9 Integrated Case

Ron McLellan came to an arrangement with Chip Masters and sold McLellan's Shoes to Cloud 9 Inc. in 2013. The new business is named Cloud 9 Ltd. (Cloud 9). As part of the sale agreement, Ron McLellan was appointed to the Cloud 9 board of directors.

It is now April 2023. Cloud 9 has approached the accounting firm W&S Partners about performing the December 31, 2023 audit. If the client is accepted, the partner responsible for the audit will be Jo Wadley. She has asked Sharon Gallagher and Josh Thomas to assist with the client acceptance work. Sharon is an audit manager. Her task is to make sure that there are no nasty surprises for the audit team if they accept the audit. Sharon knows how crucial this is. She still has nightmares about an audit she worked on when she was a new graduate at another audit firm. The client in that case threatened to dismiss the auditor when the auditor wanted him to recognize an impairment loss on some assets. The client was the firm's largest account and the partner was under a lot of pressure to keep the client.

Josh is an audit senior. He has not been involved in the client acceptance process before and needs the experience so he can be promoted to audit manager. Sharon and Josh do not know anything about Cloud 9 other than that it manufactures and retails customized basketball shoes; it is a subsidiary of Cloud 9 Inc., a publicly listed Canadian company; and it was purchased from Ron McLellan in 2013. Sharon stresses to Josh that they want to know that the client is not going to be difficult to deal with, and that W&S Partners can do a good job of the audit. Josh asks how they can know that now, before they start the audit.

Chapter Preview

The purpose of this chapter is to provide an overview of the current audit environment. We start by considering the fundamental principles of professional ethics. In particular, we discuss the principles of professional behaviour, integrity and due care, professional competence, confidentiality, and objectivity. We will also discuss some of the specific rules that incorporate these principles and provide a framework for resolving ethical dilemmas. Along with complying with the principles of professional ethics, an auditor must exercise professional judgement and professional scepticism. We will consider a framework for applying professional judgement and ways to improve professional scepticism, including common auditor biases.

Auditor independence is described and its importance is explained. Independence in fact (actual independence) is compared and contrasted with independence in appearance (perceived independence). The factors that can threaten auditor independence are then explained. Safeguards that can reduce these threats are also discussed. These safeguards to auditor independence have been established in professional standards or in accounting firm policies and procedures.

Financial statement auditors liaise with a number of groups when completing their audit. Apart from their client's management and staff, who aid the auditor directly throughout the audit, other groups are fundamental to the successful completion of an audit. These groups include the client's shareholders, board of directors, audit committee, and internal auditors. The nature of the relationship that the auditor has with each of these groups is explored in this chapter.

An overview of the legal liability of the auditor is provided next. In that summary, we explore the current status of an auditor's liability to their client and third parties. The concept of contributory negligence is also explained.

Finally, we consider the factors that impact the auditor's client acceptance/continuation decision. This section of the chapter marks the beginning of our substantive overview of how an audit is conducted, since the first step for any audit is the decision to accept a company as a new audit client or continue as the auditor of an existing client.

2.1 The Fundamental Principles of Professional Ethics

LEARNING OBJECTIVE 1

Describe the fundamental principles of professional ethics.

Generally speaking, ethics are the standards of behaviour that promote human welfare or the overall public "good."[1] When we speak of ethics with respect to professional accountants, we are therefore referring to the standards of behaviour that promote the welfare of society and the accounting profession.

2.1.1 The Fundamental Ethical Principles

In Canada, all professional accountants must abide by a code of professional conduct based on fundamental ethical principles. Accounting professionals are expected to use these principles to guide their behaviour, as they reflect the values deemed critical to the accounting profession. These principles are to act with professional behaviour, integrity and due care, professional competence, confidentiality, and objectivity. Compliance with these fundamental ethical principles is mandatory for all members of the accounting profession. Non-compliance can lead to disciplinary measures by a member's professional body.

Professional Behaviour

professional behaviour the obligation that all members maintain the reputation of the profession and its ability to serve the public interest

Professional behaviour is the obligation that all members of the profession comply with rules and regulations and ensure that they maintain the reputation of the profession and its ability to serve the public interest. Members are expected to avoid any action that would discredit the profession. Members should not claim to be able to provide services that they are not able to provide. They should not claim to possess qualifications that they do not possess. They should not claim to have gained experience in areas where they have little or none. Finally, members should not undermine the quality of work produced by others or question their reputation.

Integrity and Due Care

integrity the obligation that all members of the accounting profession be straightforward and honest

due care the obligation to act diligently and comply with both technical and professional standards

Integrity is the obligation that all members of the profession be straightforward and honest. Members should not be associated with information that is materially false or misleading. Members must also exhibit **due care**; they must act diligently and comply with both technical and professional standards. This involves taking care to complete each task thoroughly, document all work, and finish on a timely basis. Members with seniority have an obligation to ensure that their juniors are adequately trained and appropriately supervised.

Professional Competence

professional competence the obligation that all members of the accounting profession maintain their knowledge and skill at a required level

Professional competence is the obligation that all members of the profession maintain their knowledge and skill at a level required by the professional body. Members must attain a level of competence and keep up to date with changes in regulations and standards. The attainment of competence comes from education and work experience. Competence is maintained through continuing education and work experience.

Confidentiality

confidentiality the obligation that all members of the profession refrain from disclosing information that is learned as a result of their employment to people outside of their workplace

Confidentiality is the obligation that all members of the profession refrain from disclosing information that is learned as a result of their employment to people outside of their workplace. An exception is made where a client has allowed this disclosure to occur or where there is a legal requirement to disclose such information. Members are also not allowed to use information to their advantage or to the advantage of another person that has been gained as a result of their employment and is not publicly available. An example is using information learned from a client to trade shares.

Objectivity

objectivity the obligation that all members of the profession not allow their personal feelings or prejudices to influence their professional judgement

Objectivity is the obligation that all members of the profession not allow their personal feelings or prejudices to influence their professional judgement. Members should be unbiased and not allow a conflict of interest or the influence of others to impair their decision process.

Cloud 9 Integrated Case

Josh is confident that he understands the fundamental principles of professional ethics. They apply to all of their audits and to their professional behaviour as accountants. Josh and Sharon can see no reason why they would not be able to abide by these fundamental principles in the audit of Cloud 9.

2.1.2 Specific Rules Incorporating the Principles of Professional Ethics

In addition to the guiding ethical principles for professional accountants, there are also a number of specific rules that incorporate these principles. These are important because the principles are not specifically enforceable, but the rules of professional conduct are. Some of these rules are described below.

Fees and Pricing

Fee quotes cannot be provided to a client without adequate knowledge of the work to be performed. Fees quoted should not be significantly lower than the fees charged by a predecessor firm. If fees quoted are significantly lower than those of the predecessor, it may suggest the quality of the audit work or the independence of the auditor may be compromised. Contingency fees (based on outcome of service) are not permitted for engagements where independence is required, for compilation engagements, and for the preparation of income tax returns.

Advertising

Advertising must be in good taste and it should not bring disrepute to the profession. Advertising cannot be false or misleading or make unsubstantiated claims. For example, a firm should not imply that it is better than competing firms.

Contact with Predecessor

Before accepting a new engagement, the new auditor is required to contact the predecessor auditor and ask if there is any reason why they should not accept the engagement. The rules of professional conduct require the predecessor auditor to reply on a timely basis. Due to the requirement of confidentiality, the response will be limited to a yes or no unless the client gives permission to the predecessor auditor to provide more information. **Exhibit 2.1** presents rule 302 as excerpted from the CPA Code of Professional Conduct.

Often when a client changes auditors, the new auditor will need information from the predecessor auditor. To ensure a smooth transition, the rules of professional conduct require that the predecessor auditor put the client's interest first. Therefore, client information needed by the new auditor is to be provided. While the predecessor auditor is not required to provide the new auditor with proprietary information or working papers, documents that are considered

302 Communication with predecessor

RULES:

302.1 A registrant ("successor") shall not accept an engagement with respect to the practice of public accounting or the provision of a professional service not inconsistent therewith, where the successor is replacing another registrant or other professional ("predecessor"), without taking reasonable steps to communicate with such predecessor and enquire whether there are any circumstances that should be taken into account which might influence the decision whether or not to accept the engagement.

302.2 A registrant shall respond promptly to the communication referred to in Rule 302.1.

302.3 (a) When responding as required by Rule 302.2, if a registrant was unable to continue with or resigned from an engagement with respect to the practice of public accounting, the registrant shall inform the successor of the fact of the withdrawal or resignation, as the case may be.

(b) When a registrant has been informed of the circumstances described in Rule 302.3(a), the registrant shall obtain the necessary information to make an informed decision as to whether to accept the client by:

(i) requesting such further information from the client; or
(ii) requesting permission from the client to obtain such further information from the predecessor.

EXHIBIT 2.1 Excerpt from the CPA Code of Professional Conduct

Source: Chartered Professional Accountants of British Columbia. "CPA Code of Professional Conduct." August 2018. https://www.bccpa.ca/regulatory/act-bylaws-rules/code-of-professional-conduct.pdf/ Reproduced with permission from Chartered Professional Accountants of British Columbia.

property of the client, such as account groupings and tax returns, should be provided. Professional courtesy also suggests that the predecessor meet with the new auditor to allow the new auditor to gain the required documentation to support the new client's opening balances.

Firm Names

Firm names are not to be misleading. They must be in good taste and not lower the reputation of the profession. Firm names cannot be self-laudatory and they cannot claim superiority over any other professional accountant or firm.

Professional Conduct

If a public accountant becomes aware that another designated accountant has breached the rules of professional conduct or has acted in a way that would discredit the profession, the public accountant has a duty to inform the relevant institute of the breach. However, before informing the appropriate institute, the public accountant should contact the other accountant and inform them of the criticism and request an explanation.

2.1.3 Framework for Ethical Dilemmas

Ethical dilemmas are commonplace in both life and the workplace. It is therefore likely that a professional accountant will face an ethical dilemma at some point during his or her career (see Professional Environment 2.1). While the above principles and rules guide behaviour, the resolution to an ethical dilemma usually involves making a choice between alternatives where there may not be an obvious right or wrong answer. To help make the best possible decision when facing an ethical dilemma, it is recommended that a structured decision-making process be followed, such as the one outlined below:

1. Identify the ethical issues. Recognition of the issue is the first step. Understanding the problem and identifying the relevant facts will help further analysis. Do you have all of the information you need? Can you get more information to help you make a better decision?
2. Determine who is affected by the outcome of the dilemma and how each individual or group is affected. Who are the parties involved and will they be harmed by or benefit from the issue identified?
3. Identify the likely alternatives available to the person who must resolve the dilemma. How will each alternative impact each party identified in step 2? Will any parties be harmed or benefit?
4. Decide on the appropriate action. In some situations, the appropriate action will be obvious. In other cases, it will not be as obvious. In these cases, the solution will involve selecting the most ethical alternative.

2.1 Professional Environment Ethics in Professional Accounting

While the accounting profession has a professional code of conduct, an underlying principle of the profession is that its members will act ethically. Ethical behaviour can be described as doing the right thing, which is often guided by a person's belief of what is morally right or wrong.

Students entering the profession are expected to achieve competency in both technical and enabling competencies. Enabling competencies reflect the personal attributes desirable for a CPA. One of the enabling competencies listed on the CPA Competency Map is Acting Ethically and Demonstrating Professional Values. This is described as the "ability to act with honesty, integrity, credibility, professional confidence, and independence, while coping with ambiguity, conflicts of interest, and the need to protect the public interest. That is the expectation," said Tashia Batstone, senior vice-president, external relations and business development, CPA Canada. "When you look at the unique value proposition a CPA brings to the table, it's the ability to utilize professional judgement and an ethical framework. It's our mandate to protect the public. If the public loses confidence in our ability to act in an ethical manner, we have lost all credibility and value."

Q: What are the repercussions to the reputation of the CPA brand when an accountant does not act in an ethical manner?

Sources: CPA Competency Map 2020; CPA Canada, "CPA practical experience: Competency requirements," Accessed February 28, 2017. www.cpacanada.ca/en/become-a-cpa/cpa-designation-practical-experience-requirements-overview/cpa-practical-experience-competency-requirements; Mary Teresa Bitti, "Teaching Ethics." *CPA Magazine*, January/February 2016. Accessed February 28, 2017. www.cpacanada.ca/en/connecting-and-news/cpa-magazine/articles/2016/january/teaching-ethics.

Before You Go On

2.1.1 What does it mean to act in the public interest?

2.1.2 List and explain the five fundamental ethical principles in the code of professional conduct for professional accountants.

2.1.3 What are the rules with respect to fees?

2.2 Professional Judgement and Professional Scepticism

LEARNING OBJECTIVE 2

Describe professional judgement and professional scepticism.

Auditing standards require auditors to apply professional judgement and professional scepticism. Recall that professional judgement relates to the level of expertise, knowledge, and training that an auditor uses throughout an audit. Professional scepticism occurs when an auditor has a questioning mind and thoroughly investigates all evidence presented by the client. It means the auditor considers all evidence objectively, both evidence that confirms and contradicts management's assertions.

2.2.1 A Decision-Making Framework for Applying Professional Judgement

Just like when they analyze ethical issues, it is helpful for auditors to use a framework when making professional judgements. The Center for Audit Quality issued a Professional Judgment Resource that suggests a five-step process when using professional judgement. That process is presented in **figure 2.1**. We will now discuss the process.

As with most problems, the first step in the professional judgement decision-making process is to identify the issue. From an accounting perspective, most issues relate to the recognition, measurement, or disclosure of transactions and their impact on the financial statements. From an audit perspective, most issues relate to understanding and identifying the accounts and assertions at risk, and the overall impact on the audit. While sometimes identifying the issue seems straightforward, the auditor should take the time needed to be sure they identify the actual issue. Solving the wrong issue will result in wasted audit time and effort! To avoid this, the Professional Judgment Resource suggests that identifying the issue involves careful analysis of the situation, and interaction and discussion with others, to ensure the auditor clearly understands the situation.

Once the auditor has identified the issue, then comes the fact-finding stage. At this stage, the Professional Judgment Resource suggests the auditor should gather the facts that are readily available and those that need to be gathered from others, including subject matter experts. The auditor should gather the relevant facts and information from as many sources as possible, both internal and external to the entity. The Resource also suggests the auditor take care to gather all evidence, not just evidence that supports a particular position.

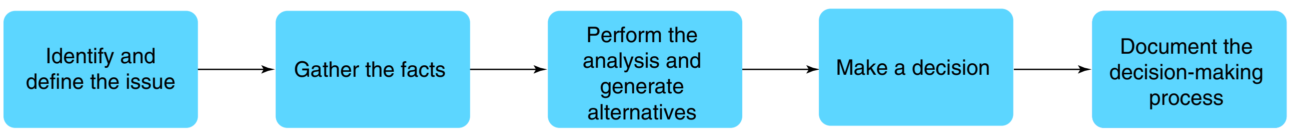


FIGURE 2.1 A professional judgement decision-making process

Once the facts are gathered, the auditor should critically assess the evidence gathered, and then perform the analysis. This likely involves consulting the accounting standards and whatever technical resources are available. As the auditor considers the facts of the situation with respect to professional standards, the auditor should generate possible solutions or alternatives. It may be beneficial at this stage for the auditor to also consult with other auditors to get different perspectives. This allows the auditor to benefit from a wider range of experience and knowledge. As solutions, estimates, or outcomes are generated, the auditor should develop a clear understanding of the overall impact of each on the financial statements, the audit, and the client.

After adequate analysis, the auditor should then make a decision, and document the decision-making process. This documentation should not only include the final outcome, but also the alternatives considered and the related facts.

2.2.2 Improving Professional Scepticism

We can see a key part of the decision-making process is the gathering of facts and evidence. As the auditor gathers evidence, he or she should use professional scepticism. It is easy to accept the evidence gathered at face value or to focus on the evidence that supports the client's assertions. However, using professional scepticism means also being alert for evidence that is contradictory, evidence that may suggest fraud, or evidence that could be altered. The auditor should use professional scepticism during the decision-making process as an element of professional judgement. In other words, professional scepticism is not synonymous with professional judgement, but rather, it is an important component or subset of professional judgement.[2]

Recall that CAS 200 defines exercising professional scepticism as having a questioning mind, being alert to conditions that indicate a misstatement whether due to fraud or error, and critically assessing evidence. Qualities associated with professional scepticism are a tendency to inquire, withholding judgement until appropriate evidence is gathered, understanding that other motivations can lead to biased decisions, having the conviction to make your own decisions, and having the self-confidence to challenge assumptions.[3] Despite possessing these qualities, auditors' professional scepticism can be affected by external factors. For example, when rushing to meet a tight deadline, an auditor may fail to take the time to critically assess or challenge the evidence. When using checklists, the auditor may be so focused on completing the checklist, he or she fails to critically assess the file documentation.

Along with external factors, unconscious biases may also impact how the auditor thinks and makes decisions during an audit, impairing their professional scepticism. Common unconscious cognitive biases that may impact an auditor are:

- Availability bias. This bias involves considering information that is easy to remember as being more likely, more relevant, and more important.[4] This bias may impact an audit if the auditor focuses on the most recent information, evidence, or explanation by management, preventing the auditor from considering possible alternatives. For example, an auditor notes a large increase in a client's wage expenses. The auditor asks management why this difference might exist. Management explains the difference is primarily because new employees were hired during the year. When the auditor gathers evidence regarding this difference, the auditor looks for evidence that supports management's explanation—that is, the hiring of new employees—yet fails to consider other possible reasons for the difference, such as changing wage rates or possible overpayments.
- Confirmation bias. This bias occurs when the auditor favours evidence that confirms his or her beliefs or expectations. When this occurs, the auditor may downplay or ignore evidence that contradicts these beliefs. For example, an auditor has been auditing a business for many years and feels he knows the entity well. The business has been stable and its financial results have been consistent over many years. For the current year under audit, the auditor has noted there were no significant changes within the business and so the auditor believes the financial results will be very similar to the past years' results. When performing a ratio analysis, the auditor finds the gross margin has not changed, and therefore concludes no further work is necessary. The auditor has confirmed his expectation. However, the auditor has ignored contradictory evidence about the industry showing

TABLE 2.1 **Strategies for the auditor to overcome common biases**

Common Bias	Strategy to Avoid the Bias
Availability bias	• Consider why something comes to mind. • Consult with others and make the opposing case.
Confirmation bias	• Make an opposing argument and consider alternative explanations. • Consider conflicting information.
Overconfidence bias	• Challenge opinions and experts. • Challenge underlying assumptions.
Anchoring bias	• Ask for input from others. • Consider management bias.

Source: Adapted from Centre for Audit Quality, Professional Judgement Resource, 2014.

there has been increased industry competition during the year, and in response selling prices decreased and so margins should have decreased as well. The declining margins did not appear in the variance analysis because there was a cut-off error resulting in an overstatement of sales.

- Overconfidence bias. This bias involves the auditor overestimating his or her ability or believing his or her judgement is better than it is. For example, a new auditor completes a part of the audit file and believes she has done a great job. She is surprised when the section is reviewed by the audit manager and several questions follow, indicating both more work and more documentation are required.
- Anchoring bias. This bias involves making assessments by starting from an initial numerical value and then adjusting insufficiently away from that initial value in forming a final judgement.[5] For example, management estimates a contingent loss of $1 million. The company's auditor believes this is too low and suggests the estimate should be $1.5 million. The loss is actually $5 million. This illustrates anchoring, because the auditor did not suggest changing the estimate enough.

The first step in overcoming these biases is to be aware of them. Possible strategies are presented in **table 2.1**.

Before You Go On

2.2.1 What are the five steps in a professional judgement decision-making framework?

2.2.2 Explain the confirmation bias.

2.2.3 What are three things an auditor could do to overcome biases?

2.3 Independence

LEARNING OBJECTIVE 3

Define and assess auditor independence.

The concept of **independence** is essential to a public accountant. It is a requirement to comply with the ethical principles to act with integrity and objectivity. It requires public accountants to ensure they are free from any influence or bias that would impair the decision-making process. This concept is fundamental to every audit and must be adhered to by every auditor who provides

independence the ability to act with integrity and objectivity

board of directors the group that represents the shareholders and oversees the activities of a company and its management

assurance services. An external auditor is often referred to as an independent auditor, which highlights the importance of independence in every audit engagement. Financial statements must be relevant, reliable, comparable, understandable, and fairly presented. It is the responsibility of those charged with governance in a company (generally the **board of directors and management**) to ensure that the financial statements meet these requirements. It is the responsibility of the external auditor to form an opinion on the fair presentation of the financial statements. If an auditor is not independent of their client, it will affect the credibility and reliability of the financial statements. It is vital that financial statement users believe that the external auditor is independent of the company they audit. If that independence is compromised in any way, it will detract from the ability of users to rely on the financial statements to make decisions.

There are two forms of independence:

- ***Independence in fact*** is the ability to act with integrity, objectivity, and professional scepticism. It is the ability to make a decision that is free from bias, personal beliefs, and client pressures.
- ***Independence in appearance*** is the belief that independence in fact has been achieved. It is not enough for an auditor to be independent; they must also be seen as independent. Auditors must consider their actions carefully and ensure that nothing is done to compromise their independence, both in fact and in appearance. That is, auditors must take care to ensure nothing impairs their perceived independence.

Both independence in fact and independence in appearance are important for every auditor on every assurance engagement. It is the responsibility of every auditor to assess potential threats to their independence and to seek out appropriate safeguards to reduce those threats to the extent possible. If a threat to an auditor's independence appears insurmountable for a particular client, an auditor should consider discontinuing as the auditor of that client.

The next section includes a discussion of the various threats to auditor independence for all assurance engagements as well as some of the additional threats to be considered for reporting issuers. That discussion is followed by a review of some of the safeguards that have been put in place by regulation, the profession, and accounting firms to minimize the threats to auditor independence.

Cloud 9 Integrated Case

Sharon tells Josh about her experience at another audit firm where the client tried to pressure the audit partner into dropping a request to write down asset values. It was an example of a threat to the auditor's independence. Although it is difficult to stop a client asking for a favour, the audit firm needs to have safeguards to prevent a simple request from turning into unreasonable pressure on the audit team to meet that request. Sharon and Josh agree that they need to consider the specific independence threats and safeguards for the audit of Cloud 9. The auditor must be independent, as well as be seen to be independent.

2.3.1 Threats to Independence

The accounting profession has identified five key threats to auditor independence. They are self-interest, self-review, advocacy, familiarity, and intimidation threats. This section focuses on independence as it applies to *all* assurance engagements. This includes all audit and review engagements but not compilation engagements (a non-assurance engagement). However, where the public accountant is not independent of the compilation client, this fact should be added to the Compilation Engagement Report.

Self-Interest Threat

self-interest threat the threat that can occur when an accounting firm or its staff has a financial interest in an assurance client

Self-interest threat is the threat that can occur when an accounting firm or its staff has a financial interest in an assurance client. Some examples include:

- assurance team members involved in the assurance engagement (and their immediate families) owning shares in the client's business

- firm members not involved in the assurance engagement (and their immediate families) owning more shares in the client than the maximum number of shares permitted by the relevant governing body
- a loan to or from the client outside of normal lending terms
- fee dependence, where the fees (from assurance and other services) from one client form a significant proportion of the total fees earned from all assurance clients
- a close business relationship with the client, unless the relationship is limited to an immaterial financial interest for the client, the firm member, and the firm

Cloud 9 Integrated Case

Sharon's old firm had a fee dependence problem. The audit fees they earned from the client resisting the recommended accounting treatment for asset values were a significant proportion of the firm's total fees. W&S Partners is a much larger audit firm than Sharon's old firm, and Cloud 9's fees will not be a significant portion of total fee revenue.

Self-Review Threat

Self-review threat is the threat that can occur when the assurance team forms an opinion on their own work or work performed by others in their firm. Some examples include:

self-review threat the threat that can occur when the assurance team needs to form an opinion on their own work or work performed by others in their firm

- an assurance team member having recently been an employee or a director of the client and therefore able to influence the subject matter of the assurance engagement
- information prepared for the client that is then assured, such as creating source documents, or preparing and recording journal entries without first obtaining management's approval
- services performed for the client that are then assured, such as internal audit services, financial information technology services, tax advisory services, legal services, litigation support services, and corporate finance services and valuations

Cloud 9 Integrated Case

Josh and Sharon do not know of any current work being done for Cloud 9 by W&S Partners, or of any other relationships between members of the audit team and the client's staff. However, they will check with all other departments at W&S Partners, particularly the consulting department. They will also ask any new member of the audit team to disclose their interests and relationships with the client before they join the team.

Advocacy Threat

Advocacy threat is the threat that can occur when an accounting firm or its assurance staff acts, or is believed to act, on behalf of its assurance client. In such a case, the objectivity of the assurance provider may come under question. Some examples include:

advocacy threat the threat that can occur when a firm or its staff acts on behalf of its assurance client

- encouraging others to buy shares or bonds being sold by the client
- representing the client in negotiations with a third party
- representing the client in a legal dispute

Cloud 9 Integrated Case

The partner, Jo Wadley, advises Sharon and Josh that the audit firm is not acting for Cloud 9 in any other matter.

Familiarity Threat

familiarity threat the threat that can occur when a close relationship exists or develops between the assurance firm (staff) and the client (staff)

Familiarity threat is the threat that can occur when a close relationship exists or develops between the assurance firm and the client, or between members of the assurance team and directors or employees of the client. The result can be that the assurance team becomes too sensitive to the needs of the client and loses its objectivity. Some examples include:

- a long association between the assurance firm and the client
- a long association between members of the assurance team and their client
- an assurance team member with a close relative who holds a senior position of influence at the client
- a former partner of the assurance firm holding a senior position with the client
- the acceptance of gifts by members of the assurance team from the client, other than very minor tokens
- the acceptance of hospitality (for example, a meal or tickets to a sporting event) by members of the assurance team from the client, other than very minor gestures

Cloud 9 Integrated Case

Familiarity is usually a greater issue for existing clients than for new clients, such as Cloud 9 for W&S Partners. However, there could be personal familiarity issues in any audit engagement. Josh is worried about asking the senior staff to declare their relationships with the management of Cloud 9. He thinks they might regard that question as impertinent. Sharon tells Josh that she knows the senior staff at W&S Partners are very committed to ethical behaviour. If they were not to ask this question as part of the process of accepting the new client, Sharon and Josh would be disciplined for poor performance.

Intimidation Threat

intimidation threat the threat that can occur when a member of the assurance team feels threatened by client staff or directors

Intimidation threat is the threat that can occur when a member of the assurance team feels threatened by the client's staff or directors. The result can be that the assurance team member is unable to act objectively, believing that if he or she does so there may be some negative consequences based upon the threat received. Some examples include:

- the threat that the client will use a different assurance firm next year
- undue pressure to reduce audit hours to reduce fees paid

Cloud 9 Integrated Case

The partner at Sharon's old firm was threatened with dismissal from the audit, and Sharon has heard of other clients pressuring auditors to reduce their fees. Sharon is confident that the firm of W&S Partners does not rely unreasonably on any one audit and is therefore less vulnerable to threats. She also knows that auditors at W&S Partners keep very detailed records of time spent on any audit tasks and can justify their fees if a client questions the amount.

reporting issuer a public company with a market capitalization and a book value of total assets greater than $10 million

While the above apply to *all* assurance engagements, there are additional prohibitions for auditors of reporting issuers. A **reporting issuer**, in accordance with the independence standard, is a public company with a market capitalization and a book value of total assets greater than $10 million. Some of the additional requirements to ensure auditor independence for reporting issuers include the following:

- There is mandatory rotation of key partners.
- Audit committee must pre-approve all services provided to the client by the firm.
- Certain services are prohibited, beyond those previously discussed as part of the self-review threat, meaning the auditor of a reporting issuer cannot perform any of the following: management functions, human resources services, certain legal functions, tax calculations for the accounting entries, and bookkeeping services.

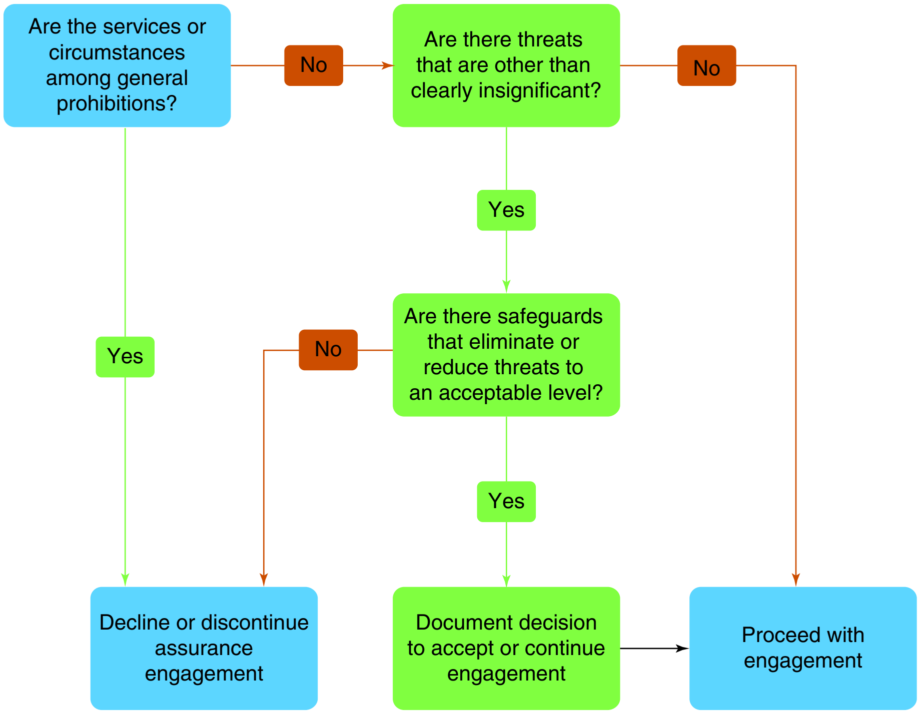


FIGURE 2.2 **Overview of independence standard for assurance engagements**

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- Where an engagement team member accepts employment in a financial reporting role with a client, the firm must refrain from being the auditor of that client for at least one year from the date the financial statements were filed with securities regulators.[6]

When any of these threats are recognized, steps should be taken to remove or reduce the threat to an acceptably low level. This can be achieved by utilizing an appropriate safeguard. Figure 2.2 shows the steps taken to minimize threats to independence in an assurance engagement.

2.3.2 Safeguards to Independence

Safeguards are mechanisms that have been developed by the accounting profession, legislators, regulators, clients, and accounting firms. They are used to minimize the risk that a threat will surface (for example, through education) and to deal with a threat when one becomes apparent (for example, through reporting processes within the assurance firm).

Safeguards Created by the Profession, Legislation, and Regulation

The accounting profession, legislation, and regulation have created a range of safeguards to eliminate or reduce an independence threat to an acceptable level. Safeguards include education of accountants about the threats to independence and the establishment of a code of ethics. For reporting issuers, legislation requires that an auditor be independent and that a communication of independence be issued to the client annually. Figure 2.3 is an illustration of the auditor independence letter.

Safeguards Created by Clients

Clients can put in place appropriate mechanisms that will reduce the threat to independence. They can introduce appropriate **corporate governance** mechanisms, such as the establishment of an audit committee to liaise between the assurance partner and

corporate governance the rules, systems, and processes within companies used to guide and control

W&S PARTNERS

1200-90 Eglinton Avenue East,
Toronto, ON M4P 2Y3.
Phone number: (416) 236-8743.

March 1, 2024
The Audit Committee
Cloud 9 Inc.

Dear Audit Committee Members:

We have been engaged to audit the financial statements of Cloud 9 Ltd. for the year ended December 31, 2023.

The purpose of this letter is to communicate with you regarding all relationships between Cloud 9 Ltd. and ourselves that, in our professional judgement, may reasonably be thought to bear on our independence.

We hereby confirm that we have complied with the requirements regarding independence in the Code of Professional Conduct of Chartered Professional Accountants of Ontario and we have disclosed all relationships and other matters between the firm and the entity that in our opinion may reasonably be thought to bear on independence.

We are not aware of any relationships between Cloud 9 Ltd. and us that, in our professional judgement, may reasonably be thought to bear on our independence that have occurred from January 1, 2023 to March 1, 2024.

The total fees charged during the period covered by the financial statements for audit and non-audit services provided by the firm to Cloud 9 Ltd. and components controlled by the entity were as follows:

Audit $50,000

This letter is intended solely for the use of those to whom it is addressed and others within Cloud 9 Ltd. and should not be used for any other purposes.

We look forward to discussing with you the matters addressed in this letter as well as any other matters that may be of interest to you.

Yours truly,

W&S Partners

CHARTERED PROFESSIONAL ACCOUNTANTS

FIGURE 2.3 **Sample independence letter**

independent directors non-executive directors without any business or other ties to the company

management to enhance independence. (See section 2.4.3 for a discussion of the role of audit committees.) Clients can ensure that the responsibility for the appointment and removal of an auditor rests with **independent directors** on the audit committee or the board. Clients can establish policies and procedures dedicated to ensuring that the financial statements are fairly presented. Finally, clients can put in place policies and procedures dedicated to ensuring that the assurance team has access to all required documents and records when required. These safeguards can reduce but not eliminate the threat to independence. To ensure their effectiveness, clients must ensure that policies and mechanisms established are working effectively.

Cloud 9 Integrated Case

Sharon explains to Josh that one of their key tasks will be to discover, document, and evaluate any independence safeguards created by Cloud 9. She explains that safeguards created by the profession and W&S Partners apply to all audits, so the relative success of an audit with respect to independence problems is significantly affected by the safeguards created by the client. The greater these safeguards, the less likely there will be any problems with the audit. The auditor needs to know that, if a problem does arise, the client has committed to protect the integrity of the audit.

Sharon asks Josh to document the governance structure at Cloud 9, including background information on the directors and senior management. Sharon will investigate the structure governing the relationships between the directors and management of Cloud 9 and the parent company, Cloud 9 Inc.

Safeguards Created by Accounting Firms

Accounting firms have in place a range of safeguards to ensure independence. They have policies and procedures to ensure the quality of their service (see Professional Environment 2.2), and they provide continuing education for their staff regarding these policies and procedures. Firms have client acceptance and continuance procedures to ensure that they identify any threats to independence on a timely basis. Firms have partner rotation policies to ensure that audit partners remain independent of their clients. They also have a policy of peer review, where audit partners review the working paper files of other partners and provide comment and feedback. Finally, firms establish procedures for staff to follow if they become aware of a threat to their independence. These safeguards can reduce but not eliminate the threat to independence. Accounting firms must ensure that the policies and mechanisms established are working effectively.

Table 2.2 lists the five threats to independence, together with some of the safeguards that can help to remove or reduce each threat to an acceptably low level.

TABLE 2.2 Summary of independence threats and safeguards

Threats to Independence	Examples	Safeguards to Independence
Self-interest threat	• An auditor has a financial interest in their client. • An audit firm relies on the fees from a client. • An audit partner is concerned about losing a prestigious client. • An auditor has a business relationship with a client.	• Policies and procedures within an accounting firm identifying any staff with a financial interest in an assurance client. • Regular review of assurance and other fees earned from each client compared with total fees from all assurance clients. • Minimizing the provision of non-audit services to assurance clients. • Policies and procedures prohibiting business relationships with clients.
Self-review threat	• An assurance team is asked to evaluate the effectiveness of an operating system that a colleague in their firm implemented on behalf of the client. • An assurance team audits records that were prepared by a colleague in their firm on behalf of the client. • A member of the assurance team has recently been an employee of the client in a position that impacted the subject matter being assured.	• Minimizing the provision of non-audit services to assurance clients. • When providing non-audit services, ensuring that the client is responsible for overseeing and guiding that work and making any final decisions regarding the outcomes of that work. • Having a cooling-off period before an audit partner can be employed in a senior role at an audit client.
Advocacy threat	• A firm promotes shares of an audit client. • An auditor represents an audit client in a legal case.	• Policies and procedures prohibiting business relationships with clients. • Policies and procedures prohibiting the representation of clients in any disputes or legal matters. • Rotating staff assigned to clients so they do not spend too much time at any one client's premises.

(*continued*)

TABLE 2.2 Summary of independence threats and safeguards (*continued*)

Threats to Independence	Examples	Safeguards to Independence
Familiarity threat	• An auditor has a family member who is a director on the board of an audit client. • An auditor has a family member involved in the preparation of the accounting information subject to audit. • An auditor accepts special gifts from their client. • A long association exists between members of the audit team and an audit client. • A director on the board of an audit client was until recently the engagement partner on the audit.	• Partner and staff rotation policies. • Education regarding acceptance of gifts and hospitality from assurance clients, providing examples of what is and what is not acceptable. • Procedures when assigning staff to assurance clients ensuring no close personal relationships exist between assurance team members and client personnel. • Education regarding socializing with client personnel.
Intimidation threat	• A client threatens to dismiss the audit firm. • The audit firm is threatened with litigation by their audit client. • The client places pressure on the audit team to reduce the scope of the audit, to reduce audit fees, or to meet an unrealistic deadline. • A member of the client's staff places undue pressure on the audit team to allow them to use an inappropriate accounting technique.	• Avoidance of fee dependence. • Appropriate corporate governance structures within clients, such as an audit committee, to liaise with senior assurance team members and client management. • Adherence to stringent procedures regarding the removal of assurance providers.

Source: Based on Accounting Professional and Ethical Standards Board 2011, APES 110, section 290.

2.2 Professional Environment Quality Control

There are standards that provide guidance for firms with respect to quality control. Canada adopted CSQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance Engagements*, on December 15, 2009, to complement its adoption of the CASs. CSQC 1 deals with a firm's responsibilities to establish, document, and maintain a system of quality control if it performs audits and reviews of financial statements and other assurance engagements. The purpose of this standard is to ensure firms comply with legal and regulatory requirements and to ensure firms issue appropriate opinions.

As a result, firms that offer assurance services must have a quality assurance manual that outlines policies and procedures in such areas as:

- leadership responsibility to promote a culture of quality
- compliance with ethical requirements including a requirement to assess independence
- client acceptance and continuance to ensure firms perform engagements within their competencies and that they have adequate resources available

At the time of writing, new quality management standards were in the process of being approved and the implementation date was not known. The revised standards take a more risk-based approach to quality management. The proposed standards will still require firms to have a quality management process and partners will still be responsible for ensuring quality at the engagement level. However, firms will be able to design a quality system that is appropriate for its nature and circumstances, as opposed to the current one-size-fits-all approach.

The revised standards will continue to provide guidance on engagement quality reviews. The proposed standards indicate that the purpose of an engagement quality review is to provide an objective evaluation of the significant judgements and conclusions reached during the engagement. The standards also provide guidance on who is eligible to be an engagement quality reviewer and the reviewers' responsibilities with respect to the engagement and documentation.

The standards will continue to include monitoring requirements. Monitoring involves the evaluation of a firm's quality management process and making corrections as needed. According to the proposed standard, monitoring may be ongoing, periodic, or a combination of both.

Q: What are the repercussions to a CPA firm when it is found to have neglected its responsibilities of quality control?

Sources: *CPA Canada Handbook – Assurance*, CSQC 1, effective as of December 15, 2009; Exposure Draft: International Standard on Quality Management 1, Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements, International Auditing and Assurance Board, February 2019.

Before You Go On

2.3.1 Why is auditor independence so important?

2.3.2 What are some examples of circumstances that may cause a familiarity threat?

2.3.3 What are the three independence safeguards that a firm can implement?

2.4 The Auditor's Relationships with Others

LEARNING OBJECTIVE 4

Explain the relationship between an auditor and key groups they have a professional link with during the audit engagement.

The external auditor has the responsibility to form an opinion on the fair presentation of the financial statements prepared by their client. In conducting their audit, the external auditor comes into contact with client staff and management on a regular basis. The key groups that the external auditor will have a professional link with are the client's shareholders, the board of directors, the audit committee, and the internal audit team.

2.4.1 Auditors and Shareholders

The audit report is addressed to the **shareholders** of the company being audited. This means that the shareholders are acknowledged as the main recipients of the financial statements and the attached audit report. Shareholders own the company. If the company fails, shareholders stand to lose most, if not all, of their investment. Shareholders rely on the audit report and the opinion contained within it to inform them about the reliability of the information provided by the management of their company in the financial statements. Auditors will not often meet the shareholders they report to except when they attend their client's annual general meeting. Exceptions include major shareholders, whom the auditor may meet with from time to time, and shareholding board members and client personnel, whom the auditor will meet with during the course of their audit. Shareholders are responsible for the appointment and removal of their company's auditors. The board of directors will facilitate this process on behalf of shareholders. Generally, the board will select an audit firm that they believe is appropriate or will propose one when it is time to appoint a new audit firm. The board will then make a recommendation to shareholders. Shareholders generally follow such recommendations made by the board of directors.

shareholders owners of the company

2.4.2 Auditors and the Board of Directors

The board of directors represents the shareholders and oversees the activities of a company and its management. It is the role of the board to ensure that the company is being run to benefit the shareholders. The board will generally comprise a mixture of executive and non-executive directors. **Executive directors** are also part of the company's management team; they are full-time employees of the company. **Non-executive directors** are not part of the company's management team; their involvement is limited to preparing for and attending board meetings and relevant board committee meetings. It is the directors' responsibility to ensure that the financial statements are fairly presented and provide a true and fair view. It is the responsibility of the external auditor to audit the financial statements. The audit partner will meet with members of the board when necessary throughout the audit.

executive directors employees of the company who also hold a position on the board of directors

non-executive directors board members who are not employees of the company. Their involvement on the board is limited to preparing for and attending board meetings and relevant board committee meetings.

It is important that the board of directors have a mixture of executive and non-executive members; however, the majority of the board should be independent directors. The executive members have a deeper understanding of the company and its workings. Auditors meet with executive directors throughout the audit. The non-executive members are better representatives of shareholders as they are not employees of the company and can be more impartial in their dealings with management. The external auditor will read the minutes of board meetings to learn about the key decisions regarding the strategic direction the board plans to take the company in the future. Other information that may be found in the minutes includes the level of dividends declared, plans for significant asset purchases, purchases and sales of major investments, and major agreements with other companies that may be contemplated.

Boards of larger companies will also have a series of committees made up of various members of the board. It is the role of these committees to efficiently deal with specific important issues. The main board committee that the auditor deals with is the audit committee. The audit committee is described in more detail in the next section.

2.4.3 Auditors and the Audit Committee

audit committee a subcommittee of the board of directors. The audit committee enhances auditor independence and ensures that the financial statements are fairly presented and that the external auditor has access to all records and other evidence required to form their opinion.

An effective **audit committee** will enhance the independence of the external audit function: an audit committee acts on behalf of the full board of directors to ensure that the financial statements are fairly presented and that the external auditor has access to all records and other evidence required to form their opinion. While ultimate responsibility for the fair presentation of the financial statements rests with the full board, an audit committee can improve the efficiency of achieving this goal.

In Canada, all listed companies are required to have an audit committee. The role of this committee is to oversee the accounting, financial reporting, and audit of the financial statements. The audit committee should be established by the board and should consist of at least three independent directors who are financially literate.

From an audit perspective, it is important that the audit committee be independent of the remainder of the board and of the financial reporting function. The audit committee should consist of only non-executive independent directors. As noted earlier, a non-executive director is not part of the company's management team. An independent director is a non-executive director without any business or other ties to the company that could impede his or her ability to act impartially.

An audit committee should consist of members who can read and understand the contents of the financial statements. It is important that audit committee members have some understanding of the accounting policies used by the company and can communicate easily with the auditor about those choices. The audit partner will report to the audit committee when they have a significant disagreement with management regarding accounting choices made and/or with the content of the notes to the financial statements.

A formal charter sets out the structure, composition, and responsibilities of the audit committee. When a company does not have an audit committee, the audit partner will meet with members of the board of directors.

The responsibilities of the audit committee include the following:

- to recommend the auditor and their fees to the board
- to oversee the audit and resolve any differences between the auditor and management
- to pre-approve all non-audit services to be provided to the entity or its subsidiaries by the independent auditor

2.4.4 Auditors and Internal Auditors

internal auditors employees of the company who evaluate and make recommendations to improve risk management, internal control procedures, and elements of the governance process

The role of internal audit (and **internal auditors**) is determined by those charged with governance, ideally the audit committee. The external auditor views the internal audit function as part of the company being audited and, as such, the internal audit function can never be wholly independent of the company. However, if a company has an effective internal audit function, the external auditor can consider modifying the nature and timing of their procedures and reducing the extent of their audit testing. The final opinion on fair presentation of the financial statements remains with the external auditor, as does the responsibility for gathering and evaluating sufficient appropriate audit evidence to form that opinion. If the external auditor intends to use the work of the internal audit function, they should consider various internal audit characteristics (CAS 610 *Using the Work of Internal Auditors*), including the objectivity, technical competence, and due professional care of the internal audit function and the effectiveness of communication between internal and external audit. These characteristics are described below.

Objectivity

Objectivity is achieved when the client organization's internal audit function has a high level of independence from the rest of the organization. The more independent the internal audit function, the more reliance can be placed upon it by the external auditor. Ideally, internal auditors should report directly to the audit committee or the board of directors.

Technical Competence

Technical competence is the skills, training, and ability of the internal audit team. The external auditor may consider the background and qualifications, the level of training undertaken, and the extent of the experience of the internal audit staff. The external auditor will also be concerned about whether internal audit staff are appropriately qualified for their roles.

technical competence the skills, training, and ability of the internal audit team

Due Professional Care

Due professional care is the documentation, planning, and supervision of the internal audit function. The external auditor is interested in the level of planning undertaken by internal audit. They will also want to see evidence of the procedures undertaken by internal auditors in formulating their conclusions.

Communication

Communication between internal and external auditors is achieved through the scheduling of regular meetings, the external auditor having access to internal audit documentation as needed, and the external auditor informing internal auditors of any issues affecting their work that arise during the external audit. It is important that internal and external auditors be free to communicate without interference from client management or staff.

Cloud 9 Integrated Case

Understanding the board of directors and its subcommittees will be a part of Josh and Sharon's work in documenting Cloud 9's governance structure. In particular, they have to find out whether Cloud 9 has an audit committee and get to know the background of the directors who sit on the board. They also have to check for the existence of an internal audit department at Cloud 9, and find out what they can about the role and function of the internal audit department at Cloud 9 Inc. (the parent company) as it relates to Cloud 9.

Before You Go On

2.4.1 What is a non-executive director?

2.4.2 Why is it important that an audit committee be independent?

2.4.3 Why might an external auditor want to use the work of the internal audit function?

2.5 Legal Liability

LEARNING OBJECTIVE 5

Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.

The external auditor must exercise due care when conducting an audit. This means that the auditor must be diligent in applying technical and professional standards and must document each stage in the audit process. If the auditor is found to be **negligent** (not to have exercised due care), they may be sued for damages by their client or a third party.

negligence failure to exercise due care

Under tort law, to prove that an auditor has been negligent, it must be established that:

- A duty of care was owed by the auditor.
- There was a breach of the duty of care.
- A loss was suffered as a consequence of that breach.

Tort law is a body of rights, obligations, and remedies that is applied by courts in civil proceedings to provide relief for persons who have suffered harm from the wrongful acts of others. The person who sustains injury or suffers pecuniary damage is known as the plaintiff, and the person who is responsible for inflicting the injury and incurs liability for the damage is known as the defendant.

2.5.1 Legal Liability to Clients

An auditor can be sued by their client. When suing the auditor, the client must prove that the auditor owed them a duty of care. A client can establish that the auditor owed them a duty of care in one of two ways: (1) under contract law for breach of contract or (2) under tort law for negligence.

1. Under contract law, a client can sue the auditor for breach of contract. This action may be taken when the auditor fails to live up to their responsibility implicit in agreeing to act as the auditor and explicit in the engagement letter. For example, if the auditor withdraws from an audit without cause, before completing the audit and issuing the report, the client can sue the auditor for breach of contract.
2. Under the tort of negligence, a client can claim that the auditor failed to take reasonable care in the performance of the audit. This means that the work was below the standard that may be reasonably expected from a designated public accountant. The injured party must prove that the auditor's carelessness or unintentional behaviour caused harm and therefore breached the duty of care.

An auditor's duty of care to their client has been established and defined through case law over more than a century. In these cases, the definition of reasonable care and skill has changed over time to reflect changes in professional standards. To prove that an auditor has been negligent, a plaintiff, whether a client or a third party, must establish that an auditor did not comply with auditing standards, ethical pronouncements, or some element of the law in place at the time the auditor conducted their audit. Often-cited cases are described below.

London and General Bank Ltd. (No. 2) (1895) 2 Ch. 673

This case established that an auditor has a duty to report to the shareholders, not the directors, of the company being audited. In forming his judgement, Lord Justice Linley noted that "an auditor however is not bound to do more than exercise reasonable care and skill in making inquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company's affairs. What is reasonable care and skill in any particular case must depend upon the circumstances of that case." This case provided an explanation of the extent to which an auditor could be held liable for the actions of their clients.

Kingston Cotton Mill (No. 2) (1896) 2 Ch. 279

In this case, Lord Justice Lopes noted that "it is the duty of an auditor to bring to bear on the work he has to perform 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 each case. An auditor is not bound to be a detective or, as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog, but not a bloodhound." This finding indicated that an auditor is not to *assume* that the client's accounts are materially misstated.

Pacific Acceptance (1970) 90 WN (NSW) 29

This case recognized that standards of reasonable care and skill had changed considerably since the Kingston Cotton Mill case of 1896. Justice Moffit pronounced the following in his judgement in the Pacific Acceptance case:

- Auditors have a duty to use reasonable care and skill.
- Auditors have a duty to check and see for themselves rather than rely on client management and staff.
- Auditors must closely supervise and review the work of junior staff.
- Auditors must properly document procedures used.
- Auditors have a duty to warn and inform the appropriate level of management.
- Auditors have a duty to take further action where suspicion is aroused that a misstatement may have occurred.
- Auditors should be guided by professional standards.

Negligence is any behaviour that is careless or unintentional and breaches the duty of care. In proving that an auditor has been negligent, a client or its shareholders would need to prove that the auditor had not complied with auditing standards or ethical guidelines. After establishing that the auditor owed them a duty of care and that the auditor has been in some way negligent (has breached that duty of care), the client or its shareholders would need to establish that they suffered a loss as a result of that negligence. To ascertain a causal relationship between the negligent act and the loss suffered, reasonable foreseeability must be proven. This means that the auditor must have been aware that any negligence on their part could cause a loss to the client or its shareholders.

2.5.2 Contributory Negligence

Contributory negligence means that where the plaintiff (the party suing) and the defendant (the auditor) can both be proven to have been negligent, each party must be held accountable in proportion to their guilt. For example, management is responsible for putting in place an adequate system of internal control. However, if management fails to do this and the auditor uncovers the weakness and reports it to management, but fails to report it to the directors when management does not repair the deficient control, management, as well as the auditor, would be found to have been negligent and to have contributed to the loss of the plaintiff.

2.5.3 Legal Liability to Third Parties

Establishing that a duty of care is owed to third parties is not straightforward. **Third parties** include anyone other than the client and its shareholders who uses the financial statements to make a decision (for example, creditors). As third parties generally do not have a contractual relationship with the auditor, they must rely on tort law. The key difficulty for third parties is establishing that a duty of care was owed to them by the auditor. If they are able to prove that such a duty is owed, third parties must provide evidence that the auditor was negligent and that the third party suffered a loss as a result of that negligence. Below is a very brief summary of the key cases that have established the legal liability of auditors to third parties.

third parties anyone other than the client and its shareholders who uses the financial statements to make a decision

Ultramares Corp v. Touche (1931) 174 N.E. 441

This is an American case that has had an impact on Canadian auditors because it resulted in what is called the Ultramares doctrine. The Ultramares doctrine establishes that auditors are not liable for ordinary negligence to parties that they do not have a privity (contractual) relationship with. In this case, Judge Cardozzo ruled that an auditor cannot have "liability in an indeterminate amount for an indeterminate time to an indeterminate class." The liability of auditors would be too great, as auditors should not be required to owe a duty of care to everyone.

Hedley Byrne & Co v. Heller and Partners Ltd. (1964) A.C. 465

This is an English case heard by the House of Lords, but the outcome has had an impact on professionals in all common law countries. It introduced the concept of foreseeable third parties. The court's ruling in this case expanded the concept of auditor liability beyond the privity (contractual) relationship. The concept of liability was extended to third parties, provided the auditors knew beforehand that the third party would be relying on their opinion.[7]

Haig v. Bamford (1977) S.C.R. 466

This is a Canadian case that furthered the foreseeable third-party concept. In this case, the auditor prepared audited financial statements knowing that the statements were being provided to an outside investor. The investor relied on the financial statements, and subsequently the company went bankrupt and the investor incurred a loss. The court ruled that, although the auditors did not know the name of the investor, they knew the audited financial statements were being passed on to unidentified members of a limited class for use in a transaction of which the accountants were aware.

Hercules Management Ltd. v. Ernst & Young (1997) S.C.R. 165

In this case, potential shareholders relied on the audited financial statements and made a share investment. They then brought a suit against the auditor claiming that the financial statements were prepared negligently. The outcome of this case reversed the trend of expanding auditor legal liability. The court dismissed the negligence claim in that it ruled the audited financial statements were prepared to evaluate management stewardship, not for individuals making investment decisions. Therefore, because the plaintiffs did not rely on the financial statements for the purpose for which they were prepared, there was no duty of care.

In summary, to establish that an auditor owes a duty of care to a third party, the third party must demonstrate that a duty of care existed, the duty of care was breached, the audit report was relied upon, and there were quantifiable damages. The third party must also establish that the auditor was aware that the third party was going to use the financial statements and that they relied on the financial statements for the purpose for which they were prepared. **Figure 2.4** illustrates auditor liability.

Livent Inc. v. Deloitte & Touche LLP, 2014 ONSC 2176

Livent, a theatre production company that ran the Phantom of the Opera, went bankrupt in the late 1990s. During the 1990s, Deloitte & Touche was Livent's auditor. Deloitte not only audited the company's financial statements, but it also provided Livent with a letter

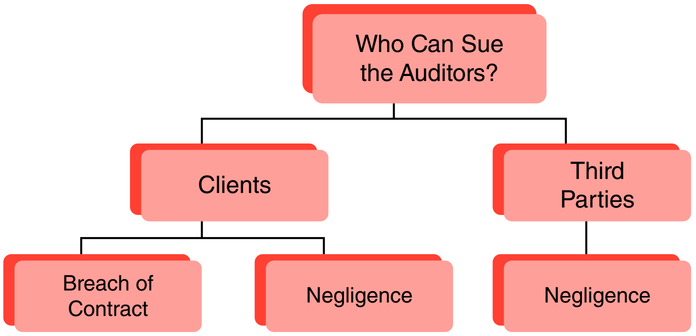

FIGURE 2.4 **Auditor liability**

affirming its financial health for its 1997 initial public offering. After Livent filed for bankruptcy, the company and its management were investigated for both criminal and securities fraud. Subsequently, two of its founders, Garth Drabinsky and Myron Gottlieb, were convicted of fraud for "cooking the books" and Deloitte & Touche was sued for failing to detect the fraud. In April 2014, an Ontario judge ruled that Deloitte was negligent for services performed in 1997 and ordered the accounting firm to pay Livent creditors $84.8 million. The lawsuit was successful because it did not challenge the doctrine established by the Hercules case above, which limited auditor liability to third parties. In the Livent case, the lawsuit was not filed directly by third-party shareholders or creditors, but rather it was filed by the receiver of the bankrupt company on behalf of the creditors. The judge ruled this fit within the Hercules limitation because the plaintiff was the company itself. Deloitte appealed this decision and in late 2017, the Supreme Court of Canada partially upheld the lower court's decision. The Supreme Court agreed with the lower court that Deloitte was negligent with respect to the 1997 audit. However, the Supreme Court also ruled that the purpose of the service is critical and the purpose of the comfort letters was not to enable shareholders to oversee the work of management. The Court therefore reduced the award from $84.8 million plus accrued interest to $40.4 million in damages.[8]

2.5.4 Avoidance of Litigation

There are a number of ways that an auditor can avoid litigation. These include:

- hiring competent staff
- training staff and updating their knowledge regularly
- ensuring compliance with ethical regulations
- ensuring compliance with auditing regulations
- implementing policies and procedures that ensure that:
  - appropriate procedures are followed when accepting a new client
  - appropriate staff are allocated to clients
  - ethical and independence issues are identified and dealt with on a timely basis
  - all work is fully documented
  - adequate and appropriate evidence is gathered before forming an opinion
- meeting with a client's audit committee to discuss any significant issues identified as part of the audit
- following up on any significant weaknesses in the client's internal control procedures in a previous year's audit

Most complaints against auditors don't go through the legal system, however. Instead, they are investigated by the professional bodies (see Professional Environment 2.3).

2.3 Professional Environment Self-Regulation of Professional Accountants

The accounting profession is self-regulating. Each province has a written code of conduct that is enforced by each provincial institute. Any complaint made against a member is investigated. If the investigation leads to a formal complaint of professional misconduct, a hearing is held. Similar to a court hearing, a committee of peers hears evidence and testimony regarding the allegation. Based on the evidence presented, a determination is made as to whether the member has violated the code of conduct. When a member is found guilty of professional misconduct, consequences include being reprimanded, fined, suspended, or expelled. In some provinces, the results of such hearings may be published.

Ontario is one province that publishes the results of professional conduct cases. The following is a sample of cases published and the consequences. (Note: The names have been changed.)

1. Public accountant Bill Summers was found guilty of professional misconduct for attempting to obtain clients through use of a telemarketing campaign. He was fined $1,500.
2. Theodore Chase was found guilty of failing to maintain the profession's good reputation. The charges arose after Mr. Chase was convicted of income tax evasion under the Income Tax Act. Over six years, Mr. Chase failed to report

over $300,000 of income and evaded income taxes of over $80,000. He was fined $5,000 and expelled from the institute.

3. Jean Santos was found guilty of using client confidential information for personal gain. Mr. Santos received confidential information that one of his clients was about to purchase all the shares of ABC Limited. Mr. Santos acted on that information to purchase shares of ABC Limited before the proposed buyout became public. Mr. Santos was fined $2,314 (an amount equal to twice the profit he realized on his subsequent sale of the shares) and was suspended for three months.
4. Public accountant Kent Ray improperly removed funds from the bank account of a not-for-profit organization, of which he was a director and signing officer, and converted the funds to his own use. He then falsified the association's financial statements in an effort to cover up his misappropriation. He was fined $3,000 and expelled from membership.

Q: The provincial institutes have established the ethical framework and require that CPAs demonstrate "the ability to act with honesty, integrity, credibility, professional competence, and independence…" If this competency is shown when CPAs enter the profession, then why are there so many cases of professional misconduct?

Source: Chartered Professional Accountants of Ontario, "Decisions, Orders and Reasons in Cases Involving Disciplinary Proceedings." Accessed February 28, 2017. www.cpaontario.ca/Public/Disciplinary-Cases/1013page1385.aspx

Before You Go On

2.5.1 What are the two ways a client can establish a duty of care?

2.5.2 What is contributory negligence?

2.5.3 What must be established under tort law to prove that an auditor has been negligent?

2.6 Client Acceptance and Continuance Decisions

LEARNING OBJECTIVE 6

Identify the factors to consider in the client acceptance or continuance decision.

The first stage of any audit is the client acceptance or continuance decision. While the decision to take on a new client is more detailed than the decision to continue with an existing client, they have much in common.

The first step involves the assessment of client integrity. When assessing client integrity, the auditor will consider:

- the reputation of the client, its management, directors, and key stakeholders
- the reasons provided for switching audit firms (client acceptance decision)
- the client's attitude to risk exposure and management
- the client's attitude to the implementation and maintenance of adequate internal controls to mitigate (minimize) identified risks
- the appropriateness of the client's interpretation of accounting rules
- the client's willingness to allow the auditor full access to information required to form their opinion
- the client's attitude to audit fees and its willingness to pay a fair amount for the work completed

Information relevant to the client acceptance or continuance decision can be found through:

- communication with the previous auditor (client acceptance decision), noting that the client's permission is required for the previous auditor to speak freely with the prospective auditor (if that permission is refused, the prospective auditor should consider declining the appointment as auditor)
- communication with client personnel
- communication with third parties such as client bankers and lawyers

- an Internet or background search
- a review of news articles about the client
- a review of prior-period financial statements

The code of professional conduct and quality standards deal with professional appointments. Before accepting a new client, the auditor must consider any threats to compliance with the fundamental principles of professional ethics (professional behaviour, integrity and due care, professional competence, confidentiality, and objectivity). Threats to the fundamental principles of professional ethics will occur if the prospective client is dishonest, involved in illegal activities, or aggressive in its interpretations of accounting rules. An audit firm should not accept an entity as a new client if it is concerned about any of these issues. Potential threats to compliance with the fundamental principles of professional ethics for existing clients should be considered from time to time.

To ensure professional competence and due care, an audit firm must make certain that it has the staff available at the time required to complete the audit (client acceptance decision). The audit firm must ensure that its audit staff has the knowledge and competence required to conduct the audit. The auditor must have access to independent experts if required.

To ensure that it is independent of prospective and continuing clients, the audit firm must review the threats to independence described earlier and make certain that safeguards are put in place to limit or remove those threats. An auditor should therefore assess independence before the client acceptance or continuance decision is made. See **figure 2.5** for a sample of an independence assessment worksheet (form 410) from the *Professional Engagement Guide (PEG).* It is important to note the PEG is not authoritative guidance, but rather it is a tool used by practitioners to assist in performing assurance and compilation engagements.

FIGURE 2.5 **Existing engagement continuance, PEG forms—audits, form 410, © 2017 CPA Canada PEG**

Independence prohibitions	**20_**
4. Independence prohibitions Identify and describe any potential independence prohibitions that could occur, and provide reasons why they do or do not preclude the firm or particular staff members from performing the engagement. Address each of the prohibitions listed below: **Services performed** a) Recording journal entries or changing account classifications without first obtaining management's approval. b) Providing tax planning or other tax advisory services that may have a material impact on the financial statements. c) Providing other non-assurance services, such as IT services, internal audit, corporate finance or legal services that involve dispute resolution. d) Preparing source documents for the client. e) Performing management functions for the client (such as decision making). f) Serving as an officer or director of the client. g) Temporary loaning of staff (except in certain situations). **Relationships** a) Close business relationships with the client. b) Family and personal relationships with the client. c) Firm personnel that have accepted a position or have had recent employment with the client as an officer, director or company secretary. **Financial interests** a) Performing the engagement for a fee quote that is considerably less than market price. b) Participating in loans/guarantees to/from the client (except where immaterial and with no unusual terms). c) Holding financial interests in entity. (Where certain criteria outlined in the standards are met, this may exclude memberships in co-operatives, credit unions, social clubs or similar organizations.) d) Accepting gifts or hospitality from client (if not clearly insignificant). Refer to the *Code of Professional Conduct/Code of Ethics* for guidance, interpretations and additional independence prohibitions for listed entities.	

(*continued*)

Independence threats	20_
5. Independence threats Identify and describe any significant threats to independence and the safeguards (if any) to reduce each threat to an acceptable level. Address each of the following threats in relation to the firm and any member of the engagement team: a) **Self-interest** (i.e., where the firm is economically dependent on maintaining the client fees or where audit judgments may be influenced by the desire to retain the client). b) **Self-review** (i.e., assisting the client in preparing the financial statements, providing bookkeeping services and making judgments for the client that will later need to be evaluated in reaching audit conclusions). c) **Advocacy** (i.e., acting as a client advocate in matters involving tax, litigation or share promotion). d) **Familiarity** (i.e., close, family or long-time relationships with the client could result in being too sympathetic to the client's interests). e) **Intimidation** (i.e., where the client makes threats, such as to replace our firm as auditors unless we agree to certain scope limitations or to accept management positions, without question, on accounting matters). Refer to the *Code of Professional Conduct/Code of Ethics* for guidance and interpretations. Comments:	

FIGURE 2.5 **Existing engagement continuance, PEG forms—audits, form 410, © 2017 CPA Canada PEG (*continued*)**

Source: PEG Forms—Audits, Form 410, © 2017 CPA Canada PEG.

If an independence threat appears insurmountable, an audit firm should consider declining an offer to act as an auditor of a prospective client or resign from the audit of an existing client. An example of such a threat is fee dependence, where the fees from a client would form a significant proportion of total fees earned. This can occur if a prospective client is much larger than an audit firm's current clients or if an existing client has grown significantly.

engagement letter letter that sets out the terms of the audit engagement, to avoid any misunderstandings between the auditor and their client

The final stage in the client acceptance and continuance decision process involves the preparation of an **engagement letter**. CAS 210 *Agreeing the Terms of Audit Engagements* provides guidance on the preparation of engagement letters. An engagement letter is prepared by an auditor and acknowledged by a client before the commencement of an audit. It is a form of contract between the auditor and the client. Engagement letters should be updated each year to remind management of the existing terms and for legal liability purposes. The purpose of the engagement letter is to set out the terms of the audit engagement to avoid any misunderstandings between the auditor and the client. The letter will confirm the obligations of both the client and the auditor.

An engagement letter includes an explanation of the scope of the audit, summarizes the responsibilities of management and the responsibilities of the auditor, identifies the applicable financial reporting framework, and makes reference to the expected form and content of the audit report. An example of an engagement letter for statements prepared in accordance with International Financial Reporting Standards (IFRS) is provided in the appendix to CAS 210. A sample engagement letter is illustrated in **figure 2.6**.

As indicated in the engagement letter, management is responsible for the entity's accounting process, which involves the recording of transactions and events. It is management's responsibility to ensure that the information is properly recorded, classified, and summarized at the end of the accounting period. Management is considered to be responsible for the financial statements and acknowledges this responsibility when they sign the engagement letter in which the following are outlined:

- Management is responsible for the selection and preparation of the financial statements in accordance with the appropriate financial reporting framework.
- Management is responsible for ensuring that there are adequate internal controls in place so that the prepared financial statements are free from material misstatement.
- Management is responsible for providing the auditor with unrestricted access to personnel and documents as needed.

By agreeing to the above, management acknowledges its understanding that the auditor does not have any responsibility for the preparation of the financial statements or for the entity's related internal controls, and that these concepts are fundamental for an independent audit.

FIGURE 2.6 **Example of an engagement letter**

W&S PARTNERS

1200-90 Eglinton Avenue East,
Toronto, ON M4P 2Y3.
Phone number: (416) 236-8743.

To those charged with governance of Securimax Ltd.

You have requested that we audit the financial statements of Securimax Ltd., which comprise the statement of financial position as at December 31, 2023, and the statement of comprehensive income, statement of changes in equity and cash flow statement for the year then ended, and notes to the financial statements, including a summary of significant accounting policies and other explanatory information. We are pleased to confirm our acceptance and our understanding of this audit 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 Canadian generally accepted auditing standards 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.

Our Responsibilities

We will conduct our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements. As part of an audit in accordance with Canadian generally accepted auditing standards, we exercise professional judgment and maintain professional skepticism 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 entity's 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 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.

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 Canadian generally accepted auditing standards.

Management's Responsibilities

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

(a) For the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards;

(*continued*)

(b) 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

(c) To provide us with:

(i) Access to all information of which management is aware that is relevant to the preparation of the financial statements such as records, documentation, and other matters;

(ii) Additional information that we may request from management for the purpose of the audit; and

(iii) Unrestricted access to persons within the entity from whom we determine it necessary to obtain audit evidence.

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

We look forward to full co-operation from your staff during our audit.

Reporting

Insert: appropriate reference to the expected form and content of the auditor's report.

The form and content of our report may need to be amended in the 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.

Acknowledged and agreed on behalf of Securimax Ltd.
by James Reynolds, CFO
Securimax Ltd.
October 1, 2023

FIGURE 2.6 **Example of an engagement letter (*continued*)**

Source: Auditing and Assurance Standards Board 2009, CAS 210 *Agreeing the Terms of Audit Engagements, App. 1.*

Cloud 9 Integrated Case

Sharon and Josh have already discussed some of the specific client acceptance issues, such as independence threats and safeguards. Sharon explains that they also have to consider the overall integrity of the client; that is, the management of Cloud 9. This means they need to perform and document procedures that are likely to provide information about the client's integrity. Josh is a little sceptical. "Do you mean that we should ask them if they are honest?" Sharon suggests that it is probably more useful to ask others, and the key people to ask are the existing auditors. Josh is still sceptical. "The existing auditors are Ellis & Associates. Are they going to help us take one of their clients from them?" Sharon says that the client must give permission first, and, if that is given, the existing auditor will usually state whether or not there were any issues that the new auditor should be aware of before accepting the work. Sharon also gives Josh the task of researching Cloud 9's press coverage, with a special focus on anything that may indicate poor management integrity.

Sharon emphasizes that they must perform and document procedures to test whether W&S Partners is competent to perform the engagement and has the capabilities, time, and resources to do so. For example, they must make sure that they have audit team members who understand the clothing and footwear business. They also must have enough staff to complete the audit on time. Cloud 9 has a December 31 year end. This means that most of the audit work will be done at a time of year when enough staff may not be available.

In addition, Sharon and Josh must perform and document procedures to show that W&S Partners can comply with all parts of the ethical code, not just those that focus on independence threats and safeguards. Finally, they can draft the engagement letter to cover the contractual relationship between W&S Partners and Cloud 9.

Before You Go On

2.6.1 What will an auditor consider in assessing the integrity of a client's management, board, and other personnel?

2.6.2 What are the key components of an engagement letter?

2.6.3 Why must an auditor seek a client's permission before communicating with its prior auditor or any other relevant third party?

Summary

1 Describe the fundamental principles of professional ethics.

The fundamental principles of professional ethics include professional behaviour (upholding the reputation of the profession); integrity (being straightforward and honest) and due care (acting diligently and complying with both technical and professional standards); professional competence (maintaining knowledge and skill at an appropriate level); confidentiality (not sharing information that is learned at work); and objectivity (not allowing personal feelings or prejudices to influence professional judgement). There are also specific rules that incorporate the guiding ethical principles and that are enforceable. Some of these rules concern fees and pricing, advertising, contact with predecessor auditors, firm names, and professional conduct. Despite principles and rules to guide professional conduct, professional accountants can expect to face ethical dilemmas over their careers. A framework for solving ethical dilemmas includes identifying the ethical issues, determining who is affected by the outcome of the dilemma and how each individual or group is affected, identifying the likely alternatives available to the person who must resolve the dilemma, and deciding on the appropriate action.

2 Describe professional judgement and professional scepticism.

Professional judgement relates to the level of expertise, knowledge, and training that an auditor uses throughout an audit. A framework for professional judgement decision-making includes identifying the issue, gathering the facts, performing the analysis, and making a decision. It also includes documenting the decision-making process. Professional scepticism is a component of professional judgement. Professional scepticism means having a questioning mind, being alert to conditions that indicate a misstatement whether due to fraud or error, and critically assessing evidence. While there are qualities associated with professional scepticism, external factors and unconscious biases can impede it. Common biases that can impede auditor professional scepticism are the availability bias, confirmation bias, overconfidence bias, and the anchoring bias.

3 Define and assess auditor independence.

Independence is the ability to make a decision that is free from bias, personal beliefs, and client pressures. An external auditor must not only be independent of their client, they must also appear to be independent of their client. Threats to auditor independence include self-interest, self-review, advocacy, familiarity, and intimidation threats. A self-interest threat can occur when an auditor has a financial interest in a client. A self-review threat can occur when an auditor must form an opinion on their own work or work done by others in their firm. An advocacy threat can occur when an auditor acts on behalf of their client. A familiarity threat can occur when there is a close relationship between the auditor and their client. An intimidation threat can occur when an auditor feels threatened by their client. Safeguards to auditor independence include the code of ethics, legislation, the establishment of audit committees by clients, client acceptance and continuance procedures, partner rotation policies, and education within accounting firms.

4 Explain the relationship between an auditor and key groups they have a professional link with during the audit engagement.

Auditors report to their clients' shareholders. These are the owners who rely on the audited financial statements when evaluating the performance of their company. The board of directors represents the shareholders and oversees the activities of the company and its management. It is the directors' responsibility to ensure that the financial statements being audited are fairly presented. The audit committee is responsible for liaising between the external auditor, the internal auditor, and those charged with governance to aid the board of directors in ensuring that the financial statements are fairly presented and that the external auditor has access to all records and other evidence required to form their opinion. The external auditor may use the work performed by the internal auditors after considering the function's objectivity, technical competence, and due professional care, and the effectiveness of communication between internal and external auditors.

5 Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.

Contributory negligence is where a client is found to be negligent and to have contributed to the loss suffered by the plaintiff. To successfully sue an auditor, a plaintiff must prove that a duty of care was owed by the auditor, there was a breach of that duty, and a loss was suffered as a result of that breach. Several cases are discussed in the chapter in relation to an auditor's liability to third parties. To establish that an auditor owes them a duty of care, a third party must now establish that the auditor was aware that the third party was going to use the financial statements and that the users relied on the financial statements for the purpose for which they were prepared.

6 Identify the factors to consider in the client acceptance or continuance decision.

Factors to consider include the integrity of a client, such as the client's reputation and attitude to risk, accounting policies, and internal controls. An auditor will gain an understanding of the client through communication with the client's previous auditor (in the case of a client acceptance decision), staff, management, and other relevant parties. The final stage in the client acceptance or continuance decision process involves preparing an engagement letter, which sets out the terms of the audit engagement to avoid any misunderstandings between the auditor and their client.

Key Terms

Advocacy threat 2-11
Audit committee 2-18
Board of directors 2-10
Confidentiality 2-4
Corporate governance 2-13
Due care 2-4
Engagement letter 2-26
Executive directors 2-17
Familiarity threat 2-12
Independence 2-9
Independent directors 2-14
Integrity 2-4
Internal auditors 2-18
Intimidation threat 2-12
Negligence 2-19
Non-executive directors 2-17
Objectivity 2-4
Professional behaviour 2-4
Professional competence 2-4
Reporting issuer 2-12
Self-interest threat 2-10
Self-review threat 2-11
Shareholders 2-17
Technical competence 2-19
Third parties 2-21

Self-Test Questions

Answers can be found in *WileyPLUS*.

2.1 Professional behaviour means that members of the professional body must:

a. maintain their knowledge and skill at the required level.

b. keep up to date with changes in regulations and standards.

c. act diligently.

d. uphold the reputation of the profession.

2.2 Due care means that members of a profession must:

a. act diligently.

b. claim to possess all qualifications.

c. question the reputation of accountants who are not members of professional bodies.

d. provide all services clients request.

2.3 The confirmation bias means:

a. an auditor remembers the most recent information.

b. an auditor believes she knows more than she does.

c. an auditor seeks only evidence that supports his belief.

d. an auditor develops an estimate and does not adequately adjust away from this amount.

2.4 Professional independence for auditors:

a. detracts from the ability of users to rely on the financial statements to make their decisions.

b. is the ability to act with integrity, objectivity, and professional scepticism.

c. is important when the auditor acts independently, and it does not matter what people believe about the auditor's independence.

d. is only relevant to audits for new clients, not for continuing clients.

2.5 A self-review threat arises when:

a. the auditor has a loan from the client.

b. the auditor represents the client in negotiations with a third party.

c. the auditor performs services for the client that are then assured.

d. there is a long association between the auditor and its client.

2.6 Safeguards to independence:

a. minimize the risk that a threat to independence will surface.

b. deal with a threat when one becomes apparent.

c. are developed by the accounting profession, legislators, regulators, clients, and accounting firms.

d. all of the above.

2.7 Audit committees for listed entities per the CSA:

a. must include the CFO if he or she is on the board of directors.

b. can be any size.

c. have the same chair as the board of directors.

d. should have a formal charter.

2.8 Generally, the auditor could be legally liable:

a. under contract law to third parties and to the client.

b. under contract law and under the tort of negligence to the client.

c. under contract law but not under the tort of negligence to third parties.

d. under the tort of negligence but not contract law to the client.

2.9 A client engagement letter should include all of the following except:

a. the objective and scope of the audit.

b. the expected form and content of the audit report.

c. management's responsibilities.

d. the results of previous audits.

2.10 If a prospective new audit client does not allow the auditor to contact its existing auditor:

a. the auditor should contact the existing auditor anyway because it is their duty.

b. the auditor should consider refusing to take on the prospective new client.

c. the existing auditor should contact the new auditor to tell them all about the client.

d. the auditor should respect the prospective client's right to privacy.

Review Questions

2.1 Explain how compliance with the fundamental principles in the code of professional conduct contributes to the ability of the auditor to discharge their duty to act in the public interest.

2.2 List and explain the four biases that may impair professional scepticism.

2.3 Which is more important, independence in fact or independence in appearance? Explain.

2.4 Self-interest, self-review, and familiarity threats all arise from an inappropriate closeness between the auditor and the client. Explain how that closeness is likely to manifest in each case and why it is a problem for the value of the audit.

2.5 How can accounting firms put in place safeguards to independence?

2.6 Explain the relationship between the auditor and the shareholders of the audited company. How realistic is it to regard the shareholders as the clients of the auditor?

2.7 What are the three conditions that must be proven for an auditor to be found negligent under tort law? Based on a review of the legal cases discussed in the chapter, which conditions appear to be most difficult to prove?

2.8 What are some ways an auditor can avoid litigation?

2.9 Why are there procedures governing the client acceptance or continuance decision? Explain why auditors do not accept every client.

2.10 What is the purpose of an engagement letter? What should be included in an engagement letter?

Professional Application Questions

Basic Moderate Challenging

2.1 Ethical principles Basic **LO 1**

Charles is at a neighbourhood party with several of his roommates. Over a few beers, Charles gets into a conversation with a neighbour, William, about mutual acquaintances. Charles is a senior auditor with a large accounting firm (although he tells William that he is a partner at the firm) and William works for a large bank. During the conversation, Charles and William discover that they have both had professional dealings with a particular family-owned manufacturing company. William reveals that the company's line of credit is about to be cancelled because of some irregularities with the security. Charles is concerned to hear this news because he has just participated in the company's financial statement audit and there was no indication of any problems with its borrowings. However, as Charles explains to William, he has his doubts about the patriarch of the family, who Charles believes is having an affair with his personal assistant. Charles also tells William that the family has quietly increased its shareholdings in a listed company that supplies components to the family's manufacturing company. The components manufacturing company is about to announce to the share market that it has just won a very large and very profitable contract with a Chinese company.

Required

Discuss the ethical principles that are potentially breached by Charles's behaviour at the party.

2.2 Application of the ethical framework Moderate **LO 5**

Hardeep Rahman is an audit senior with a national audit firm. Hardeep has been on the audit engagement of a private company, Grey & Sons Construction Ltd. Grey & Sons has been a client of the audit firm for a few years, and it has significant revenues but its profitability fluctuates. The construction company is managed by Sam Grey, who owns 51 percent of the business, and his son Josh, who owns 4 percent of the business. The remaining 45 percent of the business is owned by a variety of shareholders who invested in the business at a time Sam wanted to expand and needed a cash infusion to grow. The minority shareholders are not active in the business and so when they made their initial investment, they insisted that the annual financial statements be audited so they could have an independent opinion on the financial results.

Hardeep is now auditing the payables and expenses. He is aware that select members of management have company credit cards for business-related expenses. As Hardeep reviews the related payables, he notes that a number of significant charges are very large purchases of personal goods. It also comes to his attention that Sam is renovating his home, and he is buying most of the materials through the construction business. Most of the expenses are being recorded as repairs and maintenance, and supplies expense. Hardeep determines that the total amounts charged are just above materiality. He informs the audit partner, who says he will discuss this with Sam when he meets with him next week.

Required

Apply the ethical framework to this situation.

2.3 Ethical issues Moderate LO 1

You are a recently designated accountant. As a result of having your designation, you have been hired as the controller at a national manufacturing company. Due to a recent economic slowdown, the company has been struggling to meet earnings targets. These targets are the basis for senior management bonuses. You report directly to the CFO.

This is your second month with the company and it is your first year end (December 31). The auditor will be coming to audit the books in three weeks. You have finalized the financial statements, and you have reviewed them with the CFO and the CEO.

The week before the auditor is expected to arrive, the CFO comes to your office and explains that the financial results are very disappointing. He explains that on December 31, a sales contract was signed for $500,000 of goods with delivery to take place January 3. He asks you to record the revenue for this contract on December 31, the date the contract is signed and before the work is performed. This will result in early revenue recognition, and doing so will eliminate the overall net loss for the year.

You are married with a stay-at-home spouse and two small children. To celebrate your success, you recently purchased a new home. It cost a little more than you planned to spend and the mortgage payments are pretty expensive.

Required

What would you do? What are the ethical issues you would need to consider?

2.4 Ethical dilemma Moderate LO 1

Alex Wong, CPA, is a sole practitioner. He is having lunch with one of his long-time clients, Hudson Hughes. Hudson is very excited because he just hired a new bookkeeper, Laura Ling. This name seems familiar to Alex and so after lunch he does a web search and finds a picture of Laura on the Internet. He realizes that he knows Laura because she used to be the bookkeeper for a previous client, Mark's Meats. He remembers her because she was fired for stealing from Mark's. He recalls that she took cash from the cash sales and altered the sales and deposit records to hide the theft. The owner, Mark, didn't believe she stole a large sum before the theft was discovered. Because she was a single mother with small children, Mark fired her but did not get anyone else involved. Alex only knew about the theft because he conducted a review engagement of Mark's Meats for the year the fraud took place. Alex is concerned for Hudson Hughes, Laura's new employer, but he is not sure what he should do.

Required

a. Discuss the above in terms of the code of professional conduct.

b. Apply the ethical framework to this situation.

2.5 Professional scepticism Moderate LO 2

The auditor of a consumer goods business is working on a client's allowance for doubtful accounts. The auditor asks management what has changed with respect to accounts receivable over the prior year. The client responds that their customer composition has remained the same; therefore, they estimate a reasonable allowance would be 30 percent of accounts receivable over 90 days. The auditor reviews the preliminary accounts receivable balance and compares it with the prior year's, and notes while there has been a slight increase, it is not significant. As the auditor reviews the accounts receivable detail, she notes that much of the balance that is over 90 days due was also outstanding the prior year. When the auditor asks management about these accounts, management explains some of the customers are just very slow paying but they still believe they will get paid. The auditor plans to recalculate the allowance for doubtful accounts at 30 percent, similar to last year. But she wonders if it should be changed to 50 percent given that the outstanding balances are so old. The auditor feels she is now an expert at auditing accounts receivable because she has audited this section on her past two engagements.

Required

Discuss the biases in this situation that may be impairing the auditor's professional scepticism.

2.6 Principles and rules of the code of professional conduct Moderate LO 1, 3

Required

Identify and discuss any professional conduct and independence issues in the following independent scenarios.

a. Adnan Hussein is a CPA working for a national firm. He is at his desk when he overhears his colleague Joan having a phone conversation. She is telling the person on the other end of the call that Gupta Co., the firm's largest audit client, is about to release its audited annual financial statements and the results are spectacular. Joan says she just bought some shares as she expects that the share price will go up.

b. John Drake, a partner at Drake and Buetz, is meeting with a potential new client. The client recently saw the firm's TV advertisement claiming that the firm was "the premier accounting firm in western Canada." The client requires a review engagement report with its financial statements to obtain a bank loan. John advises that his fee will be 10 percent of any bank loan granted.

c. Sue Chen, CPA, is working on the audit engagement for Jones Construction, a reporting issuer. José, the accountant at Jones Construction, is unsure how to calculate the tax provision. Sue has advised José not to worry. She will prepare the tax provision and ensure that the disclosures are in accordance with generally accepted accounting principles (GAAP) so that she can issue an unmodified audit opinion.

d. Sue Chen is working on the audit engagement for Clara's Cleaning Services, a private entity. During the course of the engagement, she prepares a number of routine journal entries. She makes the required adjustments and reviews them with Clara, who signs off on them, before she releases the financial statements.

e. Sue Chen is working on the compilation engagement for Franks Foods, a private entity. During the course of the engagement, she prepares a number of routine journal entries. She makes the required adjustments before she releases the financial statements.

f. Jack Bond is a partner in a national firm. He is responsible for the audit for Canada Bank. He recently purchased a car for his daughter and took out a car loan with Canada Bank.

g. Philip Monroe is a partner in a national firm. The firm is the auditor for Canada Bank. Philip's father-in-law is the chief operating officer for Canada Bank.

h. James Lei, CPA, is reviewing his firm's accounts receivable. He notices that one of his largest audit clients has not paid its fees for the past two years.

i. Alison Kotecha, CPA, is meeting with a potential new audit client, Klein Advertising. She paid Johan Smit, a former colleague, $1,000 for the referral. Although she hasn't performed any audit engagements for the past four years, she did recently take a GAAP course. During the meeting, she reads over the prior year's financial statements and tells the client she will accept the engagement. After reading the financial statements, she is certain that the fee will be less than the fee charged by the previous auditor.

j. Matt Green, CPA, is married to Jennifer Green, who owns Muffins to Go, a small private entity. Jennifer is a baker and not an accountant. However, she needs a set of financial statements prepared to attach to her tax return. Her husband Matt tells her that he will prepare them.

2.7 Professional conduct **Moderate** **LO 1, 3**

Required

Identify and discuss any professional conduct issues in the following independent scenarios.

a. Jason Crane became a CPA in 2023. He is now glad to be finished his education as he does not plan to take any further accounting courses.

b. Samantha Karadzic received a letter from Malik and Rudolph, another accounting firm, asking if there is any reason they should not accept the audit engagement of her biggest client, Franks Plumbing Inc. Samantha was so upset about losing the client, she threw the letter away and decided not to reply. She ignored all requests for the client's records.

c. Sophie Kramer received a letter from Malik and Rudolph, another accounting firm, asking if there is any reason they should not accept one of her clients, Vanderkrujk Farm Ltd. Because she had disputes with management of Vanderkrujk, she was glad to see them go. She called Malik and Rudolph right away and told them about all of the issues she had.

d. William Aruna decided to start his own CPA firm as a sole practitioner. In order to attract new clients, he wants potential clients to believe he has a large established firm with many partners. Therefore, he has called his firm Aruna and Partners. His advertising materials indicate the firm has the largest number of audit partners in the region.

e. Alan Reed discovered his long-time client, the Daily Diner, was in financial distress. He decided to lend the Diner $20,000 and he had the owner sign a note payable. He informed Canada Bank, the primary user of the financial statements, of this loan after the audit report was issued.

2.8 Independence safeguards **Basic** **LO 3**

Stave, Brown and Paul, a three-partner accounting firm, has implemented the following independence safeguards.

1. In the audit report for Weltzin Educational Services Inc., partner Jessica Brown has the CFO of Weltzin sign the following: "I approve the proposed journal entries made by Stave, Brown and Paul."
2. On January 3 of each year, the firm has all of its staff review a client list and sign a disclosure statement indicating whether they hold any shares in any of the clients.
3. Cameron Stave has been the lead engagement partner on the Borba Manufacturing Ltd. audit for the past six years. This year, Jessica Brown will fulfill that role.
4. The firm's policy states it is inappropriate for staff to date client personnel.
5. Every six months, Jessica Brown reviews the proportion of fees per client to total fees.
6. Jake Paul has decided to leave the partnership. He intends to go work for his largest audit client after he travels through Asia over the next year.

Required

For each safeguard above, identify the independence threat the safeguard is designed to prevent.

2.9 Receiving shares through inheritance **Moderate** **LO 1, 3, 4, 6**

Kerry is a senior auditor and a member of the team auditing a long-standing client, the listed public company Darcy Industries Ltd. Kerry's wife's uncle died recently and his estate is being finalized. Kerry's wife has just received a letter from the executor of her uncle's estate advising her that she will receive a large parcel of shares in Darcy Industries from the estate, in addition to cash and other property. Kerry and his wife didn't know that her uncle had included her in the will, and they had not realized that her uncle was a large shareholder in Darcy Industries. Kerry's wife is very worried because she knows that Kerry must abide by strict rules laid down by his audit firm about holding shares in client companies. She asks him if he will be dismissed because of this.

Required

Advise Kerry's wife of the options available to Kerry to avoid any conflict of interest, and thus avoid being dismissed from the audit firm.

2.10 Provision of non-audit services to audit clients **Moderate** **LO 1, 3, 4, 6**

Elise Lauzière is the partner in charge of the audit of Hertenstein Ltd., a large listed public company. Elise took over the audit from Marjorie Szliske, who has recently retired from the audit firm. Marjorie was a very experienced auditor and the author of several reports into ethical standards in business, but Elise did not regard her highly for her ability to grow non-audit service fee revenue. Elise sees an opportunity to increase the provision of non-audit services to Hertenstein and thus increase her reputation within the audit firm.

Required

a. Comment on Elise's belief that increasing non-audit service fee revenue from her audit client would increase her reputation in the audit firm.

b. Which non-audit services would you advise Elise to avoid trying to sell to Hertenstein because of the potential ethical issues for the audit firm?

c. Would it make any difference to your answers if Hertenstein was a private company, not a listed public company? If so, how? If not, why not?

2.11 Unpaid audit fees **Moderate** **LO 3, 4, 6**

Linda is the managing partner of Osuji and Associates, a small audit firm. Linda's role includes managing the business affairs of the firm, and she is very worried about the amount of fees outstanding from audit clients. One client, Dreamers Ltd., has not paid its audit fees for two years despite numerous discussions between Linda, the audit partner Bill, and the management of Dreamers. Dreamers' management promised the fees would be paid before the audit report for this year was issued. Linda called Bill this morning to ensure that the audit report was not issued because Dreamers had paid only 10 percent of the outstanding account. She discovers that Bill is about to sign the audit report.

Required

Explain the ethical problem in this case. Why is it a problem? What can be done about it?

2.12 Independence threats and safeguards **Moderate** **LO 3, 4**

Featherbed Surf & Leisure Holidays Ltd. (Featherbed) is a resort company based on Vancouver Island. Its operations include boating, surfing, fishing, and other leisure activities; a backpackers' hostel; a family hotel; and a five-star resort. Justin and Sarah Morris own the majority of the shares in the Morris Group, which controls Featherbed. Justin is the chair of the board of directors of both Featherbed and the Morris Group, and Sarah is a director of both companies as well as the CFO of Featherbed.

In February 2023, Justin approached your audit firm, KFP Partners, to carry out the Featherbed audit for the year ending June 30, 2023. Featherbed has not been audited before but this year the audit has been requested by the company's bank and a new private equity investor group that has just acquired a 20 percent share of Featherbed. You know that one of the partners at KFP went to school with Justin and has been friends with both Justin and Sarah for many years.

Required

a. Identify and explain the significant threats to independence for KFP Partners in accepting the audit of Featherbed.

b. Explain any relevant and practical safeguards that KFP could implement to reduce the threats.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, May 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

2.13 Independence threats and safeguards **Moderate** **LO 3, 4**

Securimax Limited has been an audit client of KFP Partners for the past 15 years. Securimax is based in Waterloo, Ontario, where it manufactures high-tech armour-plated personnel carriers. Securimax often has to go through a competitive market tender process to win large government contracts. Its main product, the small but powerful Terrain Master, is highly specialized, and Securimax does business only with nations that have a recognized, democratically elected government. Securimax maintains a highly secure environment, given the sensitive and confidential nature of its vehicle designs and its clients.

Clarke Field has been the engagement partner on the Securimax audit for the past five years. Clarke is a specialist in the defence industry and intends to remain as review partner when the audit is rotated next year to a new partner (Sally Woodrow, who is to be promoted to partner to enable her to sign off on the audit).

In September 2023, Securimax installed an off-the-shelf costing system to support the highly sophisticated and cost-sensitive nature of its product designs. The new system replaced a system that had been developed in-house, as the old system could no longer keep up with the complex and detailed manufacturing costing process that provides tender costings. The old system also had difficulty with the company's broader reporting requirements.

Securimax's information technology (IT) department, together with the consultants from the software company, implemented the new manufacturing costing system. There were no customized modifications. Key operational staff and the internal audit team from Securimax were significantly engaged in the selection, testing, training, and implementation stages.

The manufacturing costing system uses all of the manufacturing unit inputs to calculate and produce a database of all product costs and recommended sales prices. It also integrates with the general ledger each time there are product inventory movements such as purchases, sales, wastage, and damaged inventory losses.

Securimax has a small internal audit department that is headed by an ex-partner of KFP, Rydell Creek. Rydell joined Securimax after leaving KFP six years ago after completing his Chartered Professional Accountant's qualifications. Rydell is assisted by three junior internal auditors, all of whom are completing undergraduate business studies at the University of Waterloo.

Securimax's financial year end is December 31.

Required

a. Are there any threats to independence for KFP in its audit of Securimax?

b. Can you propose any recommendations to safeguard KFP against the potential independence threats you have identified? Explain.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, May 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

Questions 2.14 and 2.15 are based on the following case.

Fellowes and Associates Chartered Professional Accountants is a successful mid-tier accounting firm with a large range of clients across Canada. In April 2023, Fellowes and Associates gained a new client, Health Care Holdings Group (HCHG), which owns 100 percent of the following entities:

- Shady Oaks Centre, a private treatment centre
- Gardens Nursing Home Ltd., a private nursing home
- Total Laser Care Limited (TLCL), a private clinic that specializes in the laser treatment of skin defects

The year end for all HCHG entities is June 30.

TLCL owns two relatively old laser machines used in therapy. Recently, staff using these machines have raised concerns that they have adverse impacts on patients.

The CEO of TLCL, Betty Raman, has approached Tania Fellowes, the audit partner responsible for the financial statement audit, about undertaking an engagement with respect to the laser machines. Betty has asked Tania to provide an opinion that the machines are fit for use. Betty pointed out that the auditor for TLCL has not been appointed for the following year and suggested Fellowes and Associates might like to take on the laser machines engagement without charging a fee as a gesture of goodwill.

Prior to the appointment as the auditor for HCHG, the group that controls TLCL, some preliminary analysis by Tania identified the following situations:

1. One of the accountants who intended to be part of the 2023 audit team owns shares in HCHG. The accountant's interest is not material to him.
2. Fellowes and Associates was previously engaged by HCHG to value its intellectual property. The consolidated balance sheet (statement of financial position) as at June 30, 2023, includes intangible assets of $30 million, which were valued by Fellowes and Associates on March 1, 2023, following HCHG's acquisition of the subsidiary Shady Oaks Centre. The intangibles are considered material to HCHG.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, December 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

2.14 Ethics of accepting engagements **Moderate** **LO 1, 6**

Required

Explain why Tania Fellowes should have reservations about accepting the TLCL engagement to provide an opinion with respect to the laser machines. Make appropriate reference to fundamental ethical principles in your answer.

2.15 Independence issues in accepting engagements **Moderate** **LO 1, 3, 4, 6**

Required

a. Identify and explain the potential type of threat to Fellowes and Associates' independence in situations (1) and (2) above.

b. What action should Fellowes and Associates take to eliminate the potential threats to independence in situations (1) and (2) above? What safeguards should be instituted to reduce the risk of similar independence threats occurring in the future?

2.16 Independence considerations **Challenging** **LO 3, 4, 6**

You are the audit manager of Currant & Co and you are planning the audit of Orange Financials Co (Orange), which specializes in providing loans and financial advice to individuals and companies. Currant & Co has audited Orange for many years.

The directors of Orange are planning to list it on a stock exchange within the next few months and have asked if the engagement partner at Currant & Co can attend the meetings with potential investors. In addition, as the finance director of Orange is likely to be quite busy with the listing, he has asked if Currant & Co can prepare the financial statements for the current year to later be audited.

During the year, the assistant finance director of Orange left and joined Currant & Co as a partner. It has been suggested that, due to his familiarity with Orange, he should be appointed as the partner on the audit engagement.

Once Orange obtains its stock exchange listing, it will require several assignments to be undertaken, such as obtaining advice about corporate governance best practice. Currant & Co is very keen to be appointed to these engagements; however, Orange has implied that, in order to gain this work, Currant & Co needs to complete the external audit quickly and with minimal questions or issues.

The finance director has informed you that, once the stock exchange listing has been completed, he would like the engagement team to attend a weekend away at a luxury hotel with his team, as a thank you for all their hard work. In addition, he has offered a senior member of the engagement team a short-term loan at a significantly reduced interest rate.

Required

a. Explain six ethical threats that may affect the independence of Currant & Co's audit of Orange. For each threat, explain how it might be reduced to an acceptable level.

b. Orange is aware that subsequent to the stock exchange listing it will need to establish an audit committee and has asked for some advice in relation to this. Explain the benefits to Orange of establishing an audit committee.

Source: Adapted from ACCA Audit Framework, Paper 6, June 2013 exam.

2.17 Using the work of internal auditors **Moderate** **LO 4**

Theobald Ltd. has an internal audit department that primarily focuses on audits of the efficiency and effectiveness of its production departments. The other main role of the internal audit department is auditing compliance with various government regulations surrounding correct disposal of waste and storage of raw materials at its five factories. Theobald's internal audit department is run by Harry Giolti, a professional accountant and a member of the Institute of Internal Auditors. There are three other members of the department, all of whom have experience in performance auditing and, in addition, have completed industry-run training courses in waste management and handling dangerous goods. Harry meets regularly with the chief production manager and sends monthly reports to the CEO and the board of directors. Your initial investigations suggest that Harry is highly regarded within Theobald, and his reports are often discussed at board meetings. In most cases, the board authorizes the actions recommended in Harry's reports with respect to major changes to production and logistics.

Required

Comment on the extent of reliance the external auditor should place on the work of the internal audit department at Theobald. Explain the likely impact of the internal audit department's work on the audit plan.

2.18 Legal implications of client acceptance **Moderate** **LO 5, 6**

Godwin, Key & Associates is a small but rapidly growing audit firm. Its success is largely due to the growth of several clients that have been with the firm for more than five years. One of these clients, Carolina Ltd., is now listed on the TSX and must comply with additional reporting regulations. Carolina's rapid growth has meant that it is financially stretched and its accounting systems are struggling to keep up with the growth in business. The client continuance decision is about to be made for the next financial year.

The managing partner of Godwin, Key & Associates, Rebecca Haque, has recognized that the audit firm needs to make some changes to deal with the issues created by the changing circumstances of their major client and the audit firm's overall growth. She is particularly concerned that the audit firm could be legally liable if Carolina's financial situation worsens and it fails.

Required

a. Provide guidance to Rebecca about the steps she can take to avoid the threat of litigation if Carolina fails.

b. What should Rebecca consider when making the client continuance decision for Carolina for the next financial year?

[1]**2.19** Auditor legal liability **Moderate** **LO 5**

Ahmad & Partners is a public accounting firm in eastern Canada. Last year, it audited Chan Corporation, a publicly traded company that manufactures automobile component parts. Although the company has been profitable for many years, Ahmad & Partners was hired by Canada Bank, which was considering extending a large loan to Chan. The bank wanted the audit because Chan's expansion plans would change the company's financial structure significantly from the previous year. Ahmad & Partners conducted the audit and gave an unmodified opinion. Xing Investments Inc. purchased $750,000 of the common shares of Chan, intending to hold the shares as a long-term investment. Unfortunately, Chan went bankrupt shortly after the share purchase and Xing Investments lost all of its investment. Canada Bank was unable to recover any of its loan to the company. Xing Investments and Canada Bank subsequently sued Ahmad & Partners to recover their losses.

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Required

a. Did Ahmad & Partners owe a duty of care to Xing Investments?

b. What are some of the arguments Ahmad & Partners could make in their defence?

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[2]**2.20** Auditor legal liability **Moderate** **LO 5**

HHH Corporation manufactures automobile engines. In 2021, the treasurer at HHH decided to invest the company's surplus funds in the commodities market. She intended for it to be a short-term investment, as the company had $1 million in extra funds that would not be needed for three months. Unfortunately, the market price of the commodity she purchased declined sharply and in three months the investment was sold for only $500,000. The treasurer prepared documents to make the loss of the investment appear as a sale of excess inventory, so the company showed a lower profit on sales than usual, but no trading loss. The auditor audited the 2021 financial statements and issued an unmodified report, even though the amount in question exceeded the materiality threshold. HHH has always been owned privately. In 2022, all of the shares of the company were purchased by a group of engineers who had retired from the automobile industry. There were no other changes in the shareholders during 2022 or 2023.

Required

Assume that the new shareholders of HHH sued the auditors. Explain how the elements of negligence would apply to this case.

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[3]**2.21** Ethical issues and consequences **Challenging** **LO 1, 2, 3, 4, 5**

Roy Dussault is a CPA who started a sports equipment importing business. The business became very successful and he sold it to his neighbour. As part of the sale agreement, Roy agreed to perform an audit of the financial statements for the first year at no charge.

Roy told the new owner that there would be no problem in issuing an unmodified opinion if the new owner operated the business without increasing the debt levels and kept inventory low. Roy has also been a partner in an audit firm for several years and, to avoid any ethical problems, Roy arranged for other staff to do the audit. Roy only reviewed the work of the other auditors and did not do any of the audit planning or testing himself. The audit for the first year was free, and if the new owner wanted an audit for the second year, Roy's firm would only charge 5 percent of the net income of the company.

Roy's firm found no material misstatements but the audit report noted a going concern issue. The new owner took on extra debt from a private source, trying to expand the business too quickly. The excess debt caused the company's current ratio to fall below 1.8, which violated a covenant of the company's bank loan agreement. Under the terms of the lending agreement, the bank then called its loan and the new owner went into bankruptcy within 18 months.

The new owner sued Roy's audit firm for negligence, claiming that Roy had issued an audit report that ruined her business.

Required

a. Identify and explain at least four ethical issues in the above situation.

b. Explain whether or not Roy's audit firm could be found negligent by issuing the audit report that harmed the client's business.

c. Discuss whether Roy has applied sound professional judgement and professional scepticism.

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2.22 Client acceptance **Challenging** **LO 2, 3, 4, 5**

Salt & Pepper & Co is a firm of Chartered Professional Accountants that has seen its revenue decline steadily over the past few years. The firm is looking to increase its revenue and client base and so has developed a new advertising strategy. It is guaranteeing that all audit engagements will be completed

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for a fixed fee and all audits will be completed within a two-week time frame. In addition, Salt & Pepper has offered all new audit clients free bookkeeping services for the first year of the engagement, as it is believed that time spent on the audit will be reduced if the firm has produced the financial statements.

The firm is seeking to reduce audit costs and has therefore decided not to update the engagement letters of existing clients, on the basis that these letters do not tend to change much on a yearly basis. One of Salt & Pepper's existing clients has proposed that this year's audit fee should be based on a percentage of their final pre-tax profit. The partners are excited about this option as they believe it will increase the overall audit fee.

Salt & Pepper has recently obtained a new audit client, Cinnamon Co., whose year end is December 31. Cinnamon requires its audit to be completed by the end of February; however, this is a very busy time for Salt & Pepper and so it is intending to use more junior staff as they are available. Additionally, in order to save time and cost, Salt & Pepper has not contacted Cinnamon's previous auditors.

Required

a. Describe the steps that Salt & Pepper should take in relation to Cinnamon prior to accepting the audit.

b. State four matters that should be included within an audit engagement letter.

c. Identify and explain five ethical and engagement issues that arise from the above actions of Salt & Pepper, and for each issue explain the steps that Salt & Pepper should adopt to reduce the risks arising.

d. Comment on whether the auditor has applied sound professional judgement and professional skepticism

Source: Adapted from ACCA Audit Framework, Paper 6, June 2013 exam.

Case Study 2.1—Cloud 9

Sharon Gallagher, Josh Thomas, and Jo Wadley are members of the audit firm W&S Partners. Sharon is the audit manager and Josh is the audit senior assisting the partner, Jo, evaluate the decision to accept the Cloud 9 Ltd. audit engagement for the year ending December 31, 2023.

Background information about the company is presented in Appendix A of this book. In addition, Josh has discovered the following facts and has requested your help to document and assess the factors that affect the client acceptance decision.

- The finance director of Cloud 9, David Collier, is married to a distant relation of P. S. Nethercott, a partner in W&S Partners' consulting department.
- The consulting department at W&S Partners has quoted on an IT installation project at Cloud 9. The fees from this project, if the tender is successful, would be twice the size of the audit fee.
- A survey of audit staff at W&S Partners has revealed that 30 percent have purchased Cloud 9's products (basketball shoes) in the past.
- Four members of the IT department at W&S Partners have shares in retailers that sell Cloud 9's products. In each case, the shareholdings were disclosed on the firm's share register, and the size of the shareholding is deemed material under W&S Partners' ethical guidelines.
- An article in a newspaper published in Canada has claimed that Cloud 9 Inc. (Cloud 9's parent company) was secretly running "third-world sweat shops." The article alleged that shoes made by other wholly owned subsidiaries of Cloud 9 Inc. in China and Brazil were using illegal child labour in factories that did not meet local health and safety rules. Cloud 9 Inc. has vehemently disputed the accuracy of the article, suggesting that it was planted by a rival company. Cloud 9 Inc. has invited international advocacy groups to visit its factories at any time.

Required

Answer the following questions based on the information presented above, in Appendix A of this book, and throughout this chapter.

a. Explain the impact, if any, of each piece of information relevant to your client acceptance decision for Cloud 9.

b. List and explain any additional actions you would take before making your client acceptance recommendation to the partner, Jo Wadley.

c. Assume the decision is made to accept Cloud 9 as a client. Prepare the client engagement letter.

Research Question 2.1

One way of getting accounting expertise onto audit committees is to recruit ex-audit firm partners and/or employees onto the board of directors. However, appointing former audit firm partners to boards and audit committees raises independence concerns, and the Canada Business Corporations Act states that a retired partner must not take on a senior role at an audit client's firm for one year after retiring.

An article by V. Naiker and D.S. Sharma provides evidence that financial statements are of higher quality when former audit partners are on the audit committee, and raises doubts about the benefits of a rule limiting their recruitment.

Required

a. What are the arguments for and against allowing former audit firm partners and/or employees to join audit committees?

b. Explain how these accounting experts could help or hinder the audit process and thereby have an impact on the quality of a company's internal controls and financial statements.

Further Reading

CPA Code of Professional Conduct

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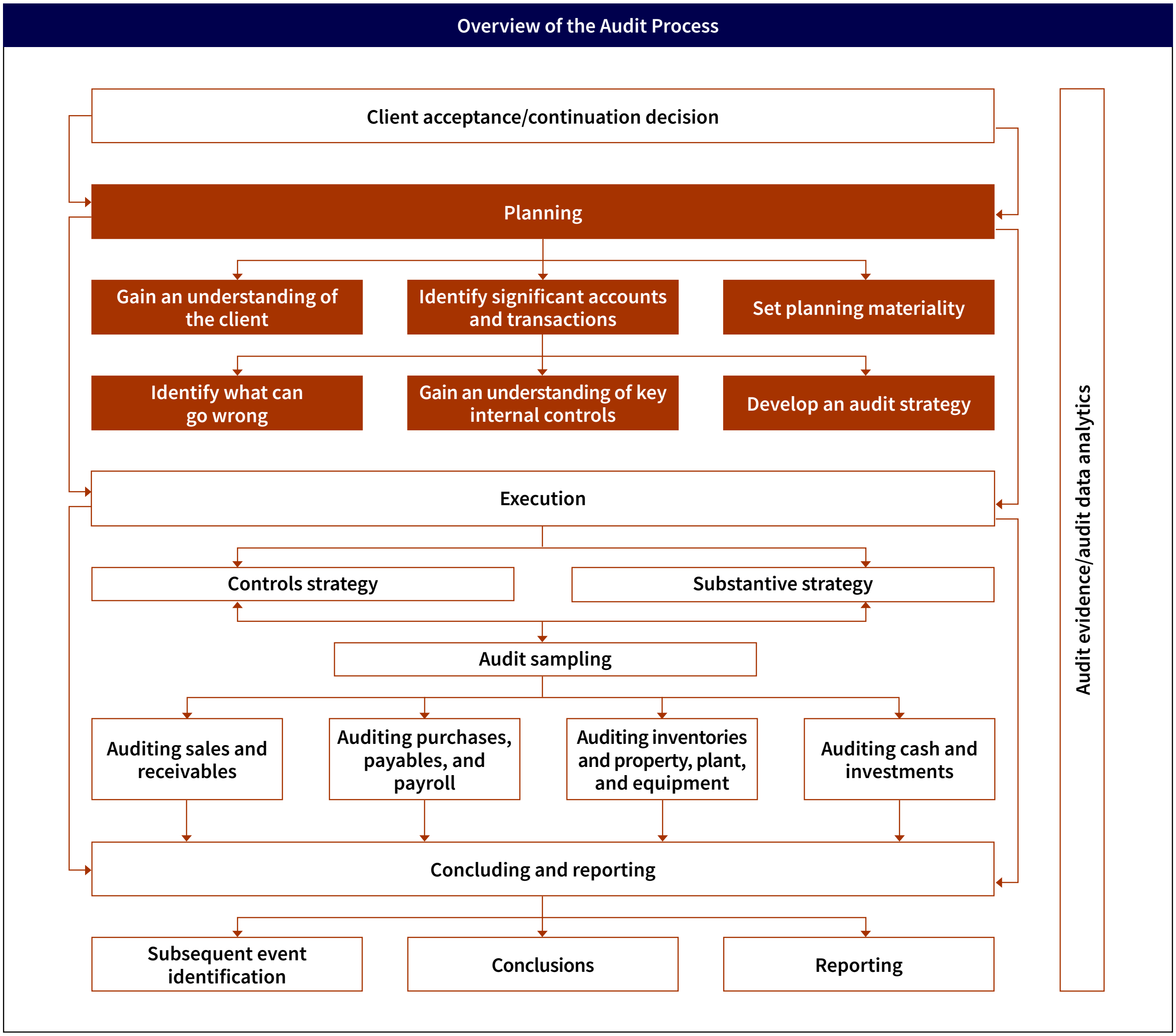
Audit Planning I



LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
After studying this chapter you should be able to:		Standards addressed in each learning objective are as follows:
1 Identify the different phases of an audit	**3.1** Phases of an Audit **3.1.1** Risk assessment phase **3.1.2** Risk response phase **3.1.3** Concluding and reporting on an audit	CAS 300 *Planning an Audit of Financial Statements*
2 Explain the process used in gaining an understanding of the client	**3.2** Gaining an Understanding of the Client **3.2.1** Entity level **3.2.2** Industry level **3.2.3** Economy level	CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
3 Explain how related parties can impact risk	**3.3** Related Parties	CAS 315 *Identifying and Assessing the Risks of Material Misstatement* CAS 550 *Related Parties*
4 Evaluate fraud risk	**3.4** Fraud Risk **3.4.1** Incentives and pressures to commit a fraud **3.4.2** Opportunities to perpetrate a fraud **3.4.3** Attitudes and rationalizations to justify a fraud **3.4.4** Audit procedures relating to fraud	CAS 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
5 Explain the going concern assumption	**3.5** Going Concern **3.5.1** Going concern risk—indicators **3.5.2** Going concern risk—mitigating factors	CAS 570 *Going Concern*
6 Explain how estimates can impact risk	**3.6** Auditing Estimates and Related Disclosures **3.6.1** Risk assessment and estimation uncertainty **3.6.2** Estimates and the entity level risk assessment	CAS 315 *Identifying and Assessing the Risks of Material Misstatement* CAS 540 *Auditing Accounting Estimates and Related Disclosures*
7 Appraise corporate governance	**3.7** Corporate Governance	CAS 315 *Identifying and Assessing the Risks of Material Misstatement*

LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
8 Evaluate how a client's information technology (IT) can affect risk	**3.8** Information Technology	CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
9 Explain how a client's financial reporting practices and closing procedures can affect reported results	**3.9** Financial Reporting and Closing Procedures	CAS 315 *Identifying and Assessing the Risks of Material Misstatement*

Cloud 9 Integrated Case

"Great news!" announces Sharon Gallagher at the weekly team meeting. "We have just had word that the audit engagement letter for Cloud 9 Ltd. (Cloud 9) has been signed. We are now officially their financial statement auditors and the planning phase starts now!"

Later, at the first planning meeting, Sharon and Josh Thomas focus on assigning the tasks for gaining an understanding of Cloud 9. Ian Harper, a first-year graduate, is not happy. He grumbles to another new member of the team, Suzie Pickering, as he leaves the room, "This is such a waste of time. Why did we sign an engagement letter if we don't understand the client? Why don't we just get on with the audit? What else is there to know?"

"Oh boy, are you missing the point!" Suzie says. "If you don't spend time planning, where are you going to start 'getting on with it'?"

"The same place you always start," replies Ian. Suzie realizes that she has a big job explaining to Ian, and invites him for a coffee so that they can talk. Although Suzie is new to the team, she has audit experience with other clothing and footwear clients, and will be helping Sharon and Josh manage the Cloud 9 audit. Her first question to Ian at coffee is "What do you think could go wrong with the Cloud 9 audit?"

Chapter Preview

Audit planning is an important topic. In this chapter, we begin with a discussion of the different phases of the audit: the risk assessment phase, the risk response phase (where the detailed work is conducted), and the reporting phase (where the audit opinion is formed). At the risk assessment and reporting phases, the auditor adopts a broad view of the client as a whole and the industry in which it operates. An understanding of the client is gained in the early stages of each audit and that knowledge drives the planning of the audit. It informs the choice of where to focus the most attention throughout the audit. When forming an opinion on the fair presentation of the financial statements, consideration is given to the evidence gathered during the risk response phase of the audit, placing that information within the context of the knowledge of the client gained from the risk assessment phase.

During the risk assessment phase of an audit, an assessment is made of the risk that a material misstatement (significant error or fraud) could occur in the client's financial statements. By understanding where the risks are most significant, an auditor can plan their audit to spend more time where the risks are greatest. During the risk assessment phase, an auditor will gain an understanding of their client, their client's internal controls, their client's information technology (IT) environment, their client's corporate governance environment, and their client's financial reporting requirements and closing procedures. An auditor will identify any related parties, factors that may affect their client's going concern status, and significant accounts, accounting estimates, and classes of transactions that will require close audit attention to gauge the risk of material misstatement.

Each of these important elements of the risk assessment phase of the audit is considered in this chapter. The process adopted when gaining an understanding of a client is explained in detail. That explanation is followed by a discussion of the specific audit risks associated with related party transactions and the risk that a client's financial statements are misstated due to fraud. The audit procedures used to assess the risk that a fraud has occurred and common frauds are included in the discussion. That is followed by a discussion of the processes used to assess the going concern assumption and the considerations in assessing the risk of material misstatement relating to accounting estimates.

Corporate governance is the rules, systems, and processes within companies used to guide and control. During the risk assessment phase, an auditor will assess the adequacy of their client's corporate governance structure in assessing the risk that the financial statements are materially misstated.

A client's IT system is used to capture, process, and report on the accounting records. During the risk assessment phase, an auditor will assess the extent and adequacy of their client's IT system. This process is discussed in this chapter.

The final section of this chapter includes a discussion of the procedures used by an auditor to assess their client's financial reporting requirements and closing procedures. The auditor needs to understand changes to the client's business during the year to understand the impact on financial reporting. Closing procedures aim to ensure that transactions are recorded in the appropriate accounting period. An auditor will assess the adequacy of their client's closing procedures to assess the risk that a material misstatement will occur in the financial statements as a consequence.

3.1 Phases of an Audit

LEARNING OBJECTIVE 1

Identify the different phases of an audit.

risk assessment phase the audit stage involving gaining an understanding of the client, identifying risk factors, developing an audit strategy, and assessing materiality

materiality the magnitude of a misstatement or omission that may influence the economic decision of a user

audit strategy a strategy that sets the scope, timing, and direction of the audit and provides the basis for developing a detailed audit plan

Before beginning our discussion of audit planning, we provide an overview of the various phases of the audit, which is represented diagrammatically in **figure 3.1**. The main phases of an audit are risk assessment, risk response, and reporting. Once the client acceptance or continuation decision has been made, the first phase of the audit is assessing the client risk and planning the audit. Broadly, the **risk assessment phase** involves gaining an understanding of the client, identifying factors that may impact the risk of a material misstatement in the financial statements, performing a risk and **materiality** assessment, and developing an **audit strategy**. The risk of a material misstatement is the risk that the financial statements include a significant error or fraud. The **risk response phase** (or performing stage) of the audit involves the performance of detailed testing of controls and substantive testing of transactions and accounts. The **reporting phase** involves evaluating the results of the detailed testing in light of the auditor's understanding of their client and forming an opinion on the fair presentation of the client's financial statements. An overview of each stage of the audit follows.

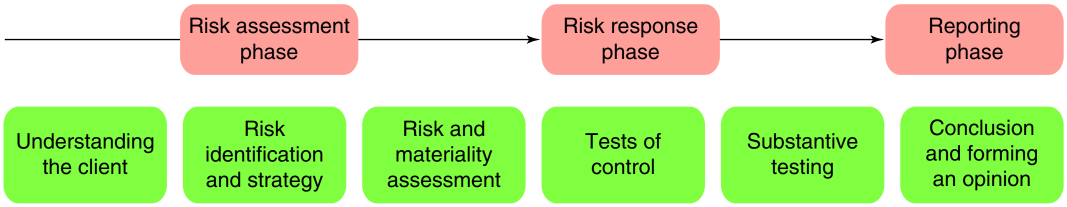


FIGURE 3.1 **Overview of the audit**

risk response phase the audit stage involving detailed testing of controls and substantive testing of transactions and accounts

reporting phase the audit stage involving evaluating the results of the detailed testing in light of the auditor's understanding of their client and forming an opinion on the fair presentation of the client's financial statements

3.1.1 Risk Assessment Phase

CAS 300 *Planning an Audit of Financial Statements* requires that an auditor plan their audit to reduce audit risk to an acceptably low level. Audit risk is the risk that an auditor issues an unmodified opinion when the financial statements are in fact materially misstated. The risk assessment phase involves assessing the audit risk and materiality, determining the audit strategy, as well as identifying the nature and the timing of the procedures to be performed. In order to plan an efficient and effective audit, an auditor must understand the entity and its environment to make a reasonable preliminary assessment of audit risk and materiality.

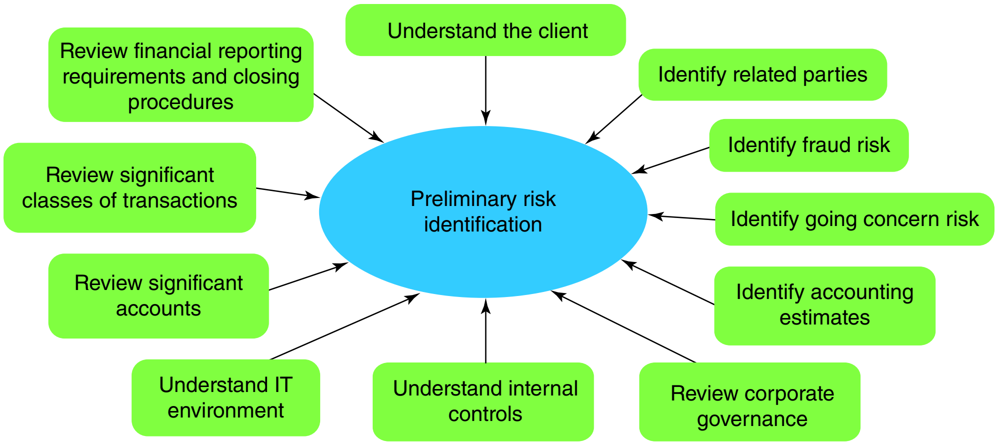


FIGURE 3.2 **Preliminary risk identification**

This also allows the auditor to identify any significant risks or unique features of the entity or the environment that may impact the audit planning. Efficiency refers to the amount of time spent gathering audit evidence. Effectiveness refers to the minimization of audit risk. A well-planned audit will ensure that **sufficient appropriate evidence** is gathered for those accounts at most risk of material misstatement. **Figure 3.2** provides a graphical depiction of the preliminary risk identification process used during the risk assessment phase of each audit.

sufficient appropriate evidence the quantity and quality of the evidence that has been gathered

Each element of figure 3.2 is now discussed in turn, starting with "understand the client" and proceeding clockwise. The process used by an auditor when gaining an understanding of their client is outlined in section 3.2. Part of that process includes the identification of a client's related parties to ensure that they are identified and appropriately disclosed following the relevant accounting standards. CAS 550 *Related Parties* provides audit guidance associated with related party transactions and disclosures. This is further discussed in section 3.3.

When planning an audit, an auditor will assess the risk of material misstatement due to **fraud** (CAS 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*) and consider whether it is appropriate to assume that their client will remain as a **going concern** (CAS 570 *Going Concern*). Fraud risk is discussed in section 3.4 and going concern is discussed in section 3.5. The impact of accounting estimates is discussed in section 3.6.

fraud an intentional act through the use of deception to obtain an unjust or illegal advantage

going concern the viability of a company to remain in business for the foreseeable future

A client's **corporate governance** structure, that is, the rules, systems, and processes within an entity to guide and control, is assessed when planning an audit. Best practices with respect to corporate governance are discussed further in section 3.7.

corporate governance the rules, systems, and processes within companies used to guide and control

According to CAS 315 *Identifying and Assessing the Risks of Material Misstatement*, an auditor must gain an understanding of their client's system of internal controls. When doing so, an auditor will consider the extent and impact of IT. IT is discussed in more detail in section 3.8.

Significant accounts and classes of transactions are identified when planning so that an auditor can structure their audit testing to ensure that adequate time is spent testing these accounts and classes of transactions. During the risk assessment phase, an auditor will determine the requirements of the financial reporting framework, assess the appropriateness of the accounting policies and disclosures, and also consider the adequacy of their client's **closing procedures**. An auditor's consideration of their client's financial reporting requirements and closing procedures and the associated risks are discussed in section 3.9. An important task in the early stages of every audit is to set the planning materiality which is considered in chapter 4.

closing procedures processes used by a client when finalizing the books for an accounting period

Cloud 9 Integrated Case

Ian thinks that all audits are pretty much the same and that W&S Partners must have an audit plan that they can use for the Cloud 9 audit. Suzie explains that if they tailor the plan to the client, the audit is far more likely to be efficient and effective. That is, they will get the job done without wasting time and ensure that sufficient appropriate evidence is gathered for the accounts that are most at risk of being misstated. If they can do this, W&S Partners will not only issue the right audit report, but make a profit from the audit as well. In other words, if the plan is good, performing the audit properly will be easier.

3.1.2 Risk Response Phase

The risk response phase or execution stage of the audit involves detailed testing of controls, transactions, and balances. If an auditor plans to rely on their client's system of internal controls, they will conduct tests of control. An auditor will conduct detailed substantive tests of transactions throughout the year and detailed substantive tests of balances recorded at year end. This detailed testing provides the evidence that the auditor requires to determine whether the financial statements are fairly presented.

3.1.3 Concluding and Reporting on an Audit

The final phase of the audit involves drawing conclusions based on the evidence gathered and arriving at an opinion regarding the fair presentation of the financial statements. The auditor's opinion is expressed in the audit report. At this stage of the audit, an auditor will draw on their understanding of the client, their detailed knowledge of the risks faced by the client, and the conclusions drawn when testing the client's controls, transactions, account balances, and disclosures.

Before You Go On

3.1.1 What are the three main phases of the audit?

3.1.2 List three factors that affect an auditor's preliminary risk identification.

3.1.3 Explain the risk response stage of an audit.

3.2 Gaining an Understanding of the Client

LEARNING OBJECTIVE 2

Explain the process used in gaining an understanding of the client.

At the outset of every audit, an auditor must gain an understanding of their client. This allows the auditor to make a reasonable preliminary risk assessment and to assess planning materiality. It also allows the auditor to determine the appropriateness of the entity's accounting policies, identify areas where additional audit work may be required (for example, related parties), and develop expectations for analytics. This ensures the auditor is able to assess the risk that the financial statements contain a material misstatement due to:

- the nature of the client's business
- the industry in which the client operates
- the level of competition within that industry
- the client's customers and suppliers
- the regulatory environment in which the client operates

CAS 315 provides guidance on the steps to take when gaining an understanding of a client. It requires the auditor to do the following:

1. Make inquiries of management and of others within the entity who may have information to help identify the risk of material misstatements. This includes making inquiries of both financial and non-financial staff at all levels of the organization, including those charged with governance, internal audit, sales, and operational personnel.
2. Perform analytical procedures at the risk assessment phase of the audit to identify any unusual or unexpected relationships that may highlight where risks exist. Analytical

procedures are a study of plausible relationships between both financial and non-financial data. These analytics may be automated when the client has large data sets or when only electronic data is available.

3. Perform observation and inspection procedures to corroborate or contradict the responses made by management and others within the organization. These procedures also provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the entity's operations, premises, and facilities; business plans and strategies; internal control manuals; and any reports prepared and reviewed by management (such as management reports, interim financial statements, and minutes of board of directors' meetings).

By performing these activities, the auditor will gain an understanding of the issues at the entity level, the industry level, and the economy level.

Cloud 9 Integrated Case

Ian knows that there are many possible problems in an audit that would cause the auditor to issue the wrong type of audit report, but he is struggling to understand why the audit team will be spending time gaining an understanding of a client. How does this help? Why aren't audits all the same?

Suzie explains to Ian that issuing the wrong type of audit report is a risk the auditor always faces, but the risk varies across audits. The variation in the risk is partly related to how well the audit team performs its tasks, which is dependent on the team members' level of skill, effort, supervision, and so on. But the variation in risk is also related to the particular characteristics of the client and its environment. Some clients are more likely than others to have errors or deficiencies in their accounting and financial reporting systems, operations, or underlying data. Even within one client's business, some areas are more likely to have problems than, or will have problems different to, others. Suzie asks Ian to think about what sorts of problems Cloud 9's draft financial statements are most likely to have, and why.

3.2.1 Entity Level

It is important that an auditor gain a detailed knowledge of their client. Knowledge about the entity is gained through interviewing client personnel, including those charged with governance. The auditor will ask questions about what the client does, where it does it, how it functions, how its ownership is structured, and what its sources of financing are. For new clients, this process is very detailed and time-consuming. For a continuing client, this process is less onerous and involves updating the knowledge gained on previous audits. By gaining an understanding of the client, the auditor is in a stronger position to assess entity-level risks and the financial statement accounts that require closer examination. The auditor is looking to identify business risks that will ultimately affect the financial statements. The following paragraphs outline some of the information that may be gathered by the auditor to gain an understanding of their client at the entity level.

Major customers are identified so that the auditor may consider whether those customers have a good reputation, are on good terms with the client (that is, they are likely to remain a customer in future), and are likely to pay the client on a timely basis. Dissatisfied customers may withhold payment, which affects the allowance for doubtful accounts and the client's cash flow, or may decide not to purchase from the client in the future, which can affect the going concern assumption. If a client has only one or a few customers, this risk is increased. The auditor also considers the terms of any long-term contracts between their client and their client's customers. In gathering information about a client's customers, the auditor gains an understanding about the markets the client serves and how it competes in these markets.

Major suppliers are identified to determine whether they are reputable and supply quality goods on a timely basis. Consideration is given to whether significant levels of goods are returned to suppliers as faulty, and what the terms of any contracts with suppliers and the terms of payment to suppliers include. The auditor also assesses whether the client pays its suppliers on a timely basis. If the client is having trouble paying its suppliers, it may have trouble sourcing goods because suppliers may refuse to transact with a company that does not pay on time.

Whether the client is an *importer* or *exporter* of goods is identified. If the client trades internationally, the auditor considers the stability of the country (or countries) the client trades with, the stability of the foreign currency (or currencies) the client trades in, and the effectiveness of any risk management policies the client uses to limit exposure to currency fluctuations (such as hedging policies).

The client's *capacity to adapt to changes in technology and other trends* is assessed. If the client is not well positioned to adjust to such changes, it risks falling behind competitors and losing market share, which in the longer term can affect the going concern assumption. If the client operates in an industry subject to frequent change, it risks significant losses if it doesn't keep abreast of such changes and "move with the times." For example, if a client sells laser printers, the auditor will need to assess whether the client is up to date with changes in technology and customer demands for environmentally friendly printers.

The nature of any *warranties* provided to customers is assessed. If the client provides warranties on products sold, the auditor needs to assess the likelihood that goods will be returned and the risk that the client has underprovided for that rate of return (adequacy of the warranty provision). The auditor will pay particular attention to goods being returned for the same problem, indicating that there may be a systemic fault. For example, say a client sells quality pens and the auditor notices that a number of pens are being returned because the mechanism to twist the pen open is faulty. In this case, the auditor will assess the likelihood that other pens will be returned for the same reason, the steps being taken by the client to rectify the problem, and whether the provision for warranty is adequate in light of this issue.

The terms of *discounts* given by the client to its customers and received by the client from its suppliers are reviewed. An assessment is made of the client's bargaining power with its customers and suppliers to determine whether discounting policies are putting profit margins at risk, which may place the future viability of the client at risk.

An assessment is made of the client's *reputation* with its customers, suppliers, employees, shareholders, and the wider community. A company with a poor reputation places future profits at risk. It is also not in the best interests of the auditor to be associated with a client that has a poor reputation.

An understanding is gained of client *operations.* The auditor will note where the client operates, the number of locations it operates in, and the dispersion of these locations. The more spread out the client's operations are, the harder it is for the client to effectively control and coordinate its operations, increasing the risk of errors in the financial statements. The auditor will need to visit locations where the risk of material misstatement is greatest to assess the processes and procedures at each site. If the client has operations in other provinces or overseas, the auditor may plan for a visit to those sites by staff from affiliated offices at those locations where risk is greatest. For example, an auditor is more likely to visit client operations if the client opens a new, large site, or if the business is located in a country where there is a high rate of inflation or where there is a high risk of theft.

An understanding is gained of the *nature of employment contracts* and the client's *relations with its employees.* The auditor will consider the way employees are paid, the mix of wages and bonuses, the level of unionization among the workforce, and the attitude of staff to their employer. The more complex a payroll system is, the more likely it is that errors can occur. When staff are unhappy, there is greater risk of industrial action, such as strikes, which disrupt client operations. The auditor will also consider whether the client will be able to attract and retain the skilled employees needed to ensure its business success.

The client's *sources of financing* are reviewed. An assessment is made of a client's debt sources, the reliability of future sources of financing, the structure of debt, and the reliance on debt versus equity financing. An auditor assesses whether the client is meeting interest payments on funds borrowed and repaying funds raised when they are due. If a client has a covenant with a debt provider, the auditor will need to understand the terms of that covenant and the nature of the restrictions it places on the client. Debt covenants vary. A company may, for example, agree to limit further borrowings. It may agree to maintain a certain debt to equity ratio. If the client does not meet the conditions of a debt covenant, the borrower may recall the debt, placing the client's liquidity position at risk and increasing the risk that the client may not be able to continue as a going concern.

The client's *ownership structure* is assessed. A complex ownership structure may lead to more complex accounting issues, such as when an entity's financial statements include goodwill, joint ventures, special purpose entities, and investments. The auditor is also interested in the amount of debt funding relative to equity, the use of different forms of shares, and the differing rights of shareholder groups. The client's dividend policy and its ability to meet dividend payments out of operating cash flow are also of interest. **Table 3.1** provides a summary of the entity-level considerations of the auditor.

TABLE 3.1 Knowledge of the business—entity-level considerations

Knowledge of the business—entity-level considerations
Who are the client's major customers? Who are the client's major suppliers?
Is the client an importer or exporter?
Is the client able to adapt to technological changes?
Does the client offer warranties with its products?
Does the client offer discounts to its customers? Is it offered discounts by its suppliers?
Does the entity have a positive reputation overall?
Where does the entity operate? Does it have one or many locations? Is it geographically dispersed?
What are the characteristics of the entity's work force? Is the payroll system complex?
What are the entity's sources of financing? What is the client's ownership structure?

Cloud 9 Integrated Case

Ian is starting to think about Cloud 9 more closely. He can remember something being said about Cloud 9 importing the shoes from a production plant in China and then wholesaling them to major department stores.

"OK," says Suzie. "Let's just take that one aspect of the operations and think about the issues that could arise."

Ian realizes that the department stores would be customers of Cloud 9 (although they should check that the stores actually purchase the shoes rather than hold them on consignment). If there was a mistake or a dispute with one of the stores, or if the store was in financial difficulties, the collectibility of the accounts receivable would be in doubt, so assets could be overstated. If the store disputed a sale, or a sale return was not recorded correctly, sales (and profit) could be overstated. Is Cloud 9 liable for warranty expenses if the shoes are faulty? Would the auditors need to read the terms of the contract to determine if a warranty liability should be recorded on the balance sheet? What about the balance of inventory? Do the shoes belong to Cloud 9 when they are being shipped from China, or only after they arrive at the warehouse?

Suzie points out that the answer to each of these questions could be different for Cloud 9 than for other clients because of its different circumstances. The auditors need to gain an understanding of these circumstances so that they can assess the risk that accounts receivable, sales, sales returns, inventory, and liabilities are misstated. Once they understand the risks, they are in a position to decide how they will audit Cloud 9.

3.2.2 Industry Level

At the industry level, an auditor is interested in their client's position within its industry, the level of competition in that industry, and the client's size relative to competitors. The auditor evaluates the client's reputation among its peers and the level of government support for companies operating in that industry. Another consideration is the level of demand for the products sold or services supplied by companies in that industry and the factors that affect that demand. For example, a soft-drink manufacturer is affected by the weather; that is, revenue is seasonal. Also, competition is generally strong.

The auditor compares the client with its close competitors nationally and internationally. When an auditor has a number of clients that operate in the one industry, this stage of the audit is more straightforward than if the client operates in an industry that the auditor is not already familiar with. The following paragraphs outline some of the procedures followed by auditors when gaining an understanding of their client at the industry level.

The *level of competition* in the client's industry is assessed. The more competitive the client's industry, the more pressure is placed on the client's profits. In an economic downturn, the weakest companies in highly competitive industries face financial hardship and possible liquidation. A key issue for an auditor is their client's position among its competitors and its ability to withstand downturns in the economy.

An auditor also considers their client's *reputation* relative to other companies in the same industry. If the client has a poor reputation, customers and suppliers may shift their business to a competing firm, threatening their client's profits. The auditor can assess their client's reputation by reading articles in the press and industry publications.

Consideration is given to the level of *government support* for the client's industry. This issue is important if the industry faces significant competition internationally or the industry is new and requires time to become established. Support is sometimes provided to industries that produce items in line with government policy, such as manufacturers of water tanks, solar heating, and reduced-flow taps in the context of environmental policies.

An assessment is made of the impact of *government regulation* on the client and the industry in which it operates. Regulations include tariffs on goods, trade restrictions, and foreign exchange policies. Regulations can affect a client's viability and continued profitability. An auditor will consider the level of taxation imposed on companies operating in their client's industry. The auditor assesses the different taxes and charges imposed on their client and the impact these have on profits.

The level of *demand* for the goods sold or services provided by companies in the client's industry is considered. If a client's products or services are seasonal, this will affect revenue flow. If a client is an ice cream producer, sales would be expected to increase in summer. However, if the weather is unseasonal, profits may suffer. If a client sells swimsuits, sales will fall in a cool summer. If a client sells ski equipment, sales will fall if the winter brings little snow. If a client operates in an industry subject to changing trends, such as fashion, the client risks inventory obsolescence if it does not keep up and move quickly with changing styles. When a product or process is subject to technological change, there is the risk that a client will quickly be left behind by its competitors. Either its products will become obsolete or its outdated processes will mean that it may find it difficult to compete with competitors that stay abreast of technological innovations. **Table 3.2** provides a summary of the industry-level considerations of the auditor.

TABLE 3.2 Knowledge of the business—industry-level considerations

Knowledge of the business—industry-level considerations
What is the level of competition in the client's industry?
What is the client's reputation relative to its competitors?
What is the level of government support for the industry?
What is the level of government regulation for the client and the industry?
What is the demand for the product sold? Where is it in the product life cycle?

3.2.3 Economy Level

Finally, when gaining an understanding of a client, an auditor assesses how economy-level factors affect the client. Economic upturns and downturns, changes in interest rates, and currency fluctuations affect all companies. An auditor is concerned with a client's susceptibility to these changes and its ability to withstand economic pressures.

During an economic upturn, companies are under pressure to perform as well as or better than competitors, and shareholders expect consistent improvements in profits. When conducting the audit in this environment, more focus is given to the risk of overstatement of revenues and understatement of expenses. During an economic downturn, companies may decide to "take a bath." This means that companies may purposefully understate profits. When the economy is poor, there is a tendency to maximize write offs, as a fall in profits can easily be explained to the investment community since most companies experience a decline in earnings. A benefit of taking a bath is that it provides a low base from which to demonstrate an improvement in results in the following year. Conducting the audit when the economy is in recession and when clients may be tempted to take a bath means the auditor must focus more on the risk of understatement of revenues and overstatement of expenses.

Cloud 9 Integrated Case

Suzie explains to Ian that the partner, Jo Wadley, has asked her to join the team for this audit because she has extensive experience in the clothing and footwear industry. Jo wants to make sure that the team's industry knowledge is very strong. Several other members of the team also have experience in auditing clients in the retail industry, including Jo and manager Sharon Gallagher. In addition, Josh is highly regarded at W&S Partners for his knowledge of sales and cash receipts systems.

Suzie has the task of assessing the industry-specific economic trends and conditions. The documentation has to include an assessment of the competitive environment, including any effects of technological changes and relevant legislation. So that Ian can appreciate how understanding the client is an important part of planning the audit, Suzie asks him to help research the product and customer and supplier elements. Then, together, they will assess the specific risks arising from the entire report, including risks at the economy level, for the Cloud 9 audit.

Before You Go On

3.2.1 What is the purpose of gaining an understanding of a client?

3.2.2 What will an auditor consider if their client is an importer or exporter?

3.2.3 What does a client risk if it operates in an industry subject to changing trends?

3.3 Related Parties

LEARNING OBJECTIVE 3

Explain how related parties can impact risk.

As discussed, it is the responsibility of the auditor to ensure that related parties are identified and appropriately disclosed in accordance with relevant accounting standards. Therefore, related party transactions require some specific consideration throughout the audit.

Accounting standards indicate that related parties include parent companies, subsidiaries, joint ventures, associates, company management, and close family members of key management. Since related parties are not independent of each other, these transactions may not be in the normal course of business. Related party transactions not only increase the susceptibility of the financial statements to material misstatement due to fraud or error, they may also impact the overall financial statement results. Therefore, financial statement users need sufficient information to assess the impact of these transactions on the financial statements overall. Some examples of related party transactions that require disclosure are listed below:

- purchase and sales transactions between companies under common control or when one party has significant influence over another
- rent paid from one related party to another
- loans made to shareholders or senior management
- loan guarantees provided by a shareholder of the company

As both the International Financial Reporting Standards (IFRS) and the Accounting Standards for Private Enterprises (ASPE) include specific reporting requirements for related party transactions, the auditor must consider the risk of material misstatement throughout the audit if such relationships are not appropriately accounted for or disclosed. Therefore, CAS 550 *Related Parties* requires the auditor to do the following:

- Discuss with the engagement team the susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions.

- Ask management to identify all related parties and to provide an explanation of the nature, type, and purpose of transactions with these entities.
- Obtain an understanding of the processes and procedures management has in place to ensure all related party transactions are identified, authorized, accounted for, and disclosed in accordance with the chosen financial reporting framework.
- Remain alert when inspecting documents such as bank confirmations, unusual sales and purchase invoices, minutes of board of director and shareholder meetings, and contracts for indicators that related party transactions may not have been identified or disclosed to the auditor.
- Identify and assess the risk that transactions may not be in the normal course of operations. For such transactions, inspect any underlying documents and determine the business rationale for such transactions to ensure that they are not an attempt to fraudulently misstate the financial results.

Figure 3.3 lists risk assessment procedures outlined in the *Professional Engagement Guide (PEG)*.

PSC = Procedures successfully completed	F/S = Financial statements	W/P ref.	PSC? (Y/N) (Initials)	Summarize findings or difficulties encountered
1	**Obtain listing of related parties** a) Request management to prepare (or assist in preparing) a comprehensive listing of related parties and transactions during the period (with information such as included in the table below), including details of changes from the previous period. b) Ensure listing includes the names of directors, managers, key staff, family members and any other entities they may own or control.			
2	**Relevant controls and procedures** Document any controls/procedures (identified from management inquiries (Form 505)) that exist to ensure related parties are identified and transactions are a) Approved (especially those outside the normal course of business); and b) Accounted for in accordance with the applicable financial reporting framework. Where relevant controls are identified, assess the control design and implementation.			
3	**Risk of undisclosed related parties** a) Consider any previous history of not disclosing related parties or transactions. b) Consider the involvement of related parties in transactions outside the normal course of business. c) Consider the susceptibility of F/S to material misstatement through the use of related-party transactions. Consider transactions that would improve liquidity/profitability, avoid corporate/personal taxes, avoid breach of a bank covenant or shift income/expense to future periods or between related entities. d) Consider whether minutes of corporate meetings (correspondence with lawyers, etc.) and other documentation reviewed indicate possible related parties. e) Inquire of key employees, advisors and any component auditors about: i) Related parties not already identified and, if so, details of transactions; ii) Agreements or loan guarantees not reflected in the F/S; and iii) Payments (kickbacks), preferential terms or side deals not disclosed. f) Ensure audit team is aware of related parties and the need for professional skepticism.			

FIGURE 3.3 **Sample risk assessment procedures, PEG Forms—Audits, Form 515**

Source: Understanding Related Parties, PEG Forms—Audits, Form 515, © 2017 CPA Canada PEG.

Before You Go On

3.3.1 Define related parties.

3.3.2 How do related parties impact risk? Why?

3.3.3 What are three procedures the auditor should perform regarding related parties?

3.4 Fraud Risk

LEARNING OBJECTIVE 4

Evaluate fraud risk.

As a part of the risk assessment phase of the audit, an auditor will assess and document the risk of a material misstatement due to fraud (CAS 240). When assessing fraud risk, an auditor will adopt an attitude of **professional scepticism** to ensure that any indicator of a potential fraud is properly investigated. This means that the auditor must remain independent of their client, maintain a questioning attitude, and search thoroughly for corroborating evidence to validate information provided by the client and consider contradictory evidence if found. The auditor must not assume that their past experience with client management and staff is indicative of the current risk of fraud.

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

Fraud is an intentional act to obtain an unjust or illegal advantage through the use of deception (CAS 240, para. 12). An auditor can use red flags[1] to alert them to the possibility that a fraud may have occurred. Red flags include:

- key finance personnel refusing to take vacation
- overly dominant management
- poor compensation practices
- inadequate training programs
- a complex business structure
- no (or ineffective) internal auditing staff
- a high turnover of auditors
- unusual transactions
- weak internal controls

There are two kinds of fraud. Financial reporting fraud is intentionally misstating items or omitting important facts from the financial statements. Misappropriation of assets generally involves some form of theft. Table 3.3 provides examples of financial reporting and misappropriation of assets frauds.

The responsibility for preventing and detecting fraud rests with those charged with governance at the client. Prevention refers to the use of controls and procedures aimed at avoiding a fraud. Detection refers to the use of controls and procedures aimed at uncovering a fraud should one occur.

It is the auditor's responsibility to assess the risk of fraud and the effectiveness of the client's attempts to prevent and detect fraud through their internal control system, especially if the risk

TABLE 3.3 Examples of frauds

Financial Reporting Frauds	Misappropriation of Assets Frauds
• Improper asset valuations • Unrecorded liabilities • Timing differences—bringing forward the recognition of revenues and delaying the recognition of expenses (or vice versa) • Recording fictitious sales • Understating expenses • Inappropriate application of accounting principles • Omitting or misstating disclosures	• Theft of cash by employees • Using a company credit card for personal use • Employees remaining on the payroll after ceasing employment • Unauthorized discounts or refunds to customers • Theft of inventory by employees or customers • Using a company car for unauthorized personal use

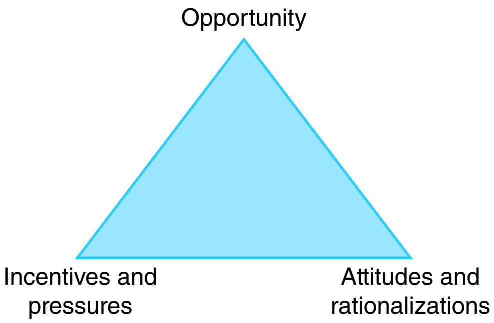


FIGURE 3.4 **Fraud triangle**

of fraud is determined to be a significant risk. Per CAS 240, Appendix 1, when assessing the risk of fraud, the auditor considers the following three factors, which are commonly known as the fraud triangle (illustrated in **figure 3.4**):

- The incentives and pressures to commit a fraud: Management and employees must first have a reason to commit fraud, and thus an incentive or pressure exists.
- The opportunities to perpetrate a fraud: There must be a lack of adequate supervision or internal controls so that an opportunity to commit fraud exists.
- The attitudes and rationalizations used to justify committing a fraud: This means that management and employees are able to justify their actions.

3.4.1 Incentives and Pressures to Commit a Fraud

In assessing the risk of fraud, an auditor will consider incentives and pressures faced by their client to commit a fraud. While the examples provided below indicate that a client may be inclined to commit a fraud, they in no way indicate that a fraud has definitely occurred. When an auditor becomes aware of any of these risk factors, in isolation or combination, they will plan their audit to obtain evidence in relation to each risk factor.

Examples of incentives and pressures that increase the risk of a client committing fraud include:

- operation in a highly competitive industry
- a significant decline in demand for products or services
- falling profits
- a threat of takeover
- a threat of bankruptcy
- ongoing losses
- rapid growth
- poor cash flows combined with high earnings
- pressure to meet market expectations
- planning to list on a stock exchange
- planning to raise debt or renegotiate a loan
- about to enter into a significant new contract
- a significant proportion of remuneration tied to earnings (that is, bonuses, options)
- personal financial obligations
- poor relationships between the business and employees who have access to cash or other assets

3.4.2 Opportunities to Perpetrate a Fraud

After identifying one or more incentives or pressures to commit a fraud, an auditor will assess whether a client has an opportunity to perpetrate a fraud. An auditor will utilize their knowledge of how other frauds have been perpetrated to assess whether the same opportunities exist at the client. While the examples below of opportunities to commit a fraud suggest that a fraud may have been carried out, their existence does not mean that a fraud has definitely occurred. An auditor must use professional judgement to assess each opportunity in the context of other risk indicators and consider available evidence thoroughly.

Examples of opportunities that increase the risk that a fraud may have been perpetrated include:

- accounts that rely on estimates and judgement
- a high volume of transactions close to year end
- significant adjusting entries and reversals after year end
- significant related party transactions
- poor corporate governance mechanisms

- poor internal controls
- a high turnover of staff
- reliance on complex transactions
- transactions out of character for a business (for example, if a client leases its motor vehicles it should not have car registration expenses)
- lack of mandatory vacations for employees performing key control functions
- large amounts of cash on hand
- inventory on hand that is small in size and high in value, or in high demand

3.4.3 Attitudes and Rationalizations to Justify a Fraud

Together with the identification of incentives or pressures to commit a fraud and opportunities to perpetrate a fraud, an auditor will assess the attitudes and rationalizations of client management and staff to fraud. Attitude refers to ethical beliefs about right and wrong, and rationalization refers to an ability to justify an act. While the examples below indicate that a fraud may occur in companies where these characteristics are identified, they do not mean that a fraud has occurred.

Examples of attitudes and rationalizations used to justify a fraud include:

- a poor tone at the top (that is, from senior management)
- the view that implementing an effective internal control structure is not a priority
- an excessive focus on maximization of profits and/or share price
- a poor attitude to compliance with accounting regulations
- changes in behaviour or lifestyle that may indicate asset misappropriation
- tolerance of petty theft
- rationalization that other companies make the same inappropriate accounting choices

Professional Environment 3.1 discusses the application of the fraud triangle in the notorious Bernie Madoff case.

3.1 Professional Environment Application of the Fraud Triangle

According to Dr. Donald Cressey, a criminologist who has studied fraudsters, three factors need to be present for fraud: incentives and pressures, opportunities, and attitudes and rationalizations. This has become known as the fraud triangle.

All of these factors can be found in Bernie Madoff's $50-billion Ponzi scheme, which has been described as one of the largest frauds in U.S. history.

Incentives and Pressures

Mr. Madoff, as manager of Ascot Investments, became known in the 1980s for producing double-digit returns and creating significant wealth for his clients. However, the 1987 stock market crash and the subsequent slow economic recovery made such returns impossible. His steady 10- to 12-percent investment returns suddenly dropped to 4.5 percent. It was at this time that Mr. Madoff felt the pressure to maintain the returns his firm had become known for. He started taking investors' capital to pay out redeeming investors and falsified results to show big returns in order to appear more successful.

Opportunities

How was Mr. Madoff able to pull off such a large fraud? Apparently, Mr. Madoff refused to disclose how he was able to earn such significant returns and investors never pressed for more information beyond the falsified return statements they received. He did admit, however, to turning down potential clients if they asked too many questions about his investment strategies.

Rationalization

Mr. Madoff rationalized his fraudulent scheme as he believed everyone was greedy. He claims he warned potential investors that his investment choices could be risky and lead to losses, and the drive for larger returns simply led them to give him more money.

In 2009, Mr. Madoff pleaded guilty to several U.S. federal felonies and he was sentenced to 150 years in prison. While this does little to rectify the losses of his victims, perhaps the best lesson we can take from this case is that when all elements of the fraud triangle are present, a "potent combination of elements" exists. While it is virtually impossible to prevent all fraud, knowing and understanding the fraud triangle can make a significant difference in reducing one's exposure.

Q: What can companies do to be proactive and decrease the risk of fraud occurring in their organizations?

Sources: Ali Velshi, "Ex-Nasdaq Chair Arrested for Securities Fraud," *CNN Money*, December 12, 2008; Robert Lenzner, "Bernie Madoff's $50 Billion Ponzi Scheme," *Forbes*, December 2008; David Lieberman, Pallavi Gogoi, Theresa Howard, Kevin McCoy, and Matt Krantz, "Investors Remain Amazed over Madoff's Sudden Downfall," *USA Today*, December 15, 2008; "Bernard Madoff Gets 150 Years behind Bars for Fraud Scheme," CBC News, June 29, 2009; Walter Pavlo, "Bernard Madoff Is The Fraud Triangle," *Forbes*, March 2011.

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Suzie explains that fraud risk is always present and that auditors must explicitly consider it as part of their risk assessment. Being aware of the incentives and pressures, opportunities, and attitudes within the client relating to fraud helps the auditor make the assessment. Ian admits that he has a little trouble understanding the difference between incentives and attitudes, but he thinks he understands the concept of opportunity. Suzie explains that incentives relate to what pushes (or pulls) a person to commit a fraud. Examples include a need for money to pay debts or gamble. Attitudes or rationalization relate to the thinking about the act of fraud. For example, a person believes it is acceptable to steal from a nasty boss; that is, the theft is justified by the boss's nastiness.

3.4.4 Audit Procedures Relating to Fraud

Besides assessing the fraud risk factors noted above, the following are some of the specific procedures the auditor should perform to assess the fraud risk and to comply with CAS 240:

1. The auditor should ask management and those charged with governance if they are aware of a known fraud or suspect there has been a fraud. If the company being audited has an internal audit department, it should also be asked this question. The auditor should also ask what processes management has in place to identify and respond to fraud and gain an understanding of how those responsible for governance exercise oversight over these processes. The auditor should also ask management how it communicates the importance of ethical behaviour to its employees. The results of these inquiries should be documented.
2. All members of the audit team, including the partner, should attend a team planning meeting. During this planning meeting, the significant fraud risk factors and where the financial statements may be particularly susceptible to fraud should be reviewed. This includes any fraud risks related to disclosures. This allows the more experienced team members to share their knowledge with the less experienced members. Significant decisions made during this meeting should be documented.
3. The auditor should perform preliminary analytics to identify any unusual relationships that may indicate fraud and thus require further investigation during the audit.
4. The auditor must consider the risk of management override. As management is in a position to manipulate the accounting records or override the controls designed to prevent such fraud, the auditor should gain an understanding of the processes over journal entries and test a sample of journal entries, review accounting estimates for reasonableness, contemplate the risk of earnings management (particularly in the area of revenue recognition), and carefully examine unusual business transactions to ensure that they have business substance.
5. The auditor should assess the risk of fraud relating to revenue. Most financial statement frauds are perpetrated by manipulating revenues. Therefore, the auditor should understand the client's revenue processes to assess this risk, which involves understanding the types of revenues of the entity and the processes the client has in place regarding recording those revenues.

Where the auditor determines there is a higher risk of fraud for the financial statements, the auditor should consider assigning more experienced staff to the engagement and introducing unpredictability to which transactions are examined.

If during the course of the audit the auditor finds fraud, then they should contemplate their legal and professional responsibilities. As the auditor remains bound by confidentiality, they should seek legal advice to determine if there is a requirement to report the fraud to an outside third party. The auditor may also consider withdrawing from the engagement. Finally, the auditor must report the fraud to the level of management above that under which the fraud occurred and report the fraud to the audit committee.

Before You Go On

3.4.1 What are the responsibilities of the client and the auditor when it comes to fraud?

3.4.2 List four incentives and pressures that increase the risk of fraud.

3.4.3 What is management override and what procedures should the auditor perform to address it?

3.5 Going Concern

LEARNING OBJECTIVE 5

Explain the going concern assumption.

During each phase of the audit, an auditor will consider whether it is appropriate to assume that their client will remain as a going concern (CAS 570). The going concern assumption is made when it is believed that a company will remain in business for the foreseeable future (CAS 570, para. 2). Under this assumption, assets are valued on the basis that they will continue to be used for the purposes of conducting a business, and liabilities are recorded and classified as current and non-current on the basis that the client will pay its debts as they fall due in the years to come. It is the responsibility of management and those charged with governance to assess whether their company is likely to remain a going concern. It is the responsibility of the auditor to obtain sufficient appropriate evidence to assess the validity of the going concern assumption made by their client's management and those charged with governance when preparing the financial statements.

3.5.1 Going Concern Risk—Indicators

For each client, an auditor will use their professional judgement to assess whether the going concern assumption is valid. There are a number of indicators that, alone or combined, can suggest that the going concern assumption may be at risk. A comprehensive list of events and conditions that place doubt on the going concern assumption is provided in CAS 570. Indicators include:

- a significant debt to equity ratio
- long-term loans reaching maturity without alternative financing in place
- prolonged losses
- an inability to pay debts when they fall due
- supplier reluctance to provide goods on credit
- the loss of a major market, key customer, franchise, or licence
- overreliance on a few customers or suppliers
- adverse key financial ratios
- shortage of a key input or raw material
- rapid growth with insufficient planning
- being under investigation for non-compliance with legislation
- falling behind competitors

If the auditor identifies risk factors that indicate that the going concern assumption is in doubt, they will undertake procedures to gather evidence regarding each risk factor. For example, if a client has a significant debt coming due for payment, the auditor will assess the ability of the entity to settle the debt or to raise the funds to replace it. If the auditor believes that there is an unresolved going concern issue outstanding, an assessment is made of the appropriateness of management disclosures in the notes to the financial statements regarding that issue. An auditor will assess the process used by management to evaluate the extent of the going concern risk. If a company has a history of losses and difficulties, an auditor will expect management to take a great deal of time and care in their going concern assessment. Once the auditor has an understanding of the process used by management, which may include the careful preparation of detailed cash flow projections and budgets, they will assess the adequacy of that process and conduct additional procedures if necessary.

If the auditor concludes that the going concern assumption is in doubt, further procedures are undertaken. CAS 570 provides a list of appropriate audit procedures. They include asking management about its plan to turn things around, and evaluating the feasibility of these plans. If a cash flow statement has been prepared, the auditor should review the data and assumptions used for reasonableness. Lastly, when completing the audit, the auditor should include a reference to the feasibility of management's future plans in the management representation letter. Possible additional procedures include:

- assessment of cash flows
- assessment of revenue and expense items
- assessment of interim financial statements
- review of debt contracts
- review of minutes of board and other meetings
- discussions with client management and lawyers
- identification and assessment of mitigating factors

3.5.2 Going Concern Risk—Mitigating Factors

Mitigating factors reduce the risk that the going concern assumption may be in doubt. For example, if a client is experiencing a severe cash shortage but has a letter from its bank agreeing to provide additional financing, the letter reduces (but does not remove) the risk that the going concern assumption may be invalid. Other mitigating factors include:

- a letter of guarantee from a parent company
- the availability of non-core assets, which can be sold to provide needed cash, without interrupting the company's operating capacity
- the ability to raise additional funds through the sale of shares
- the ability to raise additional funds through borrowings
- the ability to sell an unprofitable segment of the business

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Going concern is another type of audit risk. When management adopts the going concern assumption, it records assets and liabilities on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business. If the going concern assumption is not valid, the financial statements should include adjustments to the recoverability and classification of recorded assets and liabilities. If these adjustments are not made, the auditor must express an adverse opinion.

Suzie explains that in most cases the assessment of going concern is not clear-cut. Sometimes there are questions about the going concern assumption and various circumstances that mitigate such questions. The auditor's job is to gather evidence about the issues in order to make a judgement about the nature of the uncertainties surrounding the going concern assumption and decide if, and how, these affect the audit report.

Before You Go On

3.5.1 What is the going concern assumption?

3.5.2 List three factors that indicate that the going concern assumption may be at risk.

3.5.3 List three factors that mitigate the risk that the going concern assumption may be in doubt.

3.6 Auditing Estimates and Related Disclosures

LEARNING OBJECTIVE 6

Explain how estimates can impact risk.

The auditor should assess the risk of material misstatement with respect to accounting estimates, because they can have a significant impact on the financial statements. Financial statements incorporate accounting estimates in a variety of areas. Examples include the allowance for doubtful accounts for accounts receivable; the useful life and residual values of property, plant, and equipment; and the fair value determination of financial instruments. Further examples of accounting estimates are the following:

- inventory obsolescence
- revenue recognized for long-term contracts
- value of share-based compensation
- valuation of financial assets
- impairment of long-lived assets
- liabilities relating to employee benefits
- measurement of contingent liabilities
- warranty liabilities

These items are referred to as **accounting estimates** because an exact amount is not known and therefore the recorded or disclosed amount includes estimation uncertainty. **Estimation uncertainty** is the lack of precision with an estimate or related disclosure. Some estimates are low in complexity, such as the estimated life and residual value of property, plant, and equipment, and therefore, such estimates are lower in estimation uncertainty. Other estimates are more complex, such as a fair value estimate of financial instruments, and are higher in estimation uncertainty.

accounting estimates items for which an exact amount is not known and the recorded amount includes estimation uncertainty

estimation uncertainty the lack of precision with an estimate or related disclosure

3.6.1 Risk Assessment and Estimation Uncertainty

Estimation uncertainty is a key concept in assessing the risk of material misstatement relating to estimates. When making an estimate, management selects a method or model, and uses assumptions and data as inputs to develop the estimate. The models, assumptions, and data can all vary in terms of complexity, subjectivity, and uncertainty—all factors that impact estimation uncertainty. Generally, estimates that are complex, subjective, or uncertain are greater in estimation uncertainty. When an estimate is developed using a simple model and objective data, it is lower in estimation uncertainty than when an estimate is developed using a complex valuation model incorporating subjective, future-looking assumptions. For example, an allowance for doubtful accounts estimated regularly by management using percent of receivables, from data produced from routine transactions, is lower in estimation uncertainty. When the value of equity securities is estimated using objective, publicly available data, such as published market values, estimation uncertainty is also lower. However, when complex models are used to estimate the fair value of derivative instruments not publicly traded, estimation uncertainty is higher. CAS 540 indicates that the higher the estimation uncertainty, the higher the risk of material misstatement and the greater the audit effort required. Therefore, when conducting the risk assessment for estimates, the auditor should consider measurement uncertainty in terms of complexity, subjectivity, and uncertainty for the model, assumptions, and data used.

3.6.2 Estimates and the Entity Level Risk Assessment

The auditor is required to assess the risk of material misstatement with respect to accounting estimates. In gaining an understanding of the business, the auditor identifies the types of transactions that have taken place and the accounting standards that apply to determine the estimates made during the year. This is important because accounting standards may include specific recognition, measurement, and disclosure requirements, which influence the complexity, subjectivity, and uncertainty of an estimate. For example, some accounting standards require fair value estimates. By understanding the client's accounting estimates and identifying the requirements of the accounting standards, the auditor can assess the estimation uncertainty and the associated risks. During the risk assessment, the auditor should also determine if there are any regulatory requirements that may impact the risk relating to estimates. By understanding a client's estimates, an auditor can assess if the audit team has the skills needed to audit the estimates or if specialized skills are needed.

After the auditor understands the types of estimates required by the client, CAS 540 indicates the auditor should gain an understanding of the processes that management has in place regarding estimates. How does management identify the estimates needed? What is the entity's oversight processes regarding estimates? What is the role of those responsible for governance? How does management ensure estimates are reasonable? How does management determine changes are needed to the estimation process? CAS 540 indicates that to understand management's processes, the auditor should determine the following:

- How management identifies and addresses the risks relating to accounting estimates. Some considerations include how management ensures management bias does not impact the assumptions or the data selected and whether there is an independent review of significant judgements and estimates.
- How management determines whether they have the expertise to make the estimate. Is an expert needed?
- The information system involved in developing estimates. As discussed, the auditor should understand the types of transactions that give rise to estimates. The auditor can then assess the estimation uncertainty relating to these estimates, considering whether they relate to routine and recurring or non-routine and non-recurring transactions.
- How management selects the models, assumptions, and data used in the estimates. Things the auditor should consider include whether the model has been validated; the assumptions are relevant, complete, and consistent with other available information; and the data are from objective, external, and reliable sources.
- How management deals with management uncertainty. To do this, the auditor can ask if alternative assumptions and outcomes were considered and whether a sensitivity analysis was performed. The auditor may also ask how an outcome is selected when there is a range of acceptable outcomes.
- Whether estimates are reviewed after the fact, and if so, how management determines when changes to the estimation process is required.

The auditor should assess management's processes and procedures by comparing past estimates with the actual results to assess accuracy. Where past results have been relatively accurate, this supports management's processes over developing reasonable estimates. Where there is a great variation, it may suggest management has a poor estimation process with weak controls, or the estimate may simply include a high degree of estimation uncertainty.

Before You Go On

3.6.1 What is estimation uncertainty?

3.6.2 What three factors impact estimation uncertainty?

3.6.3 How do the results of past estimates impact the auditor's risk assessment with respect to estimates?

3.7 Corporate Governance

LEARNING OBJECTIVE 7

Appraise corporate governance.

Corporate governance is the rules, systems, and processes within companies used to guide and control. It includes the processes used to manage the business and the affairs of the entity. Public entities are regulated by legislation and securities regulators. Private entities have essentially the same responsibilities except they are not regulated by securities law and stock exchange requirements.

Governance structures are used to monitor the actions of staff and assess the level of risk faced. Controls are designed to reduce identified risks and ensure the future viability of the company. The Canadian Securities Administrators (CSA) provides *Corporate Governance Guidelines* to help improve performance and enhance accountability to shareholders. While these guidelines provide a framework for corporate governance practices, they do not dictate any particular requirements. However, reporting issuers must disclose their corporate governance practices and state why they believe these practices are appropriate for the entity.

The following is a summary of good corporate governance practices, including some of the CSA suggested practices:

- The board of directors should consist of members with expertise relating to the business. Board members should be knowledgeable and competent.
- The majority of the board should consist of independent members who are comfortable questioning management. Public companies should have at least three independent directors.
- The chair of the board should be independent. The chair should not be the CEO. The CEO should report to the board.
- The board should meet regularly and ensure there are clear lines of communication and responsibility between the CEO, board members, and management. Listed entities should plan meetings where only independent directors attend.
- The board should delegate certain responsibilities to sub-committees. Listed entities must have an audit committee, and may have a compensation committee and a nominating committee.
- The board should be ethical. The board should ensure there is written code of conduct with respect to conflict of interest, use of company assets, privacy requirements, and laws and regulations. The board should monitor compliance with this code. There should be a written whistleblower policy. These policies and procedures contribute to the tone at the top.
- The board should assess the risks to the entity and provide a strategic plan that manages these risks.
- There should be an orientation for new board members and ongoing training for existing board members.

The board of directors is not required to participate in the day-to-day decision-making of the entity; however, it is responsible to act in the best interest of the company. To help achieve this, the board of directors should develop a written mandate in which it explicitly acknowledges responsibility for the stewardship of the entity. This should be in writing and assure that the entity has systems and practices in place addressing strategic planning, risk identification, risk mitigation, internal control, succession planning, and the supervision of senior management. It is recommended that the board meet regularly and meeting minutes be maintained.

As previously stated, all listed entities must have an audit committee. The audit committee is to consist of independent board members who are financially literate. The audit committee is responsible for appointing the auditor, overseeing the work of the auditor, pre-approving all audit and non-audit services, and ensuring that a process is in place to permit the reporting of weaknesses in internal control. Some boards of directors may also elect to have other committees, such as a compensation committee to review the CEO's compensation.

From an auditor's perspective, considering a client's corporate governance principles is an important part of gaining an understanding of that client. A client that does not take its corporate governance obligations seriously may not fulfill its obligation to ensure its financial statements are fairly presented or provide effective oversight over its system of internal control. The auditor should assess how independent the board is from management and evaluate the impact this may have on the audit.

Before You Go On

3.7.1 What is corporate governance?

3.7.2 Why is the auditor concerned with an entity's corporate governance?

3.7.3 List three guidelines that should be included in a board of directors' mandate.

3.8 Information Technology

LEARNING OBJECTIVE 8

Evaluate how a client's information technology (IT) can affect risk.

information technology the use of computers to store and process data and other information

When gaining an understanding of a client, an auditor will consider the particular risks faced by the client associated with **information technology** (IT). IT is a part of most companies' accounting processes, which include transaction initiation, recording, processing, correction as necessary, transfer to the general ledger, and compilation of the financial statements including the process to prepare the necessary disclosures. CAS 315 requires that the auditor gain an understanding of the client's IT environment, which includes the IT applications, infrastructure, as well as the IT processes and personnel, and the associated risks. This includes gaining an understanding of how reliant the entity is on its IT systems, the complexity of its systems, the types of information processed by the systems, and systems security. It also includes understanding the policies that govern these elements as they affect the financial statements.

In gaining an understanding of the client's IT system, the auditor should identify the IT systems used by the client. The auditor should also gain an understanding of the extent IT is used to process transactions. CAS 315 indicates the auditor should consider such things as:

- the extent of automated processing
- volume and complexity of data in digital form
- the skill level of the personnel involved in maintaining the IT environment
- complexity over access and security levels
- the extent of third-party hosting or outsourcing of IT processes.

Risks associated with IT include unauthorized access to computers, software, and data; errors in programs; lack of backup; and loss of data, especially when only digital records are maintained. Unauthorized access to data can occur when there is insufficient security or poor password protection procedures. Unauthorized access can result in data being lost or distorted. Unauthorized access to computer programs can result in misstatements in the financial statements. Access can be limited in a number of ways, such as through the use of security (such as locked doors) and passwords.

Errors in computer programming can occur if programs are not tested thoroughly. It is important that new programs and changes to programs be tested extensively before being put into operation. Errors can also occur if mistakes are made when writing a program or if programs are deliberately changed to include errors. Deliberate changes may be made by staff or outsiders who gain unauthorized access to a client's IT system. For example, unhappy staff may purposefully change a program, causing errors to embarrass their employer. It is therefore important that access be limited to authorized staff. Errors can also occur if programming changes are not processed on a timely basis. Programs need to be changed from time to time for a variety of reasons, such as to change sales prices, update discounts being offered to customers, and so on. It is important that these changes be made by authorized personnel on a timely basis to avoid errors.

New programs can be purchased "off the shelf" from a software provider or developed internally by a client's staff. When a client purchases a general-purpose program off the shelf, there is a risk that it will require modification to suit the client's operations, which can lead to errors. An advantage of purchasing general-purpose programs from reputable companies is that they will have been tested before being made available for sale. In contrast, when a client's staff develop a program internally, the program is more likely to have the features required, but there is a risk of errors if the program is written by inexperienced staff or the program is not adequately tested before being put into operation.

When a client installs a new IT system, there are a number of risks. There is the risk that the system may not be appropriate for the client and its reporting requirements. After installation, there is the risk that data may be lost or corrupted when transferring information from an existing system to the new system. There is the risk that the new system does not process data appropriately. There is the risk that client staff are not adequately trained to use the new system effectively. It is important that a client have appropriate procedures for selecting new IT systems, changing from an old to a new system, training staff in using the new system, and ensuring that a new system includes embedded controls to minimize the risk of material misstatement.

When a client has an established IT system, an auditor will gain an understanding of the risks posed by that system as part of their assessment of the risk of a material misstatement in the client's financial statements. An auditor will assess whether their client has the processes and procedures in place required to reduce IT risk to an acceptably low level. The two broad categories of controls used to reduce IT risk are general IT controls and application controls.

General information technology controls are the entity's IT processes that support the continued proper operation of the IT environment, including information processing controls and the integrity of information (CAS 315). They include procedures for purchasing, changing, and maintaining new computers; procedures for purchasing, changing, and maintaining new software; the use of passwords and other security measures to minimize the risk of unauthorized access; and procedures to ensure appropriate segregation of duties between, for example, the staff who amend and maintain the programs and the staff who use the programs.

general information technology controls the entity's IT processes that support the continued proper operation of the IT environment

Application controls are manual or automated procedures that apply to the processing of transactions by individual applications. These controls are designed to prevent and/or detect a material misstatement in the financial statements by ensuring all transactions are recorded only once, and rejected transactions are identified and corrected. Application controls impact procedures used for data entry, data processing and output, or reporting. They include reconciliations between input and output data and automated checks on data entered to ensure accuracy; for example, a check that a customer number entered is valid.

application controls manual or automated controls that apply to the processing of transactions by individual applications.

When an auditor has identified an IT risk, they will assess the adequacy of their client's IT and application controls in mitigating that risk. If an auditor believes that their client's general and application controls appear adequate, their audit strategy is to test those controls with a view to relying on the client's procedures to minimize IT risk exposure. If an auditor believes that a client's general and application controls do not appear to be adequate, their audit strategy is to rely more heavily on their own tests of the transactions and balances produced by the client's IT system.

Cloud 9 Integrated Case

Suzie explains to Ian that her experience in the clothing and footwear industry has taught her to be very inquisitive about the systems used to manage orders. She has seen a few clothing businesses fail because they could not get their goods to retail outlets in time. Fashion is such a fickle market that being even a few weeks late means that stores run out of inventory, and when inventory does arrive, stores have to discount it to sell it. After this situation occurs a couple of times, retailers turn to more reliable suppliers, even if the designs aren't as imaginative.

Suzie has heard that Cloud 9 is very reliant on an inventory management software program developed by its parent company. Because it is not a widely used package, she does not know anything about it and is concerned about its ability to provide reliable data. Suzie and Ian decide to allocate extra time in the audit plan to assessing the reliability of this software.

Before You Go On

3.8.1 What are some of the risks associated with the purchase of a new IT system?

3.8.2 What are two common sources of new computer programs?

3.8.3 What are application controls?

3.9 Financial Reporting and Closing Procedures

LEARNING OBJECTIVE 9

Explain how a client's financial reporting practices and closing procedures can affect reported results.

When preparing the financial statements, management selects the accounting policies. To assess the risk of material misstatement, the auditor needs to understand and evaluate the accounting policies selected by management. The auditor should evaluate if the policies are applied consistently and correctly. When management changes the accounting policies, the auditor should understand why, because policy changes should be made to improve financial reporting or to meet GAAP requirements, and not to manipulate the financial statements. In identifying the financial reporting requirements, including required disclosures specific to the client, the auditor can identify areas that are at higher risk of material misstatement. The auditor can then plan to spend more time reviewing these areas. CAS 315 suggests the auditor should consider the financial reporting practices relating to industry specific practices, revenue recognition, foreign currency transactions, and complex and unusual transactions.

When finalizing the financial statements, a client will close its accounts for the financial reporting period. Revenue and expense items must include all transactions that occurred during the period and exclude transactions that relate to other periods. Asset and liability balances must include all relevant items, accruals must be complete, and contingent liabilities must accurately and completely reflect potential future obligations. From an audit perspective, there is a risk that the client's closing procedures are inadequate.

An auditor is concerned that transactions and events have been recorded in the correct accounting period. This is the responsibility of management and those charged with governance. It is the responsibility of the auditor to ensure that their client has applied its closing procedures appropriately.

An auditor will determine the risk associated with their client's closing procedures. In addition to the annual financial statements, clients prepare monthly and quarterly financial statements for internal and/or external purposes. An auditor can check these statements to assess the accuracy of their client's closing procedures when preparing those financial statements. If there are significant errors, where closing procedures are inadequate and transactions are not always recorded in the appropriate reporting period, an auditor will plan on spending more time conducting detailed testing around year end.

There are a number of ways that an auditor can assess the adequacy of their client's closing procedures. Clients that report monthly are more likely to have in place well-established closing procedures than clients that report only annually. An auditor will check the accuracy of accrual calculations around year end. An auditor can look at earnings trends to assess whether the reported income is in line with similar periods (months or quarters) in prior years. For example, revenues are generally higher for an ice cream seller in warmer months, and wages are generally higher during the months when a client holds its annual sales and extra staff are hired to help out with the increased activity.

If an auditor believes that their client is under pressure to report strong results, there is a risk that revenues earned after year end will be included in the current year's income and expenses incurred before year end will be excluded. If the auditor believes that their client is under pressure to smooth its income and not report any unexpected increases, there is a risk that revenues earned just before year end will be excluded from current income and expenses incurred after year end will be included. See Professional Environment 3.2 for further discussion of this point. In both cases, the auditor will trace transactions recorded close to year end to source documentation and confirm that all transactions are recorded in the appropriate accounting period.

3.2 Professional Environment Top Management Compensation

Just how big are the incentives for good performance by chief executive officers (CEOs) of publicly traded Canadian companies? A survey of Canadian executives shows that they can be very big indeed. The top paid CEO in Canada in 2018, John Chen, the head of BlackBerry Ltd., was paid $142.0 million in salary, stock options, and bonuses.

Second on the list was Helena Foulkes of Hudson's Bay Co who took home $29.4 million. She was followed by the CEO of Magna International Inc., Donald J. Walker, with $26.0 million. An annual review conducted by the Canadian Centre for Policy Alternatives found that the average compensation for Canada's top 100 CEOs was $11.8 million. This is 227 times the average salary for the everyday Canadian. Academic research suggests that auditors need to be aware of the potential effects of incentives related to compensation packages. For example, Paul Healy provided evidence that, when top executives are paid a bonus according to a formula incorporating minimum and maximum profit levels, profits appear to be "managed" in predictable ways. Healy's evidence suggests that, if the minimum profit is not likely to be reached, managers will take action to increase accruals (such as closing entries) to reduce the current year's profit. When the overaccrual reverses in the next year, there will be a boost to profit, and therefore managers will receive a bonus on the amount that they are able to "shift" into the next year. Managers take the same action to reduce profit if it is likely to be above the required maximum, therefore deferring the profit and bonus to the following year. However, if profit is between the required minimum and maximum, managers will try to increase profit to increase their bonus.

The lesson from the academic research is that, if auditors understand how the bonus arrangement works, they will be more alert to the type of profit shifting likely to be attempted by managers.

Q: Understanding any biases that may exist in a corporation, such as compensation formulas, should be done at what phases of an audit?

Sources: David Macdonald, "Fail Safe CEO Compensation in Canada," Canadian Centre for Policy Alternatives, January 2020; Paul Healy, "The Effect of Bonus Schemes on Accounting Decisions," *Journal of Accounting and Economics*, April 1985, pp. 85–107.

Cloud 9 Integrated Case

The partner, Jo Wadley, has learned of pressure from the parent company on Cloud 9's management to increase revenue by 3 percent this year. Jo is also aware of cost increases associated with a new store and sponsorship deals. Jo believes that this places additional pressure on Cloud 9's management to meet targets, resulting in additional risks for closing procedures. Jo has instructed Suzie to allocate additional time to auditing closing procedures on the Cloud 9 audit.

Before You Go On

3.9.1 Explain how an auditor can assess the risk associated with their client's closing procedures.

3.9.2 Outline how an auditor can assess the adequacy of their client's closing procedures.

3.9.3 What is the particular risk when an auditor believes that their client is under pressure to report strong results?

Summary

1 Identify the different phases of an audit.

The phases of an audit include risk assessment, risk response, and reporting. During the risk assessment phase, an auditor will gain an understanding of their client in order to make an informed risk assessment, develop an audit strategy, and set their planning materiality. During the risk response phase, an auditor will execute their detailed testing of account balances and transactions. The final phase of every audit involves reviewing all of the evidence gathered throughout the audit and arriving at a conclusion regarding the fair presentation of the client's financial statements. The auditor will then write an audit report that reflects their opinion based upon their findings.

2 Explain the process used in gaining an understanding of the client.

An auditor will gain an understanding of their client to aid in the risk identification process. This process involves consideration of issues at the entity level, the industry level, and the broader economic level. At the entity level, an auditor will identify the client's major customers, suppliers, and stakeholders (that is, banks, shareholders, and employees). The auditor will also determine whether their client is an importer or exporter, who the client's competitors are, what the client's capacity is to adapt to changes in technology, and what the nature of any warranties provided to customers is. At the industry level, an auditor is interested in their client's position within its industry. At the economic level, an auditor will assess how well positioned the client is to cope with current and changing government policy and economic conditions.

3 Explain how related parties can impact risk.

Related parties include parent companies, subsidiaries, joint ventures, associates, company management, and close family members of key management. Since related parties are not independent of each other, these transactions may not be in the normal course of business. This increases the risk of material misstatement and may impact the overall financial results. Therefore, related party transactions require some specific consideration throughout the audit and specific procedures should be performed and documented.

4 Evaluate fraud risk.

Fraud is an intentional act through the use of deception to obtain an unjust or illegal advantage. The two kinds of fraud are financial reporting fraud and misappropriation of assets. There are a number of techniques the auditor uses to assess the risk of fraud. The audit file must document the fraud risk assessment and procedures performed to support that assessment.

5 Explain the going concern assumption.

The going concern assumption is made when it is believed that a company will remain in business for the foreseeable future. An auditor will consider the appropriateness of this assumption during the risk assessment phase and then throughout the audit.

6 Explain how estimates can impact risk.

Accounting estimates impact the financial statements. Estimates involve estimation uncertainty, which increases with the complexity, subjectivity, and uncertainty of an estimate. The greater the estimation uncertainty, the greater the risk of material misstatement and the more audit effort required. There are a number of risk assessment procedures the auditor must perform with respect to estimates.

7 Appraise corporate governance.

Corporate governance is the rules, systems, and processes used to guide and control within companies. Among other things, governance structures are used to assess the level of risk faced and to design controls to reduce identified risks.

8 Evaluate how a client's information technology (IT) can affect risk.

There are a number of risks associated with IT. During the risk assessment phase of the audit, the auditor will assess the likelihood that their client's financial statements are misstated due to limitations in its IT system.

9 Explain how a client's financial reporting practices and closing procedures can affect reported results.

An auditor should understand the accounting policies selected by management to ensure they are applied consistently, to understand the impact of management bias, and to understand the entity's transactions to better assess where the risk of material misstatement exists. There are a number of risks associated with a client's closing procedures. Closing procedures are the processes used by a client at year end to ensure that transactions are recorded in the appropriate accounting period. From an audit perspective, there is a risk that the client's closing procedures are inadequate.

Key Terms

Self-Test Questions

Answers can be found in *WileyPLUS*.

3.1 When gaining an understanding of the client, the auditor will identify the geographic location of the client because:

- **a.** more spread-out clients are harder to control.
- **b.** the auditor will need to visit the various locations to assess processes and procedures at each site.
- **c.** the auditor will plan to use staff from affiliated offices to visit overseas locations.
- **d.** all of the above.

3.2 An auditor will perform all of the following to gain an understanding of the entity, except:

- **a.** make inquiries of both financial and non-financial staff who may be able to identify the risk of material misstatement.
- **b.** perform analytical procedures to identify any unusual or unexpected relationships that may indicate areas of risk.
- **c.** perform observation and inspection procedures to corroborate the responses by management.
- **d.** perform detailed testing on key balance sheet accounts.

3.3 When gaining an understanding of the client's operations, the auditor:

- **a.** will note the number of operations the client has.
- **b.** will consider if the client is geographically dispersed.
- **c.** will note where the client operates.
- **d.** all of the above.

3.4 When gaining an understanding of the client at the industry level, the auditor:

- **a.** will not ignore information about the client's industry.
- **b.** will not consider the level of demand for the goods and services provided by other companies in the client's industry.
- **c.** will not consider government taxes on the industry because they are out of the client's control.
- **d.** will not listen to bad news reports about the client firm because the client's reputation in the press is not important.

3.5 The CSA's *Corporate Governance Guidelines* are designed to help companies:

- **a.** improve their corporate structure.
- **b.** improve performance.
- **c.** enhance their accountability to shareholders and other interested third parties.
- **d.** all of the above.

3.6 An example of an opportunity that increases the risk of fraud is:

- **a.** the client operates in a highly competitive industry.
- **b.** the client has a history of making losses.
- **c.** there is a high volume of transactions close to year end.
- **d.** all of the above.

3.7 The auditor must consider whether it is appropriate to assume that the client will remain as a going concern:

- **a.** because this means that assets are valued on the basis that they will continue to be used for the purposes of conducting a business.
- **b.** only if the client is facing bankruptcy, and long-term debt is likely to be withdrawn.
- **c.** only if the client is listed on a stock exchange.
- **d.** because mitigating circumstances are not important.

3.8 Which of the following statements is true with respect to estimation uncertainty?

- **a.** It is an accounting concept relating to precision and so it has no impact on an audit.
- **b.** Complexity, subjectivity, and uncertainty impact estimation uncertainty.
- **c.** All accounting estimates are high in estimation uncertainty.
- **d.** Estimation uncertainty is not considered when determining the audit effort with respect to accounting estimates.

3.9 When gaining an understanding of the client, the auditor will consider:

- **a.** related party identification.
- **b.** the appropriateness of the client's system of internal controls to mitigate identified business risks.
- **c.** controls over the technology used to process and store data electronically.
- **d.** all of the above.

3.10 Client closing procedures:

- **a.** are routine transactions that do not have an impact on audit risk.
- **b.** are the responsibility of management and those charged with governance who must ensure that transactions are recorded in the correct accounting period.
- **c.** affect expense accounts only.
- **d.** all of the above.

Review Questions

3.1 Explain the relationship between the risk assessment, risk response, and reporting phases of an audit. Why is risk identification in the first phase?

3.2 What are the audit activities in the risk assessment phase of a financial statement audit?

3.3 When gaining an understanding of a client, an auditor will be interested in an entity's relationships with both its suppliers and customers. What aspects of these relationships will the auditor be interested in and how would they affect the assessment of audit risk?

3.4 List and briefly explain the key factors that the auditor would consider during preliminary risk identification with respect to related parties.

3.5 In the context of fraud, explain what "opportunity" means.

3.6 What procedures should the auditor perform with respect to fraud?

3.7 What does it mean when we say that a business is a "going concern" or, alternatively, has "going concern issues"? Why must an auditor specifically consider evidence about the going concern assessment for each client?

3.8 What are mitigating factors in the context of the going concern assessment? Give some examples of mitigating factors for a client that has experienced a loss during the current year.

3.9 Why does the auditor assess the impact of estimates on an audit? What information should the auditor obtain to perform the risk assessment with respect to accounting estimates?

3.10 Why does an auditor need to understand a client's IT system? Explain how IT affects the financial statements.

3.11 Give an example of a client closing procedure. Using your example, explain the accounts that would be affected if the closing procedure was performed inadequately.

Professional Application Questions

Basic Moderate Challenging

3.1 Audit planning **Basic** **LO 1, 2**

Michael Cheung has drafted an audit plan for a new client. The client is Countrywide Capers, a party rental business. Countrywide Capers earns 80 percent of its revenue from renting out tents, tables, dishes, cutlery, napkins, and tablecloths. Michael's plan shows that audit time is divided to reflect this revenue pattern (that is, 80 percent of the audit time is spent on the rental business and 20 percent of the time is spent on the retail business). Michael believes that the significance of the revenue activities should be the only driver of the audit plan because the client has no related parties and has a simple, effective corporate governance structure.

Required

What questions would you have for Michael before accepting his audit plan?

3.2 Understanding the client **Basic** **LO 2**

Stokes Ltd. operates in the steel fabrication industry. Its business is organized into domestic and international sales and it has many clients in each area. It obtains most of its raw materials from two suppliers, both located in the same province as Stokes's main operations. The government is currently considering relaxing the tariffs on steel, so that more overseas suppliers can enter the domestic market in competition with Stokes.

Required

What issues would the auditor be interested in researching further for Stokes?

3.3 Understanding the client and its risks—audit planning **Moderate** **LO 1, 2**

Ivy Bishnoi is preparing a report for the engagement partner of an existing client, Scooter Ltd., an importer of scooters and other low-powered motorcycles. Ivy has been investigating certain aspects of Scooter's business given the change in economic conditions over the past 12 months. She has found that Scooter's business, which experienced rapid growth over its first five years in operation, has slowed significantly during the past year. Initially, sales of scooters were boosted by good economic conditions and solid employment growth, coupled with rising gas prices. Consumers needed transportation to get to work and the high gas prices made the relatively cheap running costs of scooters seem very attractive. In addition, the low purchase price of a small motorcycle or scooter, at between $3,000 and $8,000, meant that almost anyone who had a job could obtain a loan to buy one.

However, Ivy has found that the sales of small motorcycles and scooters have slowed significantly and that all importers of these products, not just Scooter, are being adversely affected. The onset of an economic recession has restricted employment growth, and those people who still have jobs are less certain of continued employment. In addition, a slowdown in the world economy has caused oil prices to fall, further reducing demand for this type of economical transport. Ivy has also discovered that, due to the global slowdown, the finance company used by Scooter's customers to finance the purchase of scooters and motorcycles has announced that it will not be continuing to provide loans for any type of vehicle with a purchase price of less than $10,000.

Required

a. Identify the issues that potentially have an impact on the audit of Scooter.

b. Explain how each issue affects the audit plan by identifying the risks and the financial statement accounts that require closer examination.

Questions 3.4 and 3.5 are based on the following case.

Featherbed Surf & Leisure Holidays Ltd. (Featherbed) is a resort company based on Vancouver Island. Its operations include boating, surfing, fishing, and other leisure activities; a backpackers' hostel; a family hotel; and a five-star resort. Justin and Sarah Morris own the majority of the shares in the Morris Group, which controls Featherbed. Justin is the chairman of the board of directors of both Featherbed and the Morris Group, and Sarah is a director of both companies as well as the CFO of Featherbed.

In February 2023, Justin approached your audit firm, KFP Partners, to carry out the Featherbed audit for the year ending June 30, 2023. Featherbed has not been audited before but this year the audit has been requested by the company's bank and a new private equity investor group that has just acquired a 20-percent share of Featherbed.

Featherbed employs 30 full-time staff. These workers are employed in administration, accounting, catering, cleaning, and hotel/restaurant duties. During peak periods, Featherbed also uses part-time and casual workers. These workers tend to be travellers visiting the West Coast who are looking for short-term employment to help pay their travelling expenses.

Justin and Sarah have a fairly laid-back management style. They trust their workers to work hard for the company and they reward them well. The accounting staff, in particular, are very loyal to the company. Justin tells you that some of the accounting staff enjoy their jobs so much that they have never taken any holidays, and hardly any workers ever take sick leave.

There are three people currently employed as accountants, the most senior of whom is Peter Pinn. Peter heads the accounting department and reports directly to Sarah. He is in his fifties and plans to retire in two or three years. Peter prides himself on his ability to delegate most of his work to his two accounting staff, Kristen and Julie. He claims he has to do this because he is very busy developing a policy and procedures manual for the accounting department. This delegated work includes opening mail, processing payments and receipts, banking funds received, performing reconciliations, posting transactions, and performing the payroll function. Julie is a recently graduated Chartered Professional Accountant. Kristen works part-time—coming into the office on Mondays, Wednesdays, and Fridays. Kristen is responsible for posting all journal entries into the accounting system and the payroll function. Julie does the balance of the work, but they often help each other out in busy periods.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's Audit and Assurance Exam, May 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

3.4 Gaining an understanding of a new client **Moderate** **LO 2**

You have access to the following information for Featherbed:

- prior-period financial statements
- anticipated results for the current year
- industry comparisons

Required

Explain how you would use this information to understand your new client.

3.5 Assessing fraud risk **Moderate** **LO 4**

Required

a. Identify and explain any significant fraud risk factors for Featherbed.

b. For each fraud risk factor you identify, explain how the risk will affect your approach to the audit of Featherbed.

3.6 Related party transactions and accounting estimates **Moderate** **LO 3, 6**

Sisters Inc. beauty salon is a 100 percent subsidiary of Benefit Beauty Supply Inc., a beauty supply company. As a result of this relationship, there were several transactions between the two entities during the past year. Sisters rented retail space for its salon from Benefit Beauty during the past year. Sisters also purchased beauty supplies from Benefit Beauty. Lastly, Sisters has a non–interest-bearing loan owing to Benefit Beauty, and there are no repayment terms for this loan.

Sisters is looking to expand next year and is seeking a new bank loan. As a result, it has asked Sol Newton, CPA, to audit its financial statements. In a preliminary discussion with management, Sol notes that most sales are on a cash basis, and therefore accounts receivable are not significant. Sisters holds an inventory of beauty supply products, including hair products and tools. It also has property, plant, and equipment that is being depreciated over the estimated useful lives. The auditor learns Sisters is being sued because one of the stylists at Sisters provided styling services for a wedding party and over-dyed the hair of the entire wedding party, resulting in it cracking off and impossible to put in updos. The lawsuit is for a significant amount as the bride is claiming damages for pain and suffering because she says her wedding and wedding pictures were ruined due to the disastrous styling from Sisters salon. Sisters Inc. prepares its financial statements using ASPE.

Required

a. Discuss the impact these transactions will have on Sol during the risk assessment phase.
b. Discuss the accounting estimates with respect to estimation uncertainty for Sisters Inc. What information should the auditor gather with respect to these estimates?

3.7 Motives and opportunities to commit fraud **Basic** **LO 4**

Required

From the list below, identify what you would consider as

a. an incentive for fraud, or
b. an opportunity for fraud.

1. college or university tuition
2. gambling debts
3. the fact that nobody counts the inventory, so losses are not known
4. the fact that the petty cash box is often left unattended
5. illegal drugs
6. the finance vice-president having investment authority without any review
7. alimony and child support
8. expensive lifestyle (homes, cars, boats)
9. business or stock speculation losses
10. the fact that upper management considered publishing a written statement of ethics but decided not to
11. taxation on good financial results
12. supervisors setting a bad example by taking supplies home
13. the fact that an employee was caught and fired, but not prosecuted

3.8 The fraud triangle **Basic** **LO 4**

Francine Rideau, controller of Quatco Company, is reviewing the year-end financial statements with Tonya Kowalski, the company president. The financial statements currently report a net income of $563,480. Tonya is applying for a very substantial bank loan for a plant expansion, and thus would like to report a net income of at least $700,000.

Toward this end, Tonya suggests accruing several sales based on orders received, even though the goods will not be shipped until after year end, and thus they are sales of the following year. She said, "If we record sales revenue for these two large orders, our net income should be more than $700,000. This should not be a problem next year, as we will never notice the loss of these sales then, since our sales revenue will dramatically increase once the expanded plant is in place."

Required

Identify the incentives or pressures to commit a fraud, the opportunity to perpetrate a fraud, and the rationalizations used to justify committing a fraud.

3.9 Fraud risk **Moderate** **LO 4**

An airline company has been adversely impacted by a global economic slowdown and its effect on business travel. In addition to lower overall demand, the airline company faces increased competition from other airlines, which are heavily discounting flights. The airline company policy for revenue is to credit sales to an unearned revenue account (the airline reports under ASPE), and subsequently transfer them to revenue when passengers or freight are picked up or tours and travel air tickets and land transportation are utilized.

In preparing for the 2023 audit, you review the 2022 financial statements and note that revenue from passengers represents 8 percent of total revenue. The interim financial information for the 2023 year shows a 6-percent fall in revenue from passengers, and an 11-percent decrease in revenue from passengers in advance.

You read in the financial press that the global slowdown has led to an increased incidence of fraud and the majority of these frauds are committed by company directors and senior managers.

Required

Explain why the revenue from passenger accounts in the income statement is at significant risk of fraudulent financial reporting by management.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's Audit and Assurance Exam, May 2010. Provided courtesy of Chartered Accountants Australia and New Zealand.

3.10 Financial reporting fraud risk **Moderate** **LO 4**

Vaughan Enterprises Ltd. has grown from its beginnings in the steel fabrication business to become a multinational manufacturer and supplier of all types of packaging, including metal, plastic, and paper-based products. It has also diversified into a range of other businesses, including household appliances in Europe, the United States, and Asia. The growth in the size of the business occurred gradually under the leadership of the past two CEOs, both of whom were promoted from within the business.

At the beginning of last year, the incumbent CEO died of a heart attack and the board appointed a new CEO from outside the company. Despite the company's growth, returns to shareholders have been stagnant during the past decade. The new CEO has a reputation for turning around struggling businesses by making tough decisions. The new CEO has a five-year contract with generous bonuses for improvements in various performance indicators, including sales to assets ratio, profit from continuing operations, and share price.

During the first year, the new CEO disposed of several segments of the business that were not profitable. Very large losses on the discontinued operations were recorded and most non-current assets throughout the business were written down to recognize impairment losses. These actions resulted in a large overall loss for the first year, although a profit from continuing operations was recorded. During the second year, recorded sales in the household appliances business in the United States increased dramatically, and, combined with various cost-saving measures, the company made a large profit.

The auditors have been made aware through various conversations with middle management that there is now an extreme focus on maximizing profits through boosting sales and cutting costs. The attitude toward compliance with accounting regulations has changed, with greater emphasis on pleasing the CEO than taking care to avoid breaching either internal policies or external regulations. The message is that the company has considerable ground to make up to catch up with other companies in both methods and results. Meanwhile, the share price over the first year and a half of the CEO's tenure has increased 65 percent, and the board has happily approved payment of the CEO's bonuses and granted the CEO additional stock options in recognition of the change in the company's results.

Required

a. Discuss the incentives, pressures, and opportunities to commit financial statement fraud, and the attitudes and rationalizations to justify a fraud in the above case.

b. What financial statement frauds would you suspect could have occurred at Vaughan?

c. What are the procedures surrounding the fraud risk assessment that should be performed and documented?

3.11 Fraud risk **Challenging** **LO 4**

Fellowes and Associates Chartered Professional Accountants is a successful mid-tier accounting firm with a large range of clients across Canada. In April 2023, Fellowes and Associates gained a new client, Health Care Holdings Group (HCHG), which owns 100 percent of the following entities:

- Shady Oaks Centre, a private treatment centre
- Gardens Nursing Home Ltd., a private nursing home
- Total Laser Care Limited, a private clinic that specializes in laser treatment of skin defects.

The year end for all HCHG entities is June 30.

The audit partner for the audit of HCHG, Tania Fellowes, has discovered that two months before the end of the financial year, one of the senior nursing officers at Gardens Nursing Home was dismissed. Her employment was terminated after it was discovered that she had worked in collusion with a number of patients to reduce their fees. The nurse would then take secret payments from the patients.

The nursing officer had access to the patient database. While she was only supposed to update room-location changes for patients, she was able to reduce the patients' period of stay and the value of other services provided. The fraud was detected by a fellow employee who overheard the nurse discussing the scam with a patient. The employee reported the matter to Gardens Nursing Home's general manager.

Required

a. Which accounts on the balance sheet and income statement are potentially affected by the fraud?

b. Describe how Gardens Nursing Home's business could be affected as a result of the fraud.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's Audit and Assurance Exam, December 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

3.12 Going concern Moderate LO 5

The Wellington Plaza Hotel is located close to the main railway station in a large regional city. Its main client base is business people visiting the city for work-related purposes. The second-largest group of clients consists of people visiting the city for its great shopping. All major department stores have a presence in the city and there are also lots of specialty shops and factory outlets. Another large group of clients are people visiting the city for various sports events, including several important hockey games during the winter.

Occupancy rates have been reasonable but stagnant for several years, providing a steady but unsatisfactory rate of return for the owners of the hotel. Revenues have been sufficient to cover operating costs, but no substantial progress has been made on repaying the large, long-term loans used to finance the hotel. In an effort to increase the hotel's profitability, a major renovation program was undertaken and completed earlier this year. The renovation was predicted to increase the relative attractiveness of the hotel to guests. It was also undertaken to earn additional revenue from the rent of a new coffee shop on the ground floor. The coffee shop is run by a separate company that has purchased a franchise of a major international brand.

An economic slowdown means business travel is down by 25 percent across the country. Further, discretionary retail spending is down by 40 percent. Several specialty shops in the city have already shut down and others are cutting their opening hours. In addition, the hockey series was won by the local team in four games (instead of the possible seven games). Thousands of visitors left the city early once the final game was over. Just before the hockey games began, the coffee-shop owners went bankrupt and closed down, breaking their lease. The hotel owners are seeking legal advice on whether they can claim penalty fees on the broken lease.

Finally, the hotel owners' bank is warning that the short-term financing obtained for the renovations will not be renewed when it is due (one month after year end). The hotel managers had expected to repay the debt from this year's bookings and the coffee-shop lease. The hotel owners are still hopeful that the summer will bring a large increase in occupancy (and revenue) as the weather is expected to be nice. This expected summer trade is essential to meet repayments on the long-term debt and to convince the bank to extend the short-term debt.

Required

a. Is there a going concern issue in this case? Explain.

b. Are there mitigating factors? Explain them and how they would affect the auditor's conclusion.

3.13 Risk assessment—going concern financial considerations Basic LO 1, 5

A new client, an oil and gas explorer in Western Canada, is currently negotiating a loan worth $3 million to avoid defaulting on its long-term debt that is due in three months. Its latest quarterly earnings report indicated the entity has a working capital deficiency of $500,000, while its cash balance fell to $250,000, down from $500,000 a year earlier. There is a 0.5:1 current ratio. With little expectation of improved sales, the entity plans to cut back on production to preserve cash. It has also been paying suppliers late consistently and as a result some suppliers have begun demanding cash on delivery from the client. As a result, the share price has plunged and the entity has lost more than half of its market value in the past week.

Required

Discuss whether there are any events or conditions that may cast doubt on the new client's ability to continue as a going concern.

3.14 Going concern and accounting estimates Moderate LO 5, 6

Francine, a CPA, is planning the audit of Richmond Contractors, a construction company that reports under ASPE. Francine notes the following with respect to Richmond:

- Richmond records revenue using the percent of completion method, using costs to date to total estimated costs to record the revenue earned.
- Francine notes that Richmond has significant accounts receivable and in the past, the allowance for doubtful accounts has been a good estimate of the actual uncollectible amounts.
- The company has inventory on hand, primarily goods needed for the projects in process. There is also inventory left over from past jobs. Management claims this leftover inventory can be reused. Francine notes some of this inventory is over two years old. The amount is material.
- The largest assets on the balance sheet include an office building and heavy equipment.
- Several years ago, Richmond purchased a competitor, which resulted in a large balance of goodwill on the balance sheet.

- Richmond has not been profitable the past two years. Competition in the construction industry has meant the company needs to bid low to be awarded any contracts. In addition, there have been some substantial cost overruns on the largest contracts in the past year.
- During the year, Richmond decided to withdraw from a contract it determined it could not complete, and the property owner is suing the company for damages. If the property owner is awarded a large payment for damages, Richmond is not sure how it will settle it.
- The company's line of credit and lending capacity is at its maximum.
- In order to encourage cost management, the company implemented a stock option plan for employees during the year.

Required

a. Discuss the factors that question whether Richmond is a going concern and what Francine should do in this situation when planning the audit.

b. What estimates should Francine expect to see in the financial statements of Richmond? Discuss each with respect to estimation uncertainty.

c. What is Francine required to do with respect to the accounting estimates?

3.15 Assessing corporate governance **Moderate** **LO 7**

Sax Co. sells insurance, and it has recently become a listed company. In accordance with corporate governance guidelines, the finance director of Sax is reviewing the company's corporate governance practices.

Bill Duguay is the chair of Sax. Bill vacated the chief executive position last year to become the chair of the board, and a new chief executive has not yet been found. Bill is unsure if Sax needs more non-executive directors. There are currently six members on the board: four executive directors and two non-executive directors. He is considering appointing one of his brothers, who is a retired chief executive officer.

The finance director, Jessica Oblonski, is considering setting up an audit committee, but she has not undertaken this task yet as she is very busy. A new board director was appointed nine months ago. He has yet to undertake his board training as this is normally provided by the chief executive and this role is still vacant.

There are a large number of shareholders, and therefore the directors believe that it is impractical and too costly to hold an annual general meeting of shareholders. Instead, the board has suggested sending out the financial statements and any voting resolutions by email; shareholders can then vote on the resolutions via email.

Required

Identify and explain the corporate governance weaknesses with Sax and provide a recommendation to address each weakness.

Source: Adapted from ACCA Audit Framework, Paper 6, June 2014 exam.

3.16 Understanding the client and its governance **Basic** **LO 2, 7**

Ajax Ltd. is a listed company and a new client of Delaware Partners, a medium-sized audit firm. Jeffrey Nycz is the engagement partner on the audit and has asked the members of the audit team to start the process of gaining an understanding of the client in accordance with CAS 315. One audit manager is leading the group investigating the industry and economic effects, and another is helping Jeffrey consider issues at the entity level. Jeffrey is holding discussions with members of the audit committee, and his talks will cover a wide range of issues, including the company's corporate governance principles. He has a meeting arranged for next week with the four members of the audit committee, including the chair of the committee, Stella South, who, like the other members of the audit committee, is an independent director.

Required

a. Make a list of the main factors that will be considered by each audit manager's group.

b. What are the required disclosures related to Ajax's corporate governance practices? What should Ajax consider if it wants to have good corporate governance practices?

3.17 Assessing the risks associated with information technology **Moderate** **LO 8**

Shane Whitebone is getting to know his new client, Clarrie Potters, a large discount electrical retailer. Gail Brothers has been the engagement partner on the Clarrie Potters audit for the past five years, but the audit partner rotation rules have meant that the engagement partner had to change this year. Shane discovers that, toward the end of last year, Clarrie Potters installed a new IT system for inventory control. The system was not operating prior to the end of the past financial year, so its testing was not included in the previous audit. The new system was built for Clarrie Potters by a Montreal-based software company, which modified another system it had designed for a furniture manufacturer and retailer.

Required

What audit risks are associated with the installation of the new inventory IT system at Clarrie Potters?

3.18 Audit planning in an EDP environment **Challenging** **LO 8**

Farm Fresh Foods Inc. (FFF) is a new food distribution company that has been profitable since the second month of operations. It has arranged with Smith LLP, an accounting firm, to conduct an external audit of its first year of operations. FFF has a large electronic data processing (EDP) installation with six EDP employees, including the EDP manager, a former accountant who is taking courses to upgrade her skills in computer operations and programming. Mary Heston of Smith LLP is in charge of designing an audit plan for the EDP function, and Ahmed Khan is auditing receivables, purchases, and payroll.

Required

What should the auditor consider when assessing the risks related to this IT environment?

Source: Adapted from the Certified General Accountants Association of Canada, Auditing 1 Exam, June 2006.

3.19 IT risk assessment **Basic** **LO 8**

Expansion Aviation has installed a new payroll module for its existing accounting system that integrates with the general ledger application. The new payroll application is more complex than the old system, but its reporting function provides more details. For example, the new application calculates vacation, pension, payroll tax, and workers' compensation expenses, as well as the corresponding accounting accruals. There was very little time available to implement the new system, so the old application ceased operation on December 31, 2022, and the new application went live on January 1, 2023. There was no time to run the two systems in parallel and there was limited staff training and testing of the new application.

Required

What concerns would you have about the implementation of the new payroll system?

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's Audit and Assurance Exam, July 2010. Provided courtesy of Chartered Accountants Australia and New Zealand.

3.20 Impact of financial reporting practices and closing procedures on performance **Basic** **LO 9**

Dunks Holdings Ltd. (Dunks) imports hardware goods and distributes them to hardware retailers around the country. The growth in the do-it-yourself (DIY) market, which has accompanied the boom in house prices in most capital cities over the past five years, has provided consistent sales growth for both hardware retailers and wholesalers like Dunks. However, the recession that began last year has cast doubt on the ability of this sector to keep growing. Some analysts believe that the DIY market will not be affected by the recession because, in tough economic times, homeowners increase their "nesting" behaviour; that is, they spend even more on improving their homes and retreat from outside activities such as holidays, the theatre, and restaurants. This view is disputed by other analysts, who believe that job losses and general pessimism in the economy will hurt all company profits, including Dunks.

Dunks's share price has fallen over the past year as doubt spreads about its ability to grow its profits in the current year. The CEO and other senior management have large bonuses linked to both share prices and company profitability, and there is a mood within the company that achieving sales and profit targets this year is vital to avoid job losses. To prevent layoffs, the CEO has suggested changing some of the accounting polices to boost profits.

You have been brought into the audit team for Dunks this year and given the responsibility for auditing Dunks's financial reporting practices and closing procedures. Dunks has a monthly reporting system for internal management, but you notice that the reports are being issued later in the following month this year than they were last year.

Required

a. Explain why and how the circumstances described above could affect your risk assessment.

b. How do you plan to audit Dunks's closing procedures? What potential errors would you be most interested in?

Cases

[1]**3.21** Integrative Case Study—Cool Look Limited **Challenging**

Cool Look Limited (CLL) is a high-end clothing design and manufacturing company that has been in business in Canada since 1984. CLL started as an owner-managed enterprise created and run by Hector Gauthier. Its ownership has stayed within the family, and Martin Roy, Hector's grandson, is the newly appointed president, chief executive officer, and chair of the board of CLL.

You are a Chartered Professional Accountant and the audit senior on the CLL audit for its fiscal year, which ended November 30, 2023. Today is December 9, 2023, and you are reviewing correspondence from CLL's bank. You come upon a letter dated November 1, 2023, from the bank's credit manager that causes you some concern (**Exhibit I**). You pull out your notes from your review of the board's minutes (**Exhibit II**) to clarify your thoughts.

EXHIBIT I Letter to CLL from bank

November 1, 2023

Dear Sir:

We have reviewed CLL's internal third-quarter financial statements, dated August 31, 2023. As a result of this review, we have determined that your financial ratios continue to decline and that you are in default of the covenants in our agreement for the second consecutive quarter.

However, since the bank and CLL have a long history, and because CLL continues to make required debt payments on time, we are willing to extend the $6,000,000 secured operating line of credit until the end of February 2024.

Based on CLL's February 29, 2024, internal financial statements, we will expect CLL to meet the following financial ratios. If this is not done, we reserve the right to call the loan at that time.

Ratios:

Current ratio no less than 1:1
Maximum debt to equity ratio (Debt/(Debt + Equity)) of 80%; debt is defined as total liabilities.

We thank you for your business.

Yours truly,
Charles Burbery
Credit Manager

EXHIBIT II Excerpts from notes taken during review of board minutes

- August 7, 2023. Management presented a document discussing the temporary cash crunch at CLL. Management presented options to conserve cash until the Christmas buying season, when a new large contract with a U.S. chain of stores begins. One alternative was to delay remitting HST and employee withholdings. The board passed a resolution to temporarily delay remitting HST and employee withholdings until cash flows improved.
- September 5, 2023. The board received information from management regarding an incident at the factory. Some dirty rags had caught fire in a metal garbage can. The fire was put out quickly and no damage was done. Management and the board were quite relieved that the fire had not spread because CLL has not renewed its fire and theft insurance this year due to the need to conserve cash. For the same reason, CLL has not renewed the directors' liability insurance. The board decided that the renewals would be done immediately after cash flows improved.
- November 10, 2023. The board passed a motion to allow Martin Roy to postpone repayment of his interest-free shareholder loan by another six months to May 31, 2024. He owes CLL $500,000.

Source: Adapted from the Uniform Final Exam (UFE), The Institutes of Chartered Accountants in Canada and Bermuda, Paper 3, 2005.

[1] Adapted with permission of the Chartered Professional Accountants of Canada, Toronto, Canada. Any changes to the original material are the sole responsibility of the publisher and have not been reviewed or endorsed by the Chartered Professional Accountants of Canada.

Financial facts

- The November 30, 2023, unadjusted financial statements show CLL's current ratio is 1.64:1.
- If the $6-million secured operating line of credit is reclassified as a current liability, the current ratio would be 0.42:1.
- The $500,000 shareholder loan to Martin Roy is also classified as long term; however, if it is classified as current, the ratio would decline further.
- The debt to equity ratio is 85.8 percent.
- The company has traditionally had a history of positive earnings; however, in the past two years, it has reported a net loss.
- Cash on hand is $1,094,000.
- Accounts payable have increased by more than 100 percent.
- Share capital is reported on the 2023 balance sheet at $10,386,000.
- CLL's long-term debt includes the $6-million secured operating line of credit. The line of credit is a revolving loan, which the bank can call on three months' notice if certain financial covenants are not met. It had been classified as long-term debt in 2022 because the bank waived its right to call the loan before December 1, 2023.

Required

a. What facts indicate that CLL may not be a going concern? What facts indicate that CLL may be a going concern? Make a conclusion on whether you believe it is appropriate to assume the company will remain a going concern.

b. What are the risks related to the shareholder loan? What are three recommended procedures the auditor should perform related to the shareholder loan?

c. What type of report should be issued if management refuses to disclose the shareholder loan as required by IFRS and ASPE? Why?

d. Discuss the decisions made by the board. Are they ethical? Explain. Do they comply with the requirements of CSA's *Corporate Governance Guidelines*?

Source: Adapted from the Uniform Final Exam (UFE), The Institutes of Chartered Accountants in Canada and Bermuda, Paper 3, 2005.

Case Study—Cloud 9

You are a graduate working for W&S Partners, a Canadian accounting firm with offices located in each of Canada's major cities. W&S Partners has just been awarded the December 31, 2023, audit for Cloud 9 Ltd. (Cloud 9). The audit team assigned to this client is:

- Jo Wadley, partner
- Sharon Gallagher, audit manager
- Josh Thomas and Suzie Pickering, audit seniors
- Mark Batten, IT audit manager
- Ian Harper and you, graduates

As a part of the planning process for the new audit, the audit team needs to gain an understanding of Cloud 9's structure and its business environment. By understanding the client's business, the audit team can identify potential risks that may have a significant effect on the financial statements. This will assist the team in planning and performing the audit.

Required

Answer the following questions based on the additional information about Cloud 9 presented in Appendix A and in this and earlier chapters. You should also consider your answer to the case study questions in earlier chapters where relevant.

Your task is to research the retail and wholesale footwear industries and report back to the audit team. Your report will form part of the overall understanding of Cloud 9's structure and its environment.

You should concentrate your research on providing findings from those areas that have a financial reporting impact and are considered probable given Cloud 9's operations. In conducting your research, you should consider the following key market forces as they relate to Cloud 9's operations.

General and industry-specific economic trends and conditions

a. What is the current condition of the economy?

b. Is the business affected by developments in other countries, foreign currency fluctuations, or other global forces?

c. If the industry is labour-intensive, are there unusual or unique labour relations issues?

d. How does the company's growth and overall financial performance compare with the industry, and what are the reasons for any significant differences?

e. What is the volume and type of transactions in the business?

f. Are the client's operations centralized or decentralized?

g. Is the client's business cyclical in nature or influenced by seasonal fluctuations in the market?

h. What is the susceptibility to fraud and theft? (Is the product something that can easily be stolen and has a ready market?)

Competitive environment

i. What products does the client sell? Have there been significant changes with respect to:

- **i.** major products or brands?
- **ii.** selling strategies?
- **iii.** sales/gross margin by product?

j. Who are the client's major competitors, and what share of the market does each hold?

k. Is there significant differentiation between the client's and competitors' merchandise?

l. What is the effect on the client of potential new entrants into the market? Are there any significant barriers to entering the market?

Product information

m. Is there a specific life cycle for the product?

n. Is the product dependent on trends or styles?

Customer information

o. Are there specific customers on whom the client is highly dependent?

p. What is the overall profile of the client's customers? Have there been significant fluctuations in the client's customer base?

Supplier information

q. Who are the key suppliers?

r. Are the materials subject to significant price movements or influenced by external market forces?

Technological advances and the effect of the Internet

s. How does the industry use technology?

t. What technological trends are impacting the industry?

Laws and regulatory requirements

u. Are the client's operations affected significantly by local or foreign legislation?

v. What new laws and regulations recently enacted (or pending) may have significant effects on the company?

Research Question 3.1

Bernard Madoff was convicted in 2009 of running a Ponzi scheme, the biggest in U.S. history. A Ponzi scheme is essentially the process of taking money from new investors on a regular basis and using the cash to pay promised returns to existing investors. The high and steady returns received by existing investors are the attraction for new investors, but they are not real returns from investments.

As long as new investors keep contributing and existing investors do not seek redemptions, or the return of their money, the scheme continues. However, eventually, as in the Madoff situation, circumstances change, the scheme is discovered, and the remaining investors find that their capital has disappeared.

At age 71, Madoff was sentenced to prison for 150 years and will die in jail. Madoff's auditor, David G. Friehling, pleaded guilty to creating false and fraudulent audited financial statements for Madoff's firm, Bernard L. Madoff Investment Securities LLC. Prosecutors alleged that these fraudulent reports covered the period from the early 1990s to the end of 2008. Friehling was sentenced to a year of home detention and a year of supervised release.

Required

a. Research the case against David Friehling. Write a report explaining his role in the Madoff Ponzi scheme and legal action against him.

b. Friehling was subject to U.S. auditing standards and legislation. Explain if, and how, Friehling's alleged actions would violate Canadian auditing standards and professional ethics.

Sources: Matthew Goldstein, "Madoff Accountant Avoids Prison Term," *The New York Times*, May 28, 2015; Dionne Searcey and Amir Efrati, "Sins and Admission: Getting into the Top Prisons," *The Wall Street Journal: Europe* 17–19, July 2009, p. 29.

Research Question 3.2

The financial statements for public companies are available through the website SEDAR (www.sedar.com). This is the official site that provides access to information filed by public companies and investment funds with the CSA. The statutory objective in making this filed information public is to enhance investor awareness of the business and affairs of public companies, and to promote confidence in the transparent operation of capital markets in Canada. Achieving this objective relies heavily on the provision of accurate information to market participants.

Required

Go to www.sedar.com and select the most recent set of audited annual financial statements for a Canadian public company. Using this set of financial statements, answer the following:

a. When planning the audit, the auditor needs to gain an understanding of the entity's structure and its business environment. To do this, the auditor focuses on identifying potential risks that may have a significant effect on the financial statements. Prepare a memo for the audit planning file and discuss the entity-, industry-, and economy-level factors that the auditor should consider to plan the audit for this entity.

b. Review the financial statement notes. Are there any related parties? If so, who are the related parties? Are there many or just a few? What is disclosed in the related party note? What impact will this have on the auditor's preliminary risk assessment?

c. With the information provided, discuss the entity's ability to continue as a going concern using the going concern indicators discussed in this chapter.

Source: www.sedar.com.

Further Reading

Canadian Securities Administrators. *National Policy 58–201: Corporate Governance Guidelines*. 2005. www.osc.gov.on.ca/documents/en/Securities-Category5/rule_20050617_58-201_corp-gov-guidelines.pdf

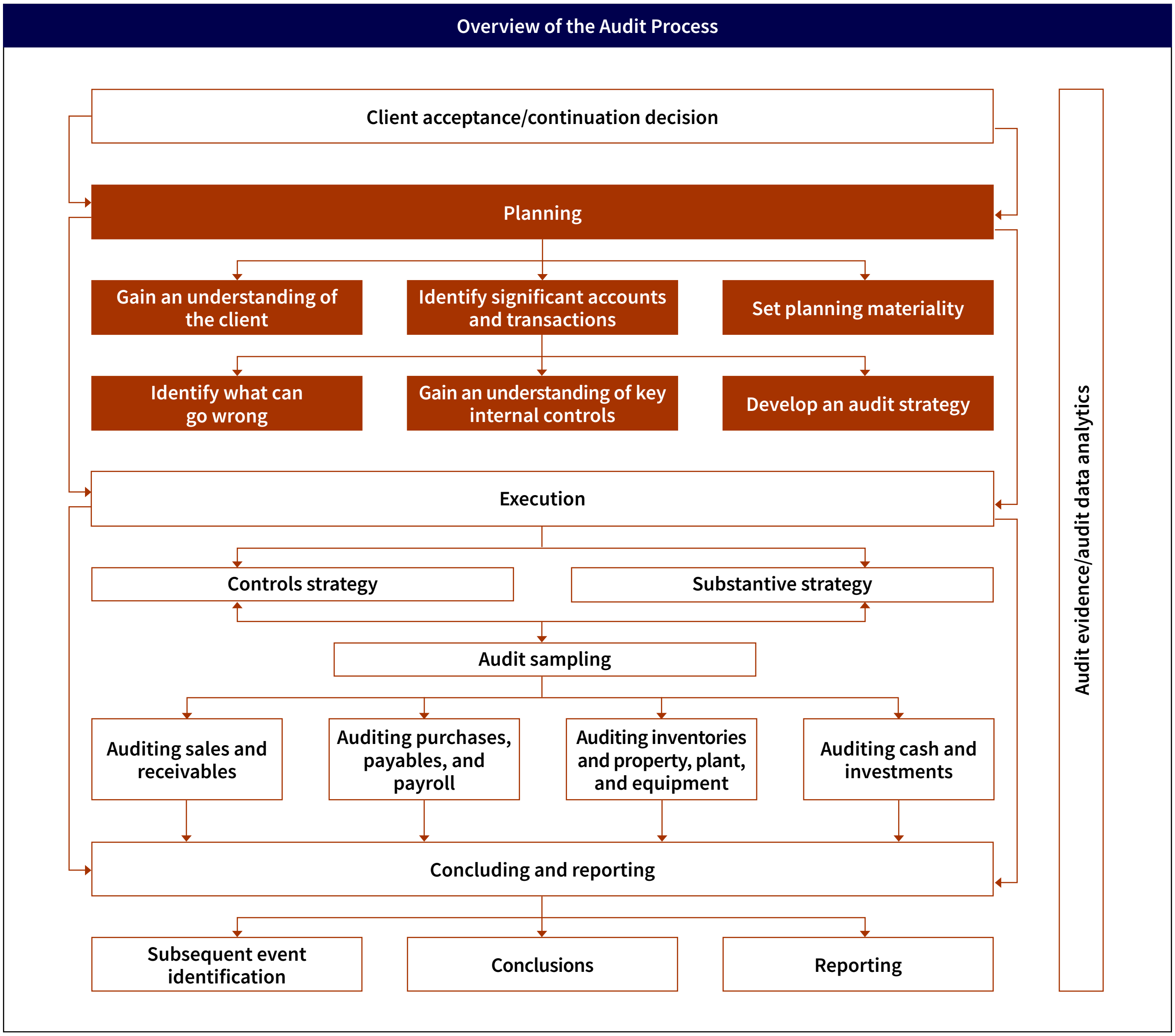
Chartered Professional Accountants of Canada. *Canadian Professional Engagement Manual.* 2016. www.castore.ca/product/canadian-professional-engagement-manual-members/5.

KnowledgeLeader. www.knowledgeleader.com.

Note

1. J. D. Wilson and S. J. Root, *Internal Auditing Manual,* 2nd ed. (Warren, Gorham & Lamont, 1989).

Audit Planning II



LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
After studying this chapter you should be able to:		Standards addressed in each learning objective are as follows:
1 Evaluate audit risk	**4.1** Audit Risk **4.1.1** The audit risk model and its components **4.1.2** Quantification of the audit risk model	CAS 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Canadian Auditing Standards* CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
2 Explain and apply the concept of materiality	**4.2** Materiality **4.2.1** Qualitative and quantitative factors **4.2.2** Materiality and audit risk	CAS 320 *Materiality in Planning and Performing an Audit* CAS 450 *Evaluation of Misstatements Identified During the Audit*
3 Describe how an auditor determines the audit strategy	**4.3** Audit Strategy	CAS 300 *Planning an Audit of Financial Statements* CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
4 Outline how clients measure performance	**4.4** Client Approaches to Measuring Performance **4.4.1** Profitability **4.4.2** Liquidity	CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
5 Summarize how an auditor uses analytical procedures when planning an audit	**4.5** Analytical Procedures **4.5.1** Comparisons **4.5.2** Trend analysis **4.5.3** Common-size analysis **4.5.4** Ratio analysis **4.5.5** Analysis with technology **4.5.6** Factors to consider when conducting analytical procedures	CAS 315 *Identifying and Assessing the Risks of Material Misstatement* CAS 520 *Analytical Procedures*

Cloud 9 Integrated Case

Ian Harper is still impatient. Despite his lengthy conversation with Suzie Pickering about the importance of gaining an understanding of the client in order to identify and manage audit risk, he is still not convinced that it makes a real difference to the audit. He has been with W&S Partners for only a few months, but every audit seems to him to be the same. Suzie knows that Ian has not yet seen enough audits to be able to understand the different strategies being used for different areas of the audit. How can she explain this to him?

Suzie calls Ian to her office. "I want you to work with me on the draft audit plan for Cloud 9," she tells him. "We have already started, but there is still a lot of work to do. What do you think is already in the plan?"

Ian is a bit surprised by Suzie's question, but he thinks about their previous discussions. "Well, first we have the results of the work done to assess the client before the engagement, followed by the engagement letter that sets out the work we have promised to perform. Then, after the client was accepted, we have the results of the partner's assessment of Cloud 9 Ltd.'s corporate governance. We also have the report on the economy-wide conditions likely to affect firms in the clothing and footwear industry, plus the specific industry reports on competition, technology, and so on. I helped you with the preliminary risk assessments based on those reports, which identify the accounts most at risk. Those risk assessments are not complete, because we haven't yet done a control system evaluation. However, the preliminary risk assessments include some consideration of going concern and fraud risk."

"That's very good," says Suzie. "So, what do you think we need to do next?"

Chapter Preview

Audit planning begins by considering the audit as a whole. Then the auditors focus on gaining an understanding of the client's business and identifying key risk factors that impact the audit plan. Auditors use this information to develop their audit strategy.

When developing an audit strategy, auditors consider the risks identified when gaining an understanding of their client's business. This helps them assess the risk that their audit procedures will not identify a material misstatement in the client's financial statements should one exist (audit risk). This chapter begins with a discussion of audit risk.

The process of setting planning materiality is then described. Qualitative and quantitative materiality factors are explained, as are performance and specific materiality. We then move on to describe how auditors develop their audit strategy based on their assessment of the risk of material misstatement.

The final sections of this chapter deal with performance measurement and analytical procedures. By understanding how a client assesses its own performance, an auditor gains an insight into which accounts may be at risk of material misstatement. An overview is provided of the performance measurement mechanisms used by companies that an auditor will focus on when planning their audit. The conduct of analytical procedures is a key element of the risk assessment phase of each audit and is explained in detail in this chapter.

4.1 Audit Risk

LEARNING OBJECTIVE 1

Evaluate audit risk.

Audit risk is the risk that an auditor expresses an inappropriate audit opinion when the financial statements are materially misstated (CAS 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Canadian Auditing Standards*). This means that an auditor reports that in their opinion the financial statements are fairly presented when, in fact, they contain a significant error or fraud, and therefore are materially misstated. While it is impossible to eliminate audit risk altogether, an auditor will aim to reduce it to an acceptably low level. Audit risk can be reduced at the risk response phase of the audit by

audit risk the risk that an auditor expresses an inappropriate audit opinion when the financial statements are materially misstated identifying the key risks faced by the client and allocating more audit time to gathering sufficient and appropriate evidence where the risk of material misstatement is highest.

inherent risk the susceptibility of the financial statements to a material misstatement without considering the internal controls

assertion statement made by management regarding the recognition, measurement, presentation, and disclosure of items included in the financial statements

spectrum of inherent risk the scale on which the inherent risk can vary

The first stage in assessing the risk of material misstatements involves an **inherent risk** assessment, where the auditor considers the risk of material misstatement before consideration of any internal controls. This is done at the financial statement level by considering such things as the nature of the business, the industry, and any previous experience with the client. Inherent risk is also assessed at the assertion level for classes of transactions, account balances, and disclosures. An **assertion** is a statement made by management regarding the recognition, measurement, presentation, and disclosure of items included in the financial statements and notes. Inherent risk at the assertion level varies as it may be higher or lower on the **spectrum of inherent risk**. After identifying a risk at the assertion level, the auditor assesses where it falls on the spectrum of inherent risk. That is, the auditor considers the inherent risk factors and the likelihood and magnitude of a possible material misstatement, and uses professional judgement to assess whether a risk is on the lower end or the higher end of the risk spectrum. Assertions and the assessed risk help guide the testing conducted by an auditor. For example, if a client sells valuable goods, such as precious gemstones, the auditor will consider the risk of overstatement of inventory because goods may be stolen but remain recorded in the client's books. Therefore, there is a high inherent risk regarding the inventory account, as there is a risk that management's assertion about the existence of the recorded inventory may not be valid. In this example, the auditor will spend more time testing for the existence of recorded inventory than in the case of a client that sells lower-valued goods. In this example, because the existence of inventory is an assertion assessed at risk of material misstatement before considering any controls, it is referred to as a **relevant assertion**. The inventory account is a **significant account**; that is, it is an account with a relevant assertion.

relevant assertion an assertion identified as at risk of material misstatement before considering any controls

significant account any account with a relevant assertion

significant risk an identified risk of material misstatement assessed at the upper end of the spectrum of inherent risk or identified as a significant risk in other auditing standards

When identifying accounts and related assertions at risk of material misstatement, some risks are classified as being more significant than others and require special audit consideration. A **significant risk** is a risk that, in the auditor's judgement, is assessed close to the upper end of the spectrum of inherent risk or identified as a significant risk in other auditing standards. For example, the risk of fraud is a significant risk and it is addressed in CAS 240.

CAS 315 suggests significant risks may arise from the following:

- transactions with more than one acceptable accounting treatment such that subjectivity is involved
- accounting estimates with high estimation uncertainty or complex models
- complexity in data collection and processing to support account balances
- account balances or quantitative disclosures that involve complex calculations
- accounting principles that may be subject to differing interpretations
- changes to the entity that involve changes to its accounting, such as mergers and acquisitions

control risk the risk that a client's system of internal controls will not prevent or detect a material misstatement

The second stage in the audit risk assessment involves an evaluation of the client's system of internal controls (**control risk**). The auditor is interested in whether the client has controls in place to minimize the risk of material misstatement in the financial statements for each account and related assertion that the auditor has identified as high risk. In the above example, if a client sells valuable goods, an auditor will assess whether the client has controls in place to reduce the risk that inventory may be stolen.

Finally, an auditor will plan to undertake detailed testing of each identified account to the extent determined necessary. This final assessment will depend upon the assessed riskiness of the account and related assertion, and the deemed effectiveness of the client's system of internal controls.

Cloud 9 Integrated Case

Ian is still struggling with the idea of risk. He knows that audit risk is the risk that the auditor issues the wrong audit report, or gives an inappropriate audit opinion, and that this risk is related to the client's circumstances. But how does that actually work in practice? What does an auditor do differently for each audit?

Suzie reminds Ian of how taking just one issue, such as how sales are made to major department stores, helped him to focus on some specific questions about accounts receivable, sales, liabilities, and inventory.

"Let's break this down," she advises. "Auditors face the risk that they issue an unmodified opinion when, in fact, the financial statements are materially misstated. So, how does a material misstatement get into the published financial statements?"

Ian works through the logic. "First, the error has to be created, either by accident or on purpose. Second, the client's control system must fail to either prevent the error from getting into the accounts or detect the error once it is in the system. And, finally, the auditor has to fail to find the error during the audit."

"Correct!" says Suzie. "Now, before we go on, I want to break down the idea of 'financial statements,' too. The financial statements are the balance sheet (statement of financial position), income statement (statement of comprehensive income), cash flow statement (statement of cash flows), statement of changes in equity, and all the required disclosures and notes. So when we talk of the risk of misstatements, we are referring to the risk of misstatement in every line item in each of these statements and the related disclosures. If we focus on just one line in a balance sheet—say, accounts receivable—what are the possible misstatements that could occur?"

Ian tries to work through the logic again. "The amount could be either understated or overstated. I suppose there are lots of errors that could occur. Obviously, basic mathematical mistakes and other clerical errors could affect the total in either direction. In addition, accounts receivable would be understated if management omitted some customer accounts when calculating the total. I think the deliberate 'mistakes' are more likely those that overstate accounts receivable because they make the balance sheet look better, and probably mean that profit is overstated, too. Accounts receivable would be overstated if some of the customer accounts claimed in the total did not exist at year end, did not belong to Cloud 9, or were overvalued because bad debts were not written off, or because sales from the next period were included in the earlier period."

"Very good," says Suzie. "It is the same for every line item. Every time management prepares the financial statements, it *asserts* that all of these errors did not occur—that all of the individual items in the statements are not materially misstated. The auditor has to break down the financial statements into accounts and assertions, and consider the risk of misstatement for *each* assertion for *each* account. The auditor deals with the risk of material misstatement of all of the financial statements by gathering evidence at the assertion level for each account. Then all the evidence is put together so the auditor can form an overall opinion on all of the financial statements. Now, let's see how this works for Cloud 9."

4.1.1 The Audit Risk Model and Its Components

Audit risk is a function of the risk of material misstatement and detection risk (CAS 200).

The risk of material misstatement exists at the financial statement level and at the assertion level. At the financial statement level, the risk of material misstatement involves risks that affect the financial statements as a whole. For example, if a client purchases a new computer system and does not adequately train staff in its use, there is a risk of errors when recording transactions used to prepare the financial statements. Therefore, an auditor needs to consider the impact of any financial statement risks on the accounts and assertions. In this example, all accounts are at risk of material misstatement. At the assertion level, the risk of material misstatement involves risks that affect classes of transactions, account balances, and disclosures. For example, if a client sells goods overseas, there is a risk that transactions may not be recorded correctly using appropriate exchange rates at the date of each transaction. The risk of material misstatement at the assertion level comprises inherent risk and control risk (CAS 200, para. 13).

Inherent risk is the possibility that a material misstatement could occur before consideration of the internal controls. This is the risk that errors can simply happen. If errors do happen, the next part of the audit risk model is control risk. That is, do the controls implemented by the client prevent or detect a misstatement before the financial statements are prepared? In assessing these risks, the auditor must identify client characteristics that place the financial statements at risk of material misstatement (inherent risk) and assess the likelihood that identified risks could result in a material misstatement. The auditor then identifies and assesses whether controls designed to limit such a risk are in place and effective (control risk). It is important to note that inherent risk and control risk are the client's risks and exist separately from the financial statement audit. The auditor has no influence on either. However, in response to the assessed client inherent and control risk, the auditor determines the amount of substantive work required to reduce the risk of material misstatement to an acceptable level. This is **detection risk**, the risk that auditors' procedures will not be effective in detecting a material misstatement should there be one. It is impossible to reduce detection risk to zero. Detection risk is the only element of the audit risk model the auditor can influence by doing more or less substantive audit work.

detection risk the risk that the auditors' procedures will not be effective in detecting a material misstatement should there be one

The audit risk model is illustrated in **figure 4.1**. The blocks represent material errors that may occur due to the nature of the business (inherent risk). The flattened circles represent

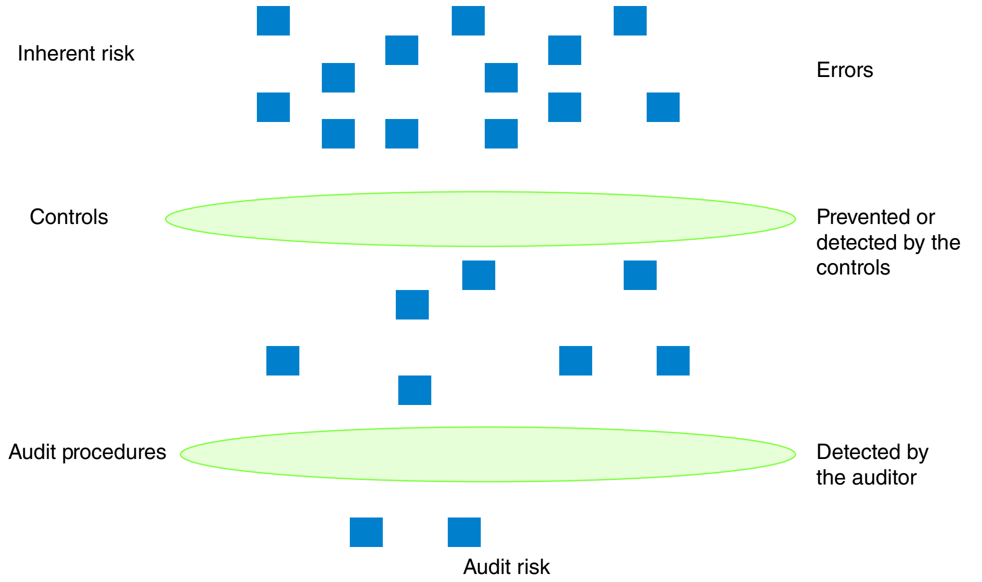


FIGURE 4.1 **Audit risk model**

"filters," which are the controls and audit procedures that are expected to prevent and detect errors. The first filter is the control of the client. If the auditor believes there are controls in place and assesses the control risk as low, the auditor believes the controls will be effective in preventing or detecting some of the blocks (errors) from getting through the filter. In this case, the auditor will plan to test these controls. The second filter is the amount of substantive work the auditor plans to perform. The auditor will plan to do enough work to reduce the risk of the blocks (errors) getting through the second filter to an acceptable level. However, there is always some risk that some blocks (errors) may get through the filter. This is the audit risk.

The inherent risk assessment is based on knowledge of the business, since many of the factors that contribute to business risks may affect inherent risk. Knowledge of the competitive environment, the current economic environment, the risk of technological obsolescence, and the level of government regulation assist in the inherent risk assessment. When assessing inherent risk, it is also important to consider such factors as the type of products and services offered by the entity, the size and complexity of the organization, the experience and knowledge level of employees, the pressures on management to meet earnings targets, the extent of errors found in previous audits, and the accounting policies selected.

The factors listed above help the auditor determine whether there may be a management bias or economic pressures that increase the likelihood of a material misstatement. For example, an organization in a highly competitive industry will have a higher inherent risk than an entity in an industry with few competitors, as greater competition usually places pressure on margins. It also may put pressure on management to make the financial results appear more favourable, therefore increasing inherent risk.

By understanding the entity, the auditor can also identify the risks that may be related to the business and the business structure. For example, a client that expands into a new market will have a higher inherent risk, because the expected sales are uncertain. A geographically dispersed conglomerate will have a higher inherent risk than an organization with a single location, as this usually translates into a greater number of transactions and more complexity. For example, an entity with complex transactions, such as numerous foreign exchange transactions, will have a higher inherent risk than one with transactions only in the local currency. An organization undergoing a first-time audit will also be assessed as having a higher inherent risk than an entity having a repeat audit, as the auditor does not have the benefit of previous experience with the entity. Also, if a client is a repeat client and the auditor has found a significant number of misstatements in the past, the auditor may assess inherent risk as higher as there is a higher likelihood of misstatements recurring. Lastly, an organization with significant staff turnover will have higher inherent risk than one with a stable staff environment, primarily due to the new employees' learning curve with the entity's various business practices and policies.

Table 4.1 provides examples of events and conditions that may give rise to a material misstatement.

Inherent risk is also assessed at the assertion level. Recall that an auditor identifies the relevant assertions and the significant accounts and assesses where the identified risks fall on the spectrum of inherent risk. To assess where a risk falls on the spectrum of inherent risk, the auditor considers inherent risk factors, along with the likelihood and magnitude of a possible misstatement. **Inherent risk factors** are the events that make a material misstatement more likely. CAS 315 identifies the following inherent risk factors:

inherent risk factors conditions that make a material misstatement more likely

1. Complexity: Events and transactions that are higher in complexity make processing errors and human errors more likely, increasing inherent risk.
2. Subjectivity: Events and transactions that require judgements are more susceptible to bias, increasing inherent risk.
3. Uncertainty: Events and transactions where the outcome is uncertain require estimation, increasing inherent risk.
4. Change: The more changes that impact the entity, the greater the risk the entity does not respond appropriately, increasing inherent risk.
5. Susceptibility of accounts or transactions to management bias or fraud: The greater the pressure on management to produce specific results, the greater the risk of management bias or fraud.

Table 4.1 contains examples of inherent risk factors.

TABLE 4.1 Conditions and events that may indicate risk of material misstatement

The following are examples of conditions and events that may indicate the existence of risks of material misstatement. The examples provided cover a broad range of conditions and events; however, not all conditions and events are relevant to every audit engagement and the list of examples is not necessarily complete.

Relevant Inherent Risk Factor	Examples of Events or Conditions that May Indicate the Existence of Risks of Material Misstatement at the Assertion Level
Complexity	**Regulatory:** • Operations that are subject to a high degree of complex regulation. **Business model:** • The existence of complex alliances and joint ventures. **Applicable financial reporting framework:** • Accounting measurements that involve complex processes. **Transactions:** • Use of off-balance sheet finance, special-purpose entities, and other complex financing arrangements.
Subjectivity	**Applicable financial reporting framework:** • A wide range of possible measurement criteria of an accounting estimate. For example, management's recognition of depreciation or construction income and expenses • Management's selection of a valuation technique or model for a non-current asset, such as investment properties.
Change	**Economic conditions:** • Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies. **Markets:** • Operations exposed to volatile markets, for example, futures trading.

(*continued*)

TABLE 4.1 **Conditions and events that may indicate risk of material misstatement (*continued*)**

Relevant Inherent Risk Factor	Examples of Events or Conditions that May Indicate the Existence of Risks of Material Misstatement at the Assertion Level
Change	**Customer loss:** • Going concern and liquidity issues including loss of significant customers. **Industry model:** • Changes in the industry in which the entity operates. **Business model:** • Changes in the supply chain. • Developing or offering new products or services, or moving into new lines of business. **Geography:** • Expanding into new locations. **Entity structure:** • Changes in the entity such as large acquisitions or reorganizations or other unusual events. • Entities or business segments likely to be sold. **Human resources competence:** • Changes in key personnel including departure of key executives. **IT:** • Changes in the IT environment. • Installation of significant new IT systems related to financial reporting. **Applicable financial reporting framework:** • Application of new accounting pronouncements. **Capital:** • New constraints on the availability of capital and credit. **Regulatory:** • Inception of investigations into the entity's operations or financial results by regulatory or government bodies. • Impact of new legislation related to environmental protection.
Uncertainty	**Reporting:** • Events or transactions that involve significant measurement uncertainty, including accounting estimates and related disclosures. • Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees, and environmental remediation.
Susceptibility to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk	**Reporting:** • Opportunities for management and employees to engage in fraudulent financial reporting, including omission, or obscuring, of significant information in disclosures. **Transactions:** • Significant transactions with related parties. • Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end. • Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold, and classification of marketable securities.

Other events or conditions that may indicate risks of material misstatement at the financial statement level:

- Lack of personnel with appropriate accounting and financial reporting skills.
- Control deficiencies, particularly in the control environment, risk assessment process, and process for monitoring, and especially those not addressed by management.
- Past misstatements, history of errors or a significant amount of adjustments at period end.

Source: IAS 315, Final Pronouncement, International Federation of Accountants, December 2019.

Control risk is the risk that a client's system of internal controls will not prevent or detect a material misstatement. That is, if a misstatement has been made, will the client's controls prevent or detect this error? In order to determine this risk, the auditor must have an understanding of the controls in place. The auditor will consider, for example, the organization's attitudes toward controls and the control procedures implemented. If the auditor determines the controls are effective, then control risk may be assessed as lower. If control risk is assessed as lower, the auditor will plan to rely on the controls and therefore perform less detailed audit work on year-end balances. If control risk is assessed as high, the auditor believes the controls are ineffective and will not test the controls. This means the assessment of the risk of material misstatement will be the same as the assessment of inherent risk (CAS 315 para. 34). As a result, the auditor will do the minimum work required on the controls and then perform more detailed work on the year-end balances.

An auditor must identify client characteristics that place the financial statements at risk of material misstatement (inherent risk, the first stage in audit risk assessment) and determine whether controls designed to limit such a risk exist and are effective (control risk, the second stage in audit risk assessment). As a result of this assessment, the auditor will then determine the detection risk required in response to the assessed audit risk and the client's inherent and control risk combined. Detection risk is the risk that the auditor's testing procedures fail to detect a material misstatement should there be one. That is, if an error was made by the client, and the controls did not detect it, will the auditor's procedures detect it?

As noted in CAS 200, para. A39, audit risk can be presented in a mathematical model that indicates the relationship between its components. The model states that audit risk is inherent risk multiplied by control risk multiplied by detection risk, as shown in **figure 4.2**.

$$AR = IR \times CR \times DR$$

where:

AR = Audit risk

IR = Inherent risk

CR = Control risk

DR = Detection risk

FIGURE 4.2 **Audit risk calculation**

An auditor will plan and perform their audit to hold audit risk to an acceptably low level (CAS 200). The acceptable audit risk for the financial statements overall is set by the auditor at the beginning of the audit. This generally tends to be quite low, and it remains constant throughout the audit. Factors that impact the determination of audit risk include the number of users relying on the financial statements, the risk the client may no longer continue to be a going concern, and past issues with management integrity. For example, audit risk would be set lower for a large public company with many financial statement users than for a privately held entity with fewer users. It would also be set lower for an entity where there are significant indicators that the entity may not continue to be a going concern than for an entity that appears financially healthy. Lastly, audit risk would be set lower for an entity where there has been a past history of questionable management integrity than for an entity where there have never been any questions about management's integrity.

The inherent and control risks are then assessed, and the auditor determines the acceptable level of detection risk. Therefore, there is an inverse relationship between the assessed level of inherent and control risk (the risk of material misstatement) and the acceptable level of detection risk. For example, if inherent and control risk are assessed as high, the resulting detection risk will be assessed as low to bring audit risk down (see **table 4.2**). This means that the auditor will increase the level of reliance placed on their detailed substantive procedures, which involve intensive testing of year-end account balances and transactions from throughout the year.

TABLE 4.2 **Assessment of detection risk in a high-risk client**

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

Example

A client sells high-end fashion clothing and has inadequate security. Inherent risk is high for inventory because clothing may be stolen but not removed from the client's books. Control risk is high because there is inadequate security, increasing the risk of theft. The auditor cannot rely on the client's security system to reduce the risk of material misstatement associated with the existence of inventory. The auditor will therefore set detection risk as low and spend more time checking that recorded inventory is actually on hand.

Example

A client is an importer with inexperienced clerical staff. Inherent risk is high for the accuracy of recorded purchases because they involve foreign currency translation. Control risk is high because clerical staff members are inexperienced and not accustomed to recording complex foreign currency transactions. Therefore, the auditor will not test the controls. Because detection risk is set as low, the auditor will perform more substantive testing, such as checking that purchases are recorded at appropriate amounts.

In contrast, if inherent risk and control risk are assessed as low, the auditor will assess the detection risk as high (see **table 4.3**). As above, there is an inverse relationship between the assessed level of inherent and control risk (the risk of material misstatement) and the auditor's acceptable level of detection risk. By assessing detection risk as high, an auditor will reduce the level of reliance placed on their detailed substantive procedures. This does not mean that the auditor is eliminating their detailed testing of year-end account balances and transactions from throughout the year. Rather, the auditor is acknowledging that the client is low risk; that is, there is a low risk of material misstatement in the client's financial statements, and extensive substantive testing is not required.

TABLE 4.3 Assessment of detection risk in a low-risk client

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

The examples provided in this section are extremes. The reality will often fall somewhere in between, where inherent risk is high, but the client has an effective system of internal controls in place to mitigate that risk. For example, a client sells high-end fashion clothing and has adequate security, so the risk for the existence of inventory is reduced. Alternatively, inherent risk is low and the client does not consider it worthwhile to invest in sophisticated control procedures. (That is, any benefit is perceived to exceed the cost.) For example, a client sells granite and has low security, reasoning that the granite slabs would be very difficult to steal. In both cases, an auditor will spend a moderate amount of time testing for the existence of inventory.

Example

A client sells granite slabs and has a high-voltage fence surrounding the inventory of granite slabs. Inherent risk is low for the existence of inventory as granite slabs are very heavy and difficult to move; thus, it is unlikely that recorded slabs do not exist. After checking that the security system is working and has been operational throughout the year, the auditor can assess control risk as low. In this case, the auditor will need to spend relatively little time checking that the recorded slabs actually exist.

> Example
>
> A client uses a reputable off-the-shelf computer program to record purchases of raw materials. Inherent risk is low for the accuracy of recorded purchases because the program is considered reliable; thus, purchases should be recorded accurately. After checking that the program is working properly and the transactions are recorded correctly, the auditor will verify that access to the program is limited to authorized personnel and that the program has not been tampered with. When the auditor is satisfied that the program is working well and that the client's controls are effective, the auditor can set control risk as low. In this case, the auditor will need to spend relatively little time testing that purchases are recorded accurately.

4.1.2 Quantification of the Audit Risk Model

Another way of viewing audit risk is to highlight the role of detection risk, which is demonstrated in **figure 4.3**. As previously stated, detection risk is the only element of the audit risk model the auditor can change in response to the client's risk of material misstatement.

Audit risk is the risk the auditor will issue the wrong audit opinion. Because audits involve sampling and professional judgement, audit risk can never be zero or eliminated entirely. Therefore, an auditor has to be willing to accept some audit risk. However, because auditors want to minimize the risk of issuing the wrong opinion, their acceptable level of risk is generally low. Most auditors assess an acceptable level of audit risk as no more than 5 percent. This means the auditor is willing to accept a 5-percent likelihood that the financial statements are materially misstated or the auditor is seeking 95-percent assurance that there are no material misstatements.

Once the acceptable audit risk has been determined, the auditor then assesses the risk of material misstatement. They do this by assessing the inherent and control risks, as previously discussed. Based on the auditor's assessment of the audit risk, inherent risk, and control risk, the auditor then determines the detection risk required. This establishes the amount of audit evidence required from substantive procedures to obtain the desired level of audit assurance.

For example, assume the auditor of Cloud 9 determines that an acceptable audit risk is 5 percent. If the auditor believes there is a high inherent risk, in that there is a high likelihood of errors happening, the auditor assesses inherent risk at maximum or 100 percent. Assuming the auditor believes there are few controls in place that can be relied upon, the auditor then sets control risk at high, again 100 percent. The auditor then determines the required detection risk by solving the following: DR = AR/RMM or 5/100 = 5 percent. This means the auditor requires 95-percent assurance from substantive procedures that there are no material misstatements.

Using the same example but assuming the auditor determines that an acceptable audit risk is 2 percent, the result will be DR = 2/100. Therefore, the auditor is willing to accept a 2-percent risk of not detecting errors and therefore wants 98-percent assurance from substantive procedures that there are no material misstatements. Comparing the two examples, assuming all things being equal, the higher the level of assurance desired by the auditor, the more audit work the auditor will have to do to achieve that desired level of assurance.

$$DR = AR/RMM$$

where:

DR = Detection risk

AR = Audit risk

RMM = Risk of material misstatement (IR × CR)

FIGURE 4.3 **Detection risk calculation**

Cloud 9 Integrated Case

Cloud 9 sells customized basketball shoes. The shoes are likely to "go out of fashion" reasonably quickly, making obsolescence a big issue. This factor affects the inherent risk of inventory valuation. Based on their brief discussion of the complications surrounding transporting the shoes from the Chinese factory to the department stores in Canada, Ian can see that there is a risk of errors occurring in transactions with suppliers, which will also affect inventory balances. How high is the control risk? Much to Suzie's delight, Ian suggests that they will be able to make better assessments of both inherent and control risk for all assertions now that they have a better understanding of the client.

Before You Go On

4.1.1 What are the three components of audit risk?

4.1.2 What is the relationship between audit risk and detection risk?

4.1.3 What are four factors that affect inherent risk?

4.2 Materiality

LEARNING OBJECTIVE 2

Explain and apply the concept of materiality.

materiality information that impacts the decision-making process of users of the financial statements

Materiality is used to guide audit testing and to assess the validity of information contained in the financial statements and their notes. Information is considered material if it impacts the decision-making process of the users of the financial statements. This includes information that is misstated or omitted but should be disclosed. CAS 320 *Materiality in Planning and Performing an Audit* provides guidelines on materiality from an audit perspective.

Materiality is a key auditing concept and is assessed during the risk assessment phase of every audit. This preliminary assessment of materiality guides audit planning and testing. Before learning how an auditor arrives at their preliminary materiality assessment, it is important to understand the qualitative and quantitative factors to be considered when determining materiality.

4.2.1 Qualitative and Quantitative Factors

The determination of materiality involves professional judgement about the financial statement users and their needs. When determining materiality, the auditor needs to consider both quantitative and qualitative factors, as information can be considered material because of its nature and/or its magnitude. These concepts are explained below. The auditor should also consider performance materiality and whether specific materiality is necessary. This is also explained below.

Qualitative Materiality Factors

Information is considered material if it affects a user's decision-making process. This may be due to factors other than the magnitude of misstatements. While the auditor calculates materiality as described below, misstatements under this determined dollar threshold may

TABLE 4.4 Qualitative considerations with respect to misstatements

- Affects compliance with regulatory requirements;
- Affects compliance with debt covenants or other contractual requirements;
- Relates to the incorrect selection or application of an accounting policy that has an immaterial effect on the current period's financial statements but is likely to have a material effect on future periods' financial statements;
- Masks a change in earnings or other trends, especially in the context of general economic and industry conditions;
- Affects ratios used to evaluate the entity's financial position, results of operations or cash flows;
- Has the effect of increasing management compensation, for example, by ensuring that the requirements for the award of bonuses or other incentives are satisfied;
- Is significant having regard to the auditor's understanding of known previous communications to users, for example, in relation to forecast earnings;
- Relates to items involving particular parties (for example, whether external parties to the transaction are related to members of the entity's management);
- Is an omission of information not specifically required by the applicable financial reporting framework but which, in the judgment of the auditor, is important to the users' understanding of the financial position, financial performance or cash flows of the entity.

Source: CPA Canada Handbook–Assurance, CAS 450, para. A21.

be material due to their nature. For example, a misstatement due to fraud is considered to be significant because of its nature, regardless of the dollar value of the fraud. When such a misstatement is uncovered, it is investigated further by an auditor. The disclosures necessary to achieve fair presentation of the financial statements are also considered because omitting disclosures, such as accounting policies, may be material to the financial statements. Items that should be considered significant due to their nature include a change in an accounting method, related party transactions, a change in operations that affects the level of risk faced, and the danger of breaching a debt covenant.

A list of considerations that may indicate a misstatement is material from a qualitative perspective are listed in **table 4.4**.

Quantitative Materiality Factors

Information is considered **quantitatively material** if it exceeds an auditor's preliminary materiality assessment. An auditor uses their professional judgement to arrive at an appropriate materiality figure for each client. In doing so, they are mindful of the primary users of the financial statements. For listed entities, the primary users are the shareholders. For private companies, the primary users are generally the owners and/or major lenders of funds. Audit firms vary in the method they use to set materiality in the risk assessment phase of the audit. Materiality is a percentage of an appropriate base. An auditor will select an appropriate base and then decide on the percentage to use depending on the client's circumstances.

quantitative materiality information that exceeds an auditor's preliminary materiality assessment

Before selecting a base, the auditor should consider whether there are any unusual or non-recurring items that may need to be "normalized" or adjusted for. Examples of such normalizing items include bonuses paid to owner-managers for tax-planning purposes, unusual gains and losses, and significant repair and maintenance expenses that may not be recurrent.

Once normalizing items are adjusted for, the auditor will then use their professional judgement to consider an appropriate base. This may be an item from the balance sheet or income statement. The primary consideration in selecting a base should be the financial statement users' needs. See **table 4.5** for other considerations when determining an appropriate base. Balance sheet bases are generally total assets or equity. Income statement bases are profit before tax, revenue, expenses, or gross profit. For example, if a client is publicly listed, net income before tax is likely to be important as it drives dividends and

TABLE 4.5 Factors to consider in selecting a base for materiality

Factors that may affect the identification of an appropriate base include the following:

- the elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses)
- where the financial statement users may intend to focus their attention, for example, for the purpose of evaluating financial performance users may tend to focus on profit, revenue, or net assets
- the nature of the entity, where the entity is in its life cycle, and the industry and economic environment in which the entity operates
- the entity's ownership structure and the way it is financed; for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings
- the relative volatility of the benchmark

Source: Adapted from CPA Canada Handbook–Assurance, CAS 320, para. A4.

return-on-investment decisions. Therefore, the base selected would be net income before tax. However, if a client is a not-for-profit organization, either assets or expenses are more likely to be chosen as a base.

Net income before tax will not be used as a base when a client is in a loss position. When profits vary significantly from one year to the next, the auditor may use either an average of net income or revenue as a base. For newly established companies with little or no revenue, equity or total assets are generally the preferred base. These choices depend on an auditor's knowledge of their client and on the auditor's professional judgement.

Once a base is selected, an appropriate percentage is determined. The *PEG* provides guidelines on the percentages to use when calculating materiality (see **figure 4.4**). Typically, 5 percent of profit before tax from continuing operations is used to determine materiality when profit is the appropriate base, but an acceptable range is from 3 to 7 percent. When using total assets or revenue as a base, the percentages fall to 1 to 3 percent, and when equity is the base, the percentages are 3 to 5 percent. Whichever base is used, there is a percentage above which items are deemed to be clearly material, a percentage below which items are deemed to be immaterial, and a range in the middle that is a matter for an auditor's professional judgement.

- 3–7% of normalized pre-tax profit
- 1–3% of total assets
- 3–5% of equity
- 1–3% of revenues or expenditures

FIGURE 4.4 Common bases and percentages used for materiality

When a lower planning materiality level is established, an auditor increases the quality and quantity of evidence that needs to be gathered. When gathering evidence, one of the criteria may be to test material items. The lower the materiality level set, the more items will fall into this definition. For example, if the auditor determines planning materiality to be $10,000, then more work will have to be done to ensure there is no material misstatement than if materiality is set at $100,000. Also, by setting a lower materiality level, an auditor increases their sensitivity to potential misstatements. The lower the materiality, the more likely the auditor will conclude that misstatements are material. For an example of materiality, see Professional Environment 4.1.

4.1 Professional Environment — Were Fraudulent FIFA Payments Material?

FIFA, the international governing body of football (soccer), is a not-for-profit community of over 200 worldwide football associations. FIFA generates billions in revenues through the sale of television, marketing, hospitality, and licensing rights for the World Cup soccer tournament. However, during 2015, FIFA was embroiled in claims of widespread corruption. Several FIFA officials were arrested for corruption and bribery involving more than $200 million over a 20-year period. Subsequent to the corruption charges, questions arose as to how FIFA's auditor did not detect such schemes. The primary reason is that many of the payments were made directly to the various individuals, and therefore the payments did not go through the FIFA financial records.

This is not the case for all of the payments. Charges were laid against Jack Warner, who was responsible for the Confederation of North, Central American, and Caribbean Association Football from 1990 to 2011. He allegedly had $10 million transferred directly to him by FIFA in return for helping South Africa secure the 2010 World Cup. This payment did go through FIFA's books, so why was it not found by the auditor? The reason is most likely that, with FIFA's enormous revenues of $5 billion, a payment of $10 million was likely not material from an audit perspective. However, a prominent financial reporting and forensic accountant in the United States notes that "while the $10 million payment could be insignificant, or immaterial in accounting terms, given FIFA's size, it would not be immaterial in qualitative terms. That's something people would want to know about."

Q: How can an auditor consider items below materiality in the risk assessment phase of an audit?

Sources: www.fifa.com; Lynnley Browning, "Corruption in FIFA? Its Auditors Saw None," *The New York Times*, June 5, 2015; "Attention Turns to Auditor in FIFA Scandal," *Bottom Line News*, August 2015.

Performance Materiality

The auditor also determines **performance materiality**. This is an amount less than materiality, which is set by the auditor to reduce the likelihood that any uncorrected and undetected misstatements within a class of transactions, account balances, or disclosures, in aggregate, do not exceed overall materiality. For example, if an auditor assesses that there is a risk of recorded inventory not being valued appropriately, materiality when testing for the valuation of inventory may be set lower than it would be when testing for other assertions. The determination of performance materiality is again a matter of professional judgement; however, 60–75 percent of overall materiality may be appropriate.

performance materiality an amount less than materiality, which is set to reduce the likelihood that a misstatement in a particular class of transactions, account balances, or disclosures, in aggregate, does not exceed materiality for the financial statements as a whole

Specific Materiality

The third level of materiality the auditor may determine is called **specific materiality** for account balances, specific transactions, and disclosures. Specific materiality is relevant when some areas of the financial statements are expected to influence the economic decisions made by users of the financial statements. For example, if an entity has a bank loan, and one of the requirements of the loan agreement is to maintain a particular current ratio, the auditor should consider the need to determine specific materiality for the accounts included in the current ratio calculation. This would be necessary if a material misstatement less than overall financial statement materiality could impact the bank's decision to continue extending the loan. **Figure 4.5** shows a sample materiality calculation.

specific materiality information that is relevant when some areas of the financial statements are expected to influence the economic decisions made by users of the financial statements

FIGURE 4.5 **Example of materiality calculation**

Trudo Inc. has a December 31 year end. Although Trudo is a private company, its annual financial statements must be audited as a condition of Trudo's long-term debt agreement with Canada Bank. Information from the entity's financial statements are as follows:

	This period	Last period	Preceding period
Revenue	$7,000,000	$6,500,000	$5,900,000
Bonus to owner	100,000	100,000	70,000
Pre-tax profit after bonus	1,225,000	1,150,000	1,005,000
Total assets	6,500,000	5,800,000	5,300,000

(*continued*)

To determine materiality, the auditor's first step is to identify the financial statement users. In this example, Trudo is a profit-oriented entity. The primary user of the financial statements is the bank. The bank has requested audited financial statements as it is primarily concerned with Trudo's ability to generate a positive net income, which is the best predictor of its ability to repay the loan in the future. The shareholders are users and they are interested in net income to assess the entity's overall performance. The tax authorities are also users as they use the financial statements to assess the entity's tax position.

Before performing any calculations, the auditor considers whether there are any non-recurring items that may need to be normalized. This includes any unusual gains or losses, any discontinued operations, or management bonuses. In this case, there were bonuses paid to management that were included in the expenses and that reduced overall net income. They will be added back to get the normalized net income.

	This period	Last period	Preceding period
Pre-tax profit after bonus	$1,225,000	$1,150,000	$1,005,000
Add back management bonus	$100,000	$100,000	$70,000
Normalized pre-tax profit	$1,325,000	$1,250,000	$1,075,000

Various materiality bases could be considered, such as total assets or total revenues, but based on the user needs assessment above, the bank is most sensitive to net income, and therefore this is the most appropriate base. If net income was negative or fluctuated significantly from year to year, the auditor would consider an alternative base, such as total assets, total revenue, or perhaps average net income. The percentage to be applied in the calculation is a matter of professional judgement. In this case, the auditor applies 5% to normalized pre-tax profit.

Planning materiality calculation:

Normalized pre-tax profit	$1,325,000
Percentage applied	5%
	$ 66,250

Once a preliminary determination of materiality is made, the auditor then considers whether any qualitative items exist that may suggest the calculated balance is not appropriate. In this case, nothing indicates this is true.

Based on the above considerations, planning materiality is $66,250.

Performance materiality: To reduce the risk of an aggregate material misstatement in account balances and classes of transactions, performance materiality is 60 percent of planning materiality:

60% × $66,250 = $39,750

Specific materiality: As there is no indication that users of the financial statements will be affected by any particular account balance, specific materiality is not required.

Conclusion: Materiality for financial statements overall is $66,250. This means total misstatements should be less than $66,250 for the auditor to issue an unmodified opinion.

Performance materiality is $40,000 (rounded). This means any error found in a specific account greater than $40,000 is considered material.

However, if one error is found that exceeds performance materiality, but total errors remain below overall materiality, the auditor can conclude that the financial statements are not materially misstated.

FIGURE 4.5 **Example of materiality calculation (*continued*)**

4.2.2 Materiality and Audit Risk

Materiality and audit risk are both considered in identifying and assessing the risk of a material misstatement. They both determine the nature, timing, and extent of the audit work performed, and they are both considered when evaluating the effect of uncorrected misstatements on the financial statements and in forming the opinion in the auditor's report.

However, the auditor should not use audit risk to make the materiality determination. Audit risk is based on factors that relate to the entity, while materiality is based on the needs of the users of the financial statements. In the materiality example in figure 4.5, it is important to note that, when calculating materiality for Trudo Inc., audit risk was not considered. This is because, regardless of whether the auditor assesses the audit risk as high, moderate, or low, materiality is based on the users' needs, and users generally do not consider audit risk.

For Trudo Inc., the bank is the user. Regardless of the auditor's risk assessment, the bank is still sensitive to any material misstatement of $66,250. This does not change due to audit risk being high or low. If the auditor believes there is a high risk of misstatement, it does not mean materiality should now be lower, say $20,000. If audit risk is high, it simply means the auditor will have to do more substantive work to reduce the likelihood of issuing the wrong audit opinion. Conversely, if the auditor believes there is a lower audit risk, it does not mean materiality should now be assessed as higher, say $100,000. It means the auditor may do less substantive testing to reduce the likelihood of issuing the wrong opinion. Therefore, regardless of audit risk, the bank remains sensitive to a misstatement of $66,250. While both concepts impact the quality and quantity of the audit evidence required, audit risk should not be used to determine materiality.

Cloud 9 Integrated Case

Throughout their conversation, Suzie and Ian have been discussing "material" misstatements in financial statements. What is material for Cloud 9? Suzie explains that, if they set materiality at a low level in the risk assessment phase, they will have to plan to gather more and better-quality evidence to be sure that a mistake of this low magnitude has not occurred. This will give the auditor confidence that the opinion is the appropriate one, but it will also increase the cost of the audit.

Ian is worried about getting the materiality level right. "What if we set it too low or too high?" Suzie explains that all parts of the audit plan, including the materiality decision, will be reviewed throughout the audit and changed if necessary.

Before You Go On

4.2.1 What is qualitative materiality?

4.2.2 What is quantitative materiality?

4.2.3 What is the most appropriate materiality base for a for-profit entity? Why?

4.3 Audit Strategy

LEARNING OBJECTIVE 3

Describe how an auditor determines the audit strategy.

CAS 300 *Planning an Audit of Financial Statements* requires that an auditor establish an overall **audit strategy**, which sets the scope, timing, and direction of the audit and provides the basis for developing a detailed audit plan. The audit strategy chosen depends on the auditor's preliminary inherent and control risk assessment (that is, the auditor's overall assessment of the risk of material misstatement). Tables 4.6 and 4.7 provide examples of audit strategies for two extreme cases: a high-risk client and a low-risk client.

audit strategy strategy that sets the scope, timing, and direction of the audit and provides the basis for developing a detailed audit plan

When inherent and control risk are assessed as high (see **table 4.6**), the risk of material misstatement is assessed as high and, therefore, detection risk will be low to reduce audit

TABLE 4.6 Audit strategy—high-risk client

Audit risk = f	Inherent risk	Control risk	Detection risk
Assessed risk	High	High	Low
Audit strategy		No (or very limited) tests of controls	Increased reliance on substantive tests of transactions and account balances

risk to an acceptably low level. There is an inverse relationship between audit risk (a client's inherent and control risk combined) and detection risk, as previously stated. By assessing control risk as high, an auditor has determined that the client's system of internal controls is non-existent, very poor, or unlikely to be effective in mitigating the inherent risks identified.

For example, a client sells expensive medical testing equipment and has limited security. Not many of these pieces of equipment have to go missing or be stolen for there to be a material impact on the value of the inventory. No regular inventory counts are performed either. In this case, inherent risk is high for the inventory as it may be recorded but not actually on hand. In this case, control risk is high as there are no controls in place to mitigate (reduce) the identified risk.

substantive audit strategy strategy used when the auditor does not plan to rely on the client's controls and increases the reliance on detailed substantive procedures that involve intensive testing of year-end account balances and transactions from throughout the year

When assessing control risk as high (see table 4.6), an auditor will adopt a **substantive audit strategy**. When this audit strategy is adopted, an auditor will gain the minimum necessary knowledge of the client's system of internal controls as required by the auditing standards (CAS 315), but will generally not conduct tests of those controls. If a client's system of internal controls is non-existent, very poor, or unlikely to be effective in mitigating an identified inherent risk, there is generally no point in testing the internal controls because the auditor will not be planning to rely on them. Instead, an auditor will increase their level of reliance on detailed substantive procedures, which involves intensive testing of year-end account balances and transactions from throughout the year. An exception is where an auditor has identified a significant risk or where substantive testing alone is inadequate. In this case, an auditor will gain an understanding of the client's controls relevant to that risk (CAS 315, para. 26). For example, if a client has significant transactions that involve estimation, an auditor will review the processes used by management to make those estimations.

combined audit strategy strategy used when the auditor obtains a detailed understanding of their client's system of internal controls and plans to rely on that system to identify, prevent, and detect material misstatements

When assessing control risk as low (see table 4.7), an auditor will generally plan to perform a **combined audit strategy** where the auditor obtains a detailed understanding of the client's system of internal controls and plans to rely on that system to identify, prevent, and detect material misstatements.

Once an auditor has gained a detailed understanding of their client's system of internal controls, they will conduct extensive tests of those controls. When the cost of testing controls exceeds the benefit expected, an auditor may decide not to test the client's internal controls. For low-risk clients, if tests of controls are conducted and found to be effective, an auditor will plan on reducing their reliance on detailed substantive testing of transactions and account balances. There are also some risks where substantive testing alone is inadequate;

TABLE 4.7 Audit strategy—low-risk client

Audit risk = f	Inherent risk	Control risk	Detection risk
Assessed risk	Low	Low	High
Audit strategy		Increased reliance on tests of controls	Reduced reliance on substantive tests of transactions and account balances

for example, where the client has a very automated and integrated IT system, and no paper trail exists. In these cases, the auditor will test the internal controls. However, an auditor can never completely rely on a client's system of internal controls and will always conduct some substantive procedures to gather independent evidence regarding the numbers that appear in the client's financial statements.

For example, a client sells nuts and bolts and conducts regular inventory counts. Inherent risk is low as a significant number of nuts and bolts would have to be stolen before there was a material impact on the amount recorded for inventory. The auditor will plan on testing the effectiveness of the inventory counts and the timeliness with which records are updated for any inventory losses.

The example provided above is for the development of an audit strategy at the financial statement (client) level. In practice, an audit strategy is developed for each identified risk at the assertion level. **Figure 4.6** shows the process used when developing an audit strategy for identified risks. Risks are identified when gaining an understanding of the client. Part of that process may involve conducting a **walkthrough** for each significant class of transactions. This means that each transaction flow is traced from inception to recording in the general ledger. When conducting a transaction walkthrough, an auditor will identify the risk factors.

walkthrough tracing a transaction through a client's accounting system

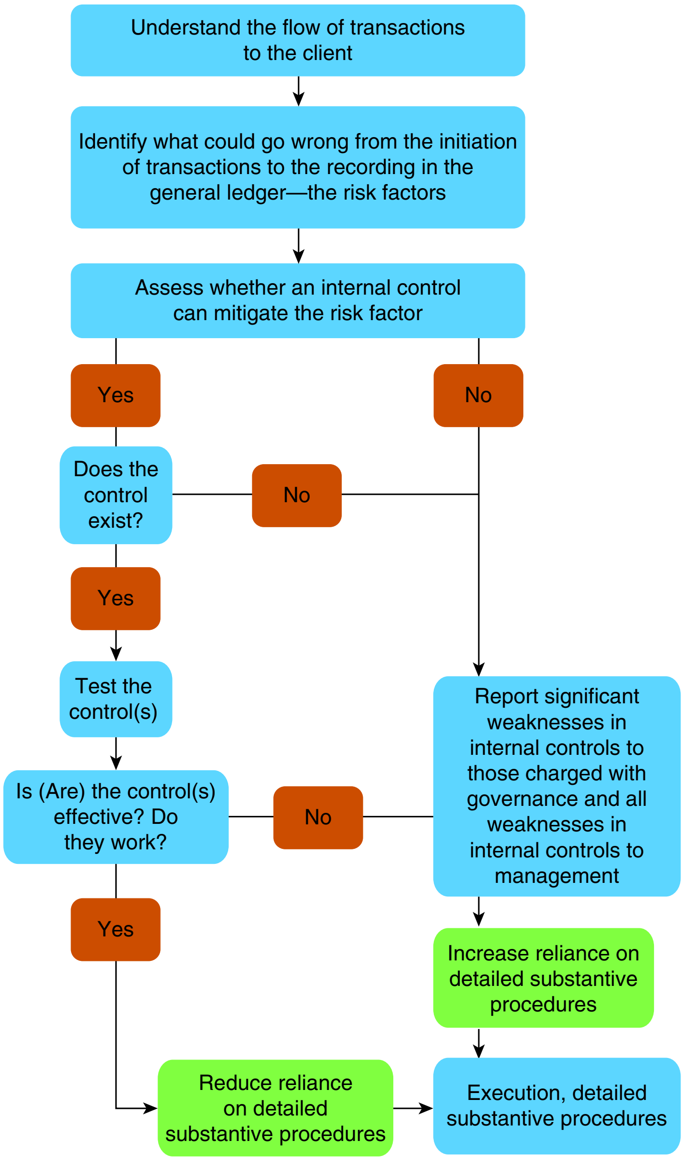


FIGURE 4.6 **The process used when developing an audit strategy for risks identified**

For each identified risk, the first step is to assess whether an internal control could reduce the likelihood of a material misstatement occurring as a result of the risk. If the auditor believes one or more internal controls could be designed to mitigate the identified risk, the auditor will assess whether the client has controls in place; that is, do they exist?

If the client has one or more appropriate controls in place, the audit strategy is to test the effectiveness of those controls; that is, do they work? If, after testing the controls, the auditor concludes that they are effective, the auditor plans to rely on those controls and is able to reduce their reliance on detailed substantive procedures. However, if the auditor tests the controls and believes them to be ineffective (that is, the controls do not work), the auditor cannot rely on the controls. In this case, the auditor reports any significant weaknesses to those charged with governance and management. The auditor may also report other internal control deficiencies to management. The auditor also makes recommendations for improving the controls, and increases the reliance placed on detailed substantive procedures.

If the client does not have appropriate controls for the identified risk in place, the audit strategy is to conduct few or no tests of controls for the identified risk. In this case as well, the auditor reports the weaknesses identified to those charged with governance, makes recommendations on improving the controls, and increases the reliance placed on detailed substantive procedures.

Cloud 9 Integrated Case

Suzie explains that Cloud 9's audit could be planned and conducted in different ways, depending on the audit strategy adopted. In fact, the overall audit strategy sets the scope, timing, and direction of the audit, and guides the development of the detailed audit plan.

"What audit strategy would be suitable for Cloud 9? Start by thinking about the scope of the audit," she prompts Ian. "The scope is about the different types of work we have to do—some audits have extra requirements."

"I suppose we should find out if Cloud 9's parent company has any special requirements. The fact that it is a Canadian public company might mean it has some additional regulations that apply," Ian suggests. "Plus, Cloud 9's statements would have to be consolidated into the parent's accounts. We would have to make sure that we plan to do the work they would need for that."

"That is a good start," says Suzie. "What else?"

"Well, I can think of a number of other things, such as whether any other auditors will be involved (including Cloud 9 Inc.'s internal auditors); whether any foreign currency translation issues exist; whether any industry-specific regulations must be followed (although I don't think this is as big an issue for clothing and footwear as it would be for banks, for example); whether any service organizations are involved, such as payroll services; and whether computer-aided audit technology is to be used."

"Very good," says Suzie. "That will do for now. What about timing issues? Are there any special considerations we should take into account for Cloud 9?"

"What date does the audit have to be finished?" asks Ian.

"Good question," says Suzie. "If we have a deadline, we obviously have to work toward it."

"Also," says Ian, "when are our staff available and when are their key people available to talk to us?"

"Yes," says Suzie. "This is all kind of basic. But if we don't ask these really important questions, we will find ourselves unable to meet the deadlines and perhaps be under pressure to cut corners. We also have to think about the timing of requests to third parties for information and so on. Now, can you think of anything to say about the direction of the audit?"

"I understand about the extra requirements and working out the timing. But I don't really know what you mean by 'direction,'" Ian says, confused.

"We have already discussed it to some extent," Suzie explains. "Remember when we spoke about the risk for Cloud 9 created by complex inventory transactions, and dealing with purchases from international suppliers? 'Direction' is about where we think there should be extra attention because of higher risk, and how we give that extra attention. We could, for example, make sure that we have suitable experts available, if required, to value the inventory. This is also where we bring in our work on materiality, both setting materiality for planning purposes and identifying the material account balances. In our plan, we need to allocate additional time to areas where there may be higher risk of material misstatement. And, one of our biggest tasks will be considering the evidence about the design and operating effectiveness of internal controls at Cloud 9, which we haven't yet considered in detail."

"I see," says Ian. "If we assess the internal controls as being strong, then we plan to do more testing of controls (to confirm our assessment), and less testing of the underlying substance of transactions and account balances. We have to put this in our plan now. But what if our first thoughts about controls are wrong? Our plan will be wrong!"

"That happens," replies Suzie. "That is why a plan is constantly changing as we gather more information about the client. Particularly, as in this case, for a new client that we don't have a lot of detailed information on yet. However, we already know what accounts are important to Cloud 9—its previous years' statements and interim results show us that. We have an understanding of the drivers of its profits and the pressure to increase profits coming from the head office. We also know about its new store opening this year (including the new debt) and the change in marketing strategy. We actually know quite a lot—certainly enough to make a start on a detailed audit plan."

Before You Go On

4.3.1 What is the purpose of developing an overall audit strategy?

4.3.2 What is a substantive audit strategy and when might an auditor adopt this approach?

4.3.3 To whom will an auditor report uncovered deficiencies in a client's system of internal controls?

4.4 Client Approaches to Measuring Performance

LEARNING OBJECTIVE 4

Outline how clients measure performance.

Part of the process used when gaining an understanding of a client involves learning how the client measures its own performance. The **key performance indicators (KPIs)** used by a client to monitor and assess its own performance and the performance of its senior staff provide an auditor with insight into the accounts that their client focuses on when compiling its financial statements and indicate which accounts are potentially at risk of material misstatement.

key performance indicators (KPIs) measurements, agreed to beforehand, that can be quantified and that reflect the success factors of an organization

Some KPIs are common to many clients, such as return on assets and return on shareholder funds. Other KPIs will vary from industry to industry and client to client. For example, a client in the airline industry is concerned about revenue per passenger kilometre, a client in the retail industry is concerned about inventory turnover, and a client in the finance industry is concerned about its risk-weighted assets and interest margins. It is very important for an auditor to understand which KPIs a client is most concerned about throughout the year so that the audit can be planned around relevant accounts. It is inappropriate to assume that all clients will use the same KPIs. It is also inappropriate to assume that a client will use the same KPIs every year. Just as businesses change their focus, KPIs change to help businesses achieve new goals.

4.4.1 Profitability

It is common for companies to use **profitability** measures to assess their performance and that of their senior staff. Companies will track their revenue and expenses over time and assess any variability. They will compare their revenue and expenses with close competitors and assess their ability to compete, as well as provide valuable insights to management as to whether results are matching expectations based on known factors such as seasonality or economic downturns. This also provides the auditor with valuable insights into the expectations of management.

profitability the ability of a company to earn a profit

A company will track revenues from month to month to identify and explain trends. Large companies will compare revenues earned across divisions to highlight good and poor performance. Comparisons between divisions may be used to assess how well the managers of those divisions are controlling costs. Changes from one year to the next may reflect an increased cost of doing business or highlight that it may be time to source cheaper suppliers.

Companies are concerned about their shareholders (owners). The **price-earnings (PE) ratio** (market price per share divided by earnings per share) shows how much a shareholder is willing to pay per dollar of earnings. **Earnings per share (EPS)** (profit divided by weighted average ordinary shares issued) reflects the profitability of the company. When a client's PE ratio or EPS is in decline, an auditor may be concerned that management may be under pressure to manipulate earnings.

price-earnings (PE) ratio market price per share to earnings per share

earnings per share (EPS) profit to weighted average ordinary shares issued

Retailers and manufacturers are generally concerned about their inventory turnover (cost of goods sold divided by inventory). An assessment of this ratio is made within the context of the industry in which a company operates. For example, a company that sells perishable goods, such as ice cream, requires a much higher turnover than a company that sells non-perishable goods, such as furniture. If a client's inventory turnover falls sharply, an auditor may be concerned that stock is overvalued.

4.4.2 Liquidity

liquidity the ability of a company to pay its debts when they fall due

Liquidity is the ability of a company to meet its needs for cash in the short and long term. It is vital for a company to have access to cash to pay its debts when they fall due. If it cannot meet these obligations, a company may go into liquidation. Companies require cash to pay their employees' wages, utility bills, supplier bills, interest payments on money borrowed, dividends to shareholders, and so on. In the longer term, companies need cash to repay long-term debt and undertake capital investment.

Companies enter into debt covenants with lenders when taking on significant loans. That is, they promise to maintain specified profitability, liquidity, or other financial ratios, or to seek the lender's permission before taking on new borrowings or acquiring other companies. These covenants are written into the borrowing contracts and restrict a company's activities. If a company breaches a debt covenant, it will need to renegotiate or repay the loan.

By understanding how their client measures and assesses its own performance and any restrictions implied by debt covenants, an auditor will gain a deeper understanding of the accounts potentially at risk of material misstatement. An auditor will use their own ratio calculations and trend analyses to identify any unusual fluctuations that warrant further investigation. This analysis is referred to as analytical procedures, which are explained in detail in the next section.

Cloud 9 Integrated Case

In her discussions with the partner, Jo Wadley, Suzie learns that the senior people in the Cloud 9 finance department are entitled to participate in the company's employee share purchase plan and also to receive stock options in the parent company if revenue targets are met. The Canadian parent company is a public company and its share price, which determines the value of the stock options, reflects market expectations about the group's future profits.

Cloud 9 has taken on additional debt this year, and costs are rising because of issues associated with its drive to increase market share. When these results are consolidated into the group, they increase debt to equity ratios and decrease profitability ratios, potentially reducing the value of the stock options. Suzie decides to allocate time in the audit plan to consider whether these pressures could impact any of the senior staff's incentives and increase audit risk.

Before You Go On

4.4.1 What is a KPI? How can it be used by an auditor?

4.4.2 Explain how internal performance reports may be used.

4.4.3 What is a debt covenant?

4.5 Analytical Procedures

LEARNING OBJECTIVE 5

Summarize how an auditor uses analytical procedures when planning an audit.

analytical procedures an evaluation of financial information by studying plausible relationships among both financial and non-financial data

CAS 520 *Analytical Procedures* defines **analytical procedures** as an evaluation of financial information by studying plausible relationships among both financial and non-financial data. They involve the identification of fluctuations in accounts that are inconsistent with the auditor's expectations based upon their understanding of their client. For example, if an auditor is aware that the client has borrowed a significant amount of money in the previous financial year, a reduction in the client's debt to equity ratio would be unusual and would warrant further investigation. It is essential that an auditor have clear expectations about the client's results for the reporting period before conducting analytical procedures, so that unexpected fluctuations can be correctly identified and investigated. An auditor's expectations are based on their understanding of the client, the industry in which it operates, and the economy as a whole.

Analytical procedures are conducted throughout an audit. During the risk assessment phase, analytical procedures are used to aid in the risk identification process. During the **risk response phase**, analytical procedures are an efficient method of identifying differences between recorded amounts and the auditor's expected values that require further investigation (CAS 520, para. 5d). At the reporting phase, analytical procedures are used to assess whether the financial statements reflect the auditor's knowledge of their client. In this section, we will concentrate on the application of analytical procedures at the risk assessment phase of the audit.

risk response phase the audit stage involving detailed testing of controls and substantive testing of transactions and accounts

Analytical procedures are conducted at the risk assessment phase of the audit to:

- highlight unusual fluctuations in accounts
- aid in the identification of risk
- enhance the understanding of a client
- identify the accounts at risk of material misstatement
- reduce audit risk by concentrating audit effort where the risk of material misstatement is greatest

CAS 315 stipulates that an auditor should perform analytical procedures as part of their risk identification process. Analytical procedures include simple comparisons, trend analysis, common-size analysis, and ratio analysis. They also include tests performed using software and the client's data, called audit data analytics. Each of these forms of analysis is now discussed, followed by a review of factors to consider when undertaking analytical procedures. Professional Environment 4.2 discusses whether analytical procedures have changed in recent years in response to high-profile accounting frauds.

4.2 Professional Environment Have Analytical Procedures Changed?

Analytical procedures are required in the risk assessment phase of the audit; however, they can also be used as substantive procedures during the risk response phase, and as a reasonableness check at the reporting phase. In performing analytics, the auditor considers the reasonableness of results based on expectations developed and formed when gaining the knowledge of the client, the industry, and the economy. As a consequence of some past accounting frauds, such as Enron, allegations were made that "had the auditors been aware of the client's industry conditions and conducted appropriate analytical procedures, such frauds would have been detected." This leads to the question: Have firms changed their practices with respect to analytical procedures as a safeguard against future financial reporting failures?

Greg Trompeter and Arnold Wright in the United States conducted a study that examined practices of the Big Four accounting firms and their use of analytical procedures. They compared their findings with past research studies and concluded that, on some dimensions, there has been little change. "Data reveal similarities in that auditors still rely a great deal on clients for information, (e.g., inquiry, budgets) to set expectations and evaluate explanations. Also, relatively simple analytical techniques continue to be employed, such as a comparison of the current year to the prior year," the authors state.

Nevertheless, analytical procedures have changed in some ways. Trompeter and Wright found that technology has had a significant impact on the setting of expectations when performing analytical procedures. "Auditors now have access to industry and analyst databases enabling the development of more precise quantitative expectations. Auditors also gather and consider a broader array of industry and company information than in the past, as nonfinancial information is now widely available through the internet." The study also found that, while analytical procedures are being conducted by more junior staff, seniors and managers still design the majority of the procedures performed. Also, there is now greater inquiry of non-accounting personnel, because with the shift toward the risk-based audit, "auditors are more knowledgeable about business processes and, thus more comfortable talking with nonfinancial staff." Lastly, they noted a greater willingness to reduce substantive testing, likely because firms put more emphasis on audit planning and risk analysis, which allows them to rely more on analytical procedures.

Q: Should analytical procedures alone be relied on as sufficient and appropriate audit evidence?

Source: Based on Greg Trompeter and Arnold Wright. "The World Has Changed—Have Analytical Procedure Practices?" Contemporary Accounting Research, June 1, 2010, p. 669

4.5.1 Comparisons

Simple comparisons are made between account balances for the current year and the previous year and for the current year and the budget. When comparing account balances from one year to the next, significant changes can be tracked and investigated further by the auditor. An auditor will assess these changes in light of their expectations based on their understanding of the client and any changes experienced over the past year. For example, if the client has opened a new retail outlet, sales may be expected to have increased since last year. When comparing account balances with budgeted amounts, an auditor is concerned with uncovering variations between actual results and those expected by the client. Significant unexpected variations are discussed with client personnel.

Figure 4.7 illustrates a comparative income statement, which shows how the auditor will calculate the dollar and percentage changes for all line items for both the income statement and the balance sheet. The auditor will identify areas where the calculated results are different from expectations based on the knowledge of the business and the evidence gathered to date, and will highlight the areas that may require further audit work. For example, if the current economy is in a slowdown, is it reasonable for revenues to grow by almost 10 percent? If the auditor determines that this is a mature company in a stable industry and expects that revenues will stay relatively flat, then this is an unexpected result, indicating that more work may be needed in this area. If this is an industry with relatively stable margins, why did the gross margin increase by 4.5 percentage points? Why did the cost of sales not increase in the same proportion as the revenues? These results may indicate that the company is missing some expenses and this area requires further investigation.

4.5.2 Trend Analysis

trend analysis a comparison of account balances over time

Trend analysis (horizontal analysis) involves a comparison of account balances over time. It is conducted by selecting a base year and then restating all accounts in subsequent years as a percentage of that base. Trend analysis allows the auditor to gain an appreciation of how

XYZ Company
Comparative Income Statement

	Current year	Prior year	Dollar change	% change	Explanation
Revenue	$1,790,000	$1,630,000	$160,000	9.8%	
Cost of goods sold	1,320,000	1,275,000	45,000	3.5%	
Gross margin	470,000	355,000	115,000	32.4%	
Gross margin %	26.26%	21.78%			
Operating expenses:					
Rent	60,000	58,000	2,000	3.4%	
Wages	150,000	145,000	5,000	3.4%	
Interest	75,000	25,000	50,000	200.0%	
Depreciation	64,000	64,000	0	0.0%	
	349,000	292,000	57,000	19.5%	
Net income	$ 121,000	$ 63,000	$ 58,000	92.1%	

FIGURE 4.7 Comparative income statement of XYZ Company

	2020	2021	2022	2023
	$M	%	%	%
Income statement items				
Sales	250	(20)	(10)	20
Cost of sales	110	(10)	0	10
Interest expense	10	(30)	30	0
Wages expense	70	(20)	(30)	6
Rent expense	40	0	0	0
Balance sheet items				
Cash	15	20	10	25
Inventory	60	30	20	10
Trade receivables	54	(10)	5	15

FIGURE 4.8 **Trend analysis**

various accounts have changed over time. When conducting a trend analysis, it is important for an auditor to consider significant changes in economy-wide factors, such as a recession, which may affect their interpretation of the trend. **Figure 4.8** provides an example of a trend analysis.

Various accounts can be selected for inclusion in a trend analysis. Accounts that vary from one year to the next are generally the focus. In the trend analysis depicted in figure 4.8, 2020 was selected as the base year. The following years appear as a percentage increase or decrease of the 2020 amount. For example, sales in 2021 were 20 percent lower than sales in 2020; in 2022, sales were only 10 percent lower than the 2020 figure; and in 2023, sales were 20 percent higher than the 2020 amount. A trend analysis allows an auditor to assess movements in the accounts over time and to determine whether the underlying trends discovered through this type of analysis match their understanding of the client and its activities over the period under review.

4.5.3 Common-Size Analysis

Common-size analysis (vertical analysis) involves a comparison of account balances with a single line item. In the balance sheet, the line item used is generally total assets. In the income statement, the line item used is generally sales or revenue. A common-size analysis allows the auditor to gain a deeper appreciation of how much each account contributes to the totals presented in the financial statements. By preparing common-size accounts for a number of years, an auditor can trace the relative contribution of various accounts through time. **Figure 4.9** provides an example of a common-size analysis.

common-size analysis a comparison of account balances with a single line item

The common-size analysis depicted in figure 4.9 shows that the cost of sales grew and then reduced as a proportion of sales. This reduction may reflect a change in prices charged by suppliers, a change in prices charged to customers, or the quantity of goods on hand. In the balance sheet, inventory levels rose and then dropped, which may indicate a buildup of inventory on hand when sales dropped in 2021.

4.5.4 Ratio Analysis

Ratio analysis is conducted by an auditor to assess the relationship between various financial statement account balances. An auditor will calculate profitability, liquidity, and solvency ratios.

	2020	2021	2022	2023
	%	%	%	%
Income statement items				
Sales	100	100	100	100
Cost of sales	44	50	49	40
Interest expense	4	4	6	3
Wages expense	28	28	22	25
Rent expense	16	20	18	13
Balance sheet items				
Cash	5	5	5	6
Inventory	20	24	23	22
Trade receivables	18	15	18	21
Payables	15	16	16	16
Total assets	100	100	100	100

FIGURE 4.9 **Common-size analysis**

Profitability Ratios

Profitability ratios reflect a company's ability to generate earnings and ultimately the cash flow required to repay debt, meet other obligations, and fund future expansion. **Table 4.8** shows the common profitability ratios: gross profit margin, profit margin, return on assets, and return on shareholders' equity.

gross profit margin gross profit to net sales

The gross profit and profit margins indicate the proportion of sales turned into profits. The **gross profit margin** indicates whether a seller of goods has a sufficient markup on goods sold to pay for other expenses. A markup is the difference between the selling price and cost of goods sold. A decline in this ratio indicates that a client may be paying more for its inventory or charging less to its customers. If the gross profit margin continues to decline, the client may face making an overall loss if it is not able to cover its operating expenses.

profit margin profit to net sales

The **profit margin** indicates the profitability of a company after taking into account all operating expenses. By looking at the trend in the profit margin over time, the auditor is able to identify variability in their client's profit-earning capacity. If the profit margin is steadily falling, this may affect the future viability of the client. If the profit margin varies widely from year to year, this indicates volatility and uncertainty, which make it difficult to assess the fair presentation of the current reported earnings without further investigation.

TABLE 4.8 **Common profitability ratios**

Ratio	Definition
Gross profit margin	$\frac{\text{Gross profit}}{\text{Net sales}}$
Profit margin	$\frac{\text{Profit}}{\text{Net sales}}$
Return on assets	$\frac{\text{Profit}}{\text{Average assets}}$
Return on shareholders' equity	$\frac{\text{Profit}}{\text{Average equity}}$

The **return on assets (ROA)** indicates the ability of a company to generate income from its average investment in total assets. The **return on equity (ROE)** indicates the ability of a company to generate income from the funds invested by its common (ordinary) shareholders. If a company is unable to generate a sufficient return on funds invested, there may be insufficient funds available to pay dividends and invest in future growth. An auditor will calculate these ratios to assess trends in profitability. If the ROA and ROE are falling, they will affect the ability of a client to generate funds to pay dividends and interest and to repay loans.

return on assets (ROA) profit to average assets

return on equity (ROE) profit to average equity

An auditor will make comparisons between the current year and previous years to identify trends in their client's profitability. Comparisons will also be made with budgeted results and with competitors. When comparing with budget, an auditor will assess how profitable the client is compared with management's expectations. An auditor will discuss any significant variance with management. When comparing the client with competitors, an auditor will assess the client's profitability relative to companies of a similar size operating in the same industry. Any significant trends that appear unusual when compared with previous years, budget, or competitors are investigated further by an auditor because they indicate that there may be a risk of a material misstatement.

Liquidity Ratios

Liquidity ratios reflect a company's ability to meet its short-term debt obligations. If a company is unable to pay its debts when they fall due, the company may lose key employees, suppliers may refuse to supply goods, and lenders may recall funds borrowed. An auditor is concerned with the client's liquidity situation and will alert the client to any potential going concern issues. **Table 4.9** shows a number of short-term liquidity ratios. These include the current ratio and the acid-test (quick) ratio. The inventory and receivables turnovers are used as liquidity ratios as well as indicators of managerial efficiency and client activity.

The **current ratio** indicates how well current assets cover current liabilities. A ratio that is greater than 1 indicates that a company should be able to meet its short-term commitments when they fall due. In reality, this will depend on the company's ability to convert its inventory and receivables into cash on a timely basis. The **acid-test (quick) ratio** indicates how well liquid (cash or near cash) assets cover current liabilities. Liquid assets include cash, short-term investments, and receivables. Acceptable current and acid-test ratio benchmarks vary from one industry to another. An auditor will compare the trend in both ratios over time to assess whether their client's liquidity situation is improving or deteriorating. An auditor will also compare the client's ratios with the industry average to assess the client's liquidity relative to close competitors. If a client's liquidity situation is deteriorating or is poor when compared with the industry average, an auditor may be concerned about the company's future viability.

current ratio current assets to current liabilities

acid-test (quick) ratio liquid assets to current liabilities

Inventory turnover measures how many times a company sells its inventory in a year. An auditor will look at the trend in this ratio to determine whether inventory is being turned over more or less frequently from year to year. This turnover will vary widely from one industry to another. For example, the turnover for a supermarket would be expected to be much

inventory turnover cost of sales to average inventory

TABLE 4.9 **Short-term liquidity ratios**

Ratio	Definition
Current ratio	$\dfrac{\text{Current assets}}{\text{Current liabilities}}$
Acid-test (quick) ratio	$\dfrac{\text{Cash + Short-term investments + Receivables (net)}}{\text{Current liabilities}}$
Inventory turnover	$\dfrac{\text{Cost of sales}}{\text{Average inventory}}$
Receivables turnover	$\dfrac{\text{Net credit sales}}{\text{Average net receivables}}$

TABLE 4.10 Common solvency ratios

Ratio	Definition
Debt to equity ratio	$\frac{\text{Liabilities}}{\text{Equity}}$
Times interest earned	$\frac{\text{Profit before income taxes and interest expense}}{\text{Interest expense}}$

higher than for a luxury boat manufacturer. An auditor will compare the inventory turnover for their client with the industry average to determine whether their client is competitive and has as high a turnover as its rivals. If a client operates in a high-technology industry or the fashion industry, where customer preferences change quickly, a slowing down of inventory turnover may indicate that the client is not keeping up with change. When a client's inventory turnover slows, an auditor will spend more time testing for the valuation of inventory, as stock may need to be written down in response to slowing demand.

receivables turnover net credit sales to average net receivables

Receivables turnover measures how many times a year a company collects cash from its accounts receivable customers. A slowdown in this ratio may indicate that the client is making sales to customers who are unable to pay for their goods on a timely basis or that the client is not efficiently following up on customers who are late in paying. If receivables turnover falls, an auditor will spend more time considering the adequacy of the allowance for doubtful accounts.

Solvency Ratios

Solvency ratios are used to assess the long-term viability of a company. Liquidity ratios tend to take a short-term view of a company; solvency ratios have a long-term perspective. **Table 4.10** shows common solvency ratios: the debt to equity ratio and times interest earned.

debt to equity ratio liabilities to equity

The **debt to equity ratio** indicates the relative proportion of total assets being funded by debt relative to equity. A high debt to equity ratio increases the risk that a client will not be able to meet interest payments to borrowers when they fall due. Companies with long-term debt are more likely to have a debt covenant with a lender, which restricts the company's activities. An auditor will consider the trend in the client's debt to equity ratio over time. An increasing ratio increases the risk that a client will not be able to repay their loans when they fall due, and the risk that a client will breach a debt covenant, as many covenants restrict the raising of additional debt. An auditor will also compare a client's debt to equity ratio with similar companies in the same industry as this ratio tends to vary across industries.

times interest earned profit before income taxes and interest expense to interest expense

Times interest earned measures the ability of earnings to cover interest payments. A low ratio indicates that a client will have difficulty meeting its interest payments to lenders. An auditor will consider how this ratio has changed over time. A downward trend is a concern as it indicates that lenders may charge the client a higher rate of interest on future borrowings. At the extreme, lenders may recall monies lent if the client does not meet interest payments.

4.5.5 Analysis with Technology

There are other more sophisticated analytical procedures used by some audit firms. Audit data analytics and computer-assisted audit techniques are tests performed using computer programs to conduct detailed analyses of client data (such as information contained in the client's ledgers and journals). These programs can be used to conduct the analysis outlined above, as well as searching for unusual transactions, including those that occur at odd times, for unusual amounts, or within unusual accounts. They can be used to conduct multidimensional analysis, journal entry summaries, validation reports, criteria-generated reports, times series analysis, and regression analysis.

Audit data analytics are procedures performed by examining large amounts of data using technology and presenting the results visually. Audit data analytics allow multidimensional analysis by sorting client data into various dimensions or measures. For example, client data can be sorted across dimensions such as location, cost centre, or manager. It can then be measured as inventories purchased, inventories sold, inventories on hand, sales, or rent expense across those dimensions. Once measured data are sorted by dimensions, they can be analyzed to determine whether the relationships between the various data are consistent with the auditor's understanding of their client. Journal entry summaries provide condensed overviews of transactions. Summaries can be prepared using a range of criteria. For example, summaries can be made by month, by division, or by manager.

Validation reports are needed when conducting audit data analytics to report on the validity of the client's data. For example, a validation report can include details of character checks, where fields are searched to ensure they include only appropriate data (for example, a numeric field includes only numbers), checks for missing data, checks for data that are less or greater than a certain amount, checks for negative amounts or balances, checks that customer numbers are valid, and checks that inventory numbers are valid.

Criteria-generated reports are summaries of information and data based on conditions set by the auditor. These reports are used to help auditors manage the significant amount of information and data held in client computer files. By setting conditions or criteria, auditors are able to collect data that are most at risk of material misstatement. In this way, auditors can focus their attention.

Times series analysis is another type of audit data analytic that can be used to analyze data that occur regularly within the client; for example, sales and purchases. This form of analysis involves using data from the past to predict the future. For example, sales made in the past can be used to predict sales in the period under audit. Significant fluctuations in expected sales trends are investigated by the auditor. When assessing variations, auditors will incorporate their understanding of changes that have occurred in the current year that may explain the variations observed. For example, the client may have closed a number of retail outlets, which would explain a sharp decline in sales. When conducting a times series analysis, auditors can look at the long-term trend, seasonal variation (for example, sales of ice cream are likely to be higher in summer), and irregularities.

These concepts will be further explored in Chapter 9.

4.5.6 Factors to Consider when Conducting Analytical Procedures

There are a number of factors to consider when conducting analytical procedures. The first is the reliability of client data. If the auditor believes there is a significant risk that the client's records are unreliable due to, for example, poor internal controls, then the auditor is less likely to rely on analytical procedures. Another issue is the ability to make comparisons over time. If the client has changed accounting methods, this will reduce the comparability of the underlying data. In this case, an auditor will need to restate prior years' financial statements using the current accounting methods before making any comparisons. If past results are unaudited, they are considered less reliable for comparison purposes.

During the risk assessment phase of an audit, an auditor may have access only to the client's interim results. In this case, an auditor will need to annualize revenue and expense items before making comparisons with the prior year. If the client earns revenues evenly throughout the year, it is appropriate to double the half-year revenues. If the client earns more revenues in some months relative to others (for example, an ice seller in warmer months), trends must be considered when annualizing interim results.

When comparing actual financial results with budgeted results, an auditor will consider the reliability of the budget. This can be assessed by comparing budget with actual results for prior years. If the client continually overestimates earnings, for example, an auditor can take this into account when comparing actual and budgeted results for the current period.

When benchmarking a client with industry data, care must be taken. If the client is significantly smaller or larger than most companies in its industry, the comparison may not be valid. If competitors do not use the same accounting methods, the comparison is problematic. If the client has very different results and ratios compared with the industry average, there may be a problem with industry data rather than with client data.

In conducting analytical procedures, the following information sources are generally considered to be reliable:

- information generated by an accounting system that has effective internal controls
- information generated by an independent reputable external source
- audited information
- information generated using consistent accounting methods
- information from a source internal to the client that has proven to be accurate in the past (for example, information used to prepare budgets)

After conducting analytical procedures, an auditor will investigate all significant unexpected fluctuations: the existence of fluctuations where none were expected and the absence of fluctuations where they were expected. An example of the former would be a significant increase in sales for no apparent reason. An example of the latter would be no significant change in inventory turnover when the auditor is aware that sales have fallen significantly.

Cloud 9 Integrated Case

Ian volunteers to start the analysis of Cloud 9's interim results and the previous period's financial data. He has previously attended a training session on the W&S Partners' software that he will use to produce reports showing unusual relationships and fluctuations. Suzie is grateful for the help but cautions Ian, "You do realize that judging what is 'unusual' is a little more complex than getting a software program to identify a change above a certain percentage? You need considerable industry experience and client knowledge to make sense of the information. For example, no change in a figure can be more suspicious than a large change, depending on the circumstances."

"Yes, I realize that," Ian says, "and I know that I don't have the experience to complete the analysis, but I am hoping that I will learn from you by seeing what you do with the data and reports that I hadn't considered doing."

Before You Go On

4.5.1 Why are liquidity ratios calculated?

4.5.2 Define the gross profit ratio and explain what it indicates.

4.5.3 What is a trend analysis and why might an auditor use this form of analysis?

Summary

1 Evaluate audit risk.

Audit risk is the risk that an auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. The three components of audit risk are inherent risk, control risk, and detection risk.

2 Explain and apply the concept of materiality.

Information is considered to be material if it impacts the decision-making process of users of the financial statements.

3 Describe how an auditor determines the audit strategy.

The audit strategy is a key component of the risk assessment phase of the audit. It sets the scope, timing, and direction of the audit and provides the basis for developing a detailed audit plan. An audit strategy will depend on the auditor's preliminary inherent and control risk assessment.

4 Outline how clients measure performance.

By understanding how a client measures its own performance, an auditor can plan the audit to take into consideration areas where the client may be under pressure to achieve certain outcomes.

5 Summarize how an auditor uses analytical procedures when planning an audit.

Analytical procedures are conducted at the risk assessment phase of the audit to identify unusual fluctuations, help identify risks, help when gaining an understanding of a client, identify the accounts at risk of material misstatement, and reduce audit risk by concentrating audit effort where the risk of material misstatement is greatest. There are many processes that can be used when conducting analytical procedures. The processes discussed in this chapter included simple comparisons, trend analysis, common-size analysis, and ratio analysis.

Key Terms

Self-Test Questions

Answers can be found in *WileyPLUS*.

4.1 Inherent risk is:

a. the risk the auditor will issue an inappropriate opinion.

b. the risk the financial statements are materially misstated without any consideration of controls.

c. the only risk the auditor can control.

d. a risk that requires special audit consideration.

4.2 For an audit, the auditor can control:

a. inherent risk.

b. control risk.

c. financial risk.

d. detection risk.

4.3 A combined audit strategy:

a. is appropriate when internal controls are minimal.

b. means that the auditor will gain the minimum necessary knowledge of the client's system of internal controls.

c. requires the auditor to conduct extensive control testing.

d. means that the auditor will conduct extensive testing of year-end account balances.

4.4 Testing controls means that:

a. the auditor can completely rely on a client's system of internal controls.

b. no substantive testing is required.

c. the auditor can plan to reduce their reliance on detailed substantive testing of transactions and account balances.

d. all of the above.

4.5 An example of an item that is material is:

a. a theft of $100.

b. an undisclosed lawsuit for $1 million.

c. an undisclosed related party.

d. all of the above.

4.6 An auditor will identify accounts and related assertions at risk of material misstatement:

a. after testing internal controls.

b. before writing the audit report.

c. in order to plan the audit to focus on those accounts.

d. to eliminate audit risk.

4.7 Profitability ratios are used to assess performance and:

a. companies will be interested in trends in the ratios.

b. companies will try to have the same ratio in each month of operation.

c. should be the same for all divisions of the company.

d. companies will track their revenue and expenses over time and assess any variability.

4.8 Common uses of analytical procedures include:

a. risk identification during the risk assessment phase.

b. estimation of account balances during the risk response phase.

c. overall assessment of the financial statements at the reporting phase.

d. all of the above.

4.9 An auditor is interested in the client's inventory turnover ratio because it helps the auditor understand:

a. if the industry is the same as another industry.

b. if the client is as competitive and has as high a turnover as the industry average.

c. if the client's accounts receivable customers are paying their accounts on time.

d. if the client is in the right industry.

4.10 Analytical procedures:

a. cannot be performed on interim data.

b. are not affected by different accounting methods between the client and other members of the industry.

c. must take into account seasonal variation in the client's business.

d. are only useful if the client's variance from budget is low.

Review Questions

4.1 Define audit risk and its components.

4.2 Explain the approach adopted by auditors when identifying accounts and related assertions at risk of material misstatement. How does this approach help reduce audit risk to an acceptably low level?

4.3 If an auditor adopts a substantive strategy for the audit, do they have to consider and test the client's internal controls? If an auditor adopts a combined audit strategy, do they have to perform any substantive procedures? Explain.

4.4 Consider the following statement: "If inherent and control risk are high, the auditor will set detection risk as low, to bring audit risk down." Explain how setting detection risk as low brings down audit risk.

4.5 How does the auditor's preliminary assessment of materiality affect audit planning? What does an auditor consider when making the preliminary assessment of materiality?

4.6 The materiality of an item is assessed relative to a particular base number. What are some of the choices for this base, and what factors guide the auditor in this choice?

4.7 What factors should be considered to determine if an item is qualitatively material?

4.8 Explain using examples how you could use analytical procedures in assessing the risk of misstatement of sales revenue.

4.9 What are some possible explanations of a change in the gross profit margin? How could the auditor investigate which of these explanations is the most likely cause of the change in the ratio?

4.10 What is the difference between liquidity and solvency? Why does this difference matter to an auditor?

Professional Application Questions

Basic Moderate Challenging

4.1 Audit risk and revenue Moderate LO 1

Ajax Finance Ltd. provides small- and medium-sized personal, car, and business loans to clients. It has been operating for more than 10 years and has been run throughout its life by Bill Schultz. Bill has been the public face of the finance company, appearing in most of its television and radio advertisements. He has developed a reputation as a friend of the "little person" who has been mistreated by the large finance companies and banks.

Ajax's major revenue stream is generated by obtaining large amounts on the wholesale money market and lending in small amounts to retail customers. Margins are tight, and the business is run as a "no frills" service. Offices are modestly furnished and the mobile lenders drive small, basic cars when visiting clients. Ajax prides itself on full disclosure to its clients, and all fees and services are explained in writing to clients before loans are finalized. However, although full disclosure is made, clients who do not read the documents closely can be surprised by the high exit charges when they wish to make early repayments or transfer their business elsewhere.

Ajax's mobile lenders are paid on a commission basis; they earn more when they write more loans. For example, they are encouraged to sell credit cards to any person seeking a personal loan. Ajax receives a commission payment from the credit card companies when it sells a new card and Ajax also receives a small percentage of the interest charges paid by clients on the credit card.

Required

What are the inherent and control risks for Ajax's revenue? Discuss the specific risks.

4.2 Audit risk and inventory **Basic** **LO 1, 5**

Cheap-as-Chips stocks thousands of items in inventory that range in value from $1 to $100. The inventory on hand represents a material portion of current assets. The merchandise items change according to the season and the promotional theme adopted by the stores' management for the year. Merchandise is ordered up to four months in advance from Chinese and Korean suppliers. These special orders require Cheap-as-Chips to give the suppliers substantial deposits upon placement of the orders.

Required

What are the inherent risks for Cheap-as-Chips's inventory? What analytics could be performed to help identify the risk of material misstatement with respect to inventory?

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, December 2010. Provided courtesy of Chartered Accountants Australia and New Zealand.

4.3 Control risk **Basic** **LO 1**

Clear Sky Aviation credits prepayments of air travel to a deferred revenue account until the travel service is provided, at which point it transfers the appropriate amount to sales revenue. A problem with its control system means that the proper allocation of revenue between sales revenue recorded in the income statement and the deferred revenue account balance in the balance sheet does not always occur. The auditor is considering conducting additional substantive testing to test whether the sales transactions have been properly classified.

Required

Describe how the balance sheet and income statement may be at risk of material misstatement if the controls regarding the proper allocation of revenue are not functioning properly.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, December 2010. Provided courtesy of Chartered Accountants Australia and New Zealand.

[1]**4.4** Risk assessment **Moderate** **LO 1**

LLL Avionics Ltd. has contacted your accounting firm to inquire about the cost of an external audit. The company's president explained that he feels that "the previous auditor charged too much and only issued a qualified opinion." Your firm was recommended to LLL by your bank manager. LLL has a large loan request at the bank, and the interest rate of the new loan will depend on the audit opinion. As the partner in charge of this file, you interviewed the president and controller of the company as part of your decision to accept or reject LLL as a client. You have found that the company has a new design for an aircraft and plans to borrow funds from the bank and to issue common shares to finance a prototype plane to test the design. The new funds will also greatly improve the company's balance sheet by providing the funds to bring the company's existing bank loan up to date. If the design is successful, more common shares will be issued for more capital.

The controller was very helpful in your discussions, and you note his high level of enthusiasm for the project as this is his first job at this level. However, the president was not so helpful and seemed annoyed with your questions.

Required

Indicate five factors in the above situation that impact the risk of material misstatement. Explain your answer.

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[2] **4.5** Audit risk **Moderate** **LO 1**

This is the second year that your firm is auditing JJ Company, which is developing a new drug for a rare form of cancer. The company is controlled by Jack Mukash, who purchased the shares from the previous owner this year. You have been informed that the company's bank requires an audit to increase the company's operating line of credit. Jack has also informed you that he would like to convert the company into a public company next year and sell shares on the stock exchange, as he does not expect that the company will have significant revenues for at least four years. At present, the company has two other drugs under patent, and these products produce sufficient revenues to service the company's debt load, including anticipated new borrowing this year. However, these patents will expire in five years, so Jack is trying to plan ahead.

Required

Indicate whether you feel the overall audit risk should be high or low in the audit of JJ. State two reasons to support your answer.

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4.6 Audit risk **Moderate** **LO 1**

Triple J Movers Ltd. is owned by Jacques Tétreault. The company used to be profitable but several new small companies have started to compete with Triple J, offering very low prices that Triple J cannot match. Jacques thinks he can make his company profitable again if he eliminates his competitors, which will allow him to raise prices.

He therefore decided to purchase one of his competitors each year for the next four years. The first company he bought was a proprietorship called Jerry's Trucking. Jacques has hired your audit firm to review the accounting system and controls at Jerry's Trucking to see what changes are needed before he can integrate it into Triple J Movers. Jacques hopes there are not many problems.

You interviewed the owner of Jerry's Trucking and the company's bank manager and learned the following information:

The company has customers in both Canada and the United States, and the owner was not very knowledgeable about customs fees that must be paid and regulations that have to be followed when transporting goods across the border. Also, the owner, Jerry, often simply took any cash that the business earned and spent it on personal items, instead of taking a salary from the business. There is only one office staff member besides Jerry: Jerry's cousin, who does all of the bookkeeping. His cousin is not an accountant but has taken some accounting courses. Jerry explained that controls at Jerry's Trucking are strong because:

- He can trust his cousin completely. (Having honest employees is important for effective control.)
- Jerry personally checks all of the bookkeeping entries, making any corrections he feels are necessary.
- At the year end, Jerry takes the bookkeeping records to a tax preparer, who prepares his tax return.

Required

Discuss the inherent risk at Jerry's Trucking based on the above information. Include six observations in your answer.

4.7 Risk assessment **Moderate** **LO 1**

You are the audit supervisor of Seagull & Co. and are currently planning the audit of your existing client, Eagle Heating Co., for the year ending December 31, 2023. Eagle manufactures and sells heating and plumbing equipment to a number of home improvement stores across the country.

Eagle has experienced increased competition and is facing significant pressure to meet sales targets. As a result, it has decreased the selling price of its products significantly since September 2023. The finance director has informed your audit manager that he expects increased inventory levels at the year end. He also notified your manager that one of Eagle's key customers has been experiencing financial difficulties. Therefore, Eagle has agreed that the customer can take a six-month payment break, after which payments will continue as normal. The finance director does not believe that any allowance is required against this receivable.

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In October 2023, the financial controller of Eagle was dismissed. He had been employed by the company for over 20 years, and he has threatened to sue the company for unfair dismissal. The role of financial controller has not yet been filled and so his tasks have been shared among members of the existing finance department team. In addition, the accounts payable supervisor left in August and a replacement has been appointed in the last week. However, for this period no supplier statement reconciliations or accounts payable reconciliations were performed.

You have undertaken a preliminary analytical review of the draft year-to-date income statement, and you are surprised to see a significant fall in administration expenses.

Required

Discuss the factors that will impact the risk of material misstatement in the financial statements and identify the relevant accounts and the related risks in planning the audit of Eagle.

Source: Adapted from ACCA Audit Framework, Paper 6, December 2015 exam.

[3]4.8 Materiality Moderate LO 2

Ana Dinh used 0.5 to 5 percent of gross profit in determining materiality of $70,000 in her audit of XYZ Inc., a company that builds replacement engines for tractors and combines. She used the $70,000 amount as her planning materiality, identifying account balances and transactions to be tested. She also used materiality as a guide when deciding on the appropriate audit opinion in her report.

Required

a. Provide two other examples of a base (other than 0.5 to 5 percent of gross profit) that an auditor could use in determining materiality in a financial statement audit.

b. Suppose Ana initially reviewed parts inventory account #102641–1 and found that none of the account transactions exceeded $45,000. Does this mean that none of these transactions should be selected for examination, based on her materiality decision of $70,000? Explain your answer.

Source:

4.9 Materiality Moderate LO 2

Atlantic Academy is a private school that offers education to children from Kindergarten to Grade 7. The school operates as a not-for-profit entity, and oversight of the school is performed by the board of directors. The board reviews the operational and financial results monthly to ensure the school is meeting its budget responsibilities. Revenues for the school generally come from three sources: student tuition, government funding, and various fundraising programs seeking additional funds for specific purposes. Government funding is provided based on the number of students enrolled, and the funds are to be spent only on the provision of education services. A requirement of the government funding is that the school must submit annual audited financial statements.

Jones and Black, CPAs, are the auditors of Atlantic Academy. Their firm's policy is to use the following percentages when determining materiality:

- 5% of normalized pre-tax profit
- 3% of equity
- 1% of total assets
- 2% of revenues or expenditures

Performance materiality is to be 65% of planning materiality.

Select financial data for Atlantic Academy are provided below:

	2023	2022
Revenue	$1,186,000	$1,229,000
Expenses	1,607,000	1,160,000
Income (loss) from continuing operations	(421,000)	69,000
Total assets	3,419,000	2,928,000

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Required

Determine planning materiality and performance materiality.

4.10 Planning, performance, and specific materiality **Challenging** **LO 2**

Claytonhill Beverages Ltd. is 100-percent owned by Buzz Bottling. While the company has in the past been profitable, it incurred a loss for the year ended December 31, 2023. The parent company, Buzz Bottling, has indicated that if Claytonhill incurs another loss, it will put the subsidiary up for sale. In response, Claytonhill is looking to expand its market share and therefore its profitability by performing private labelling for a nationwide supermarket chain, ValueFoods Inc. Private labelling involves producing and packaging pop and other non-alcoholic beverages under the ValueFoods label. However, in order to proceed with this endeavour, Claytonhill needs a packaging facility dedicated exclusively to co-packing. To finance this expansion, the company has applied to the Better Business Bank for financing.

The bank has indicated that, before it will approve the loan application, it would like to see audited financial statements for 2023. It also wants to ensure the entity has a current ratio of at least 2:1.

Claytonhill Beverages has provided you, its new auditor, with the draft (unaudited) financial statements in figure 4.10.

FIGURE 4.10 **Unaudited financial statements for Claytonhill Beverages**

Income statement for the year ended December 31, 2023 (partial)	
Revenue	
Sales	$2,057,505
Cost of goods sold	1,445,450
Gross margin	612,055
Less:	
General and administration costs	
(including bonuses of $100,000)	775,899
Net loss before tax	$(163,844)
Balance sheet as at December 31, 2023	
Assets	
Current assets	
Cash	$ 179,825
Accounts receivable, net	64,475
Inventory	1,507,413
Prepaid expenses	3,004
Total current assets	1,754,717
Property, plant, and equipment	
Land	2,004,933
Building, net	964,224
Office furniture and equipment, net	85,106
Total property, plant, and equipment	3,054,263
Total assets	$ 4,808,980

(*continued*)

Balance sheet as at December 31, 2023	
Liabilities	
Current liabilities	
Accounts payable	$ 799,255
Other accrued expenses	44,875
Warranty provision	9,456
Current portion long-term debt	25,000
Total current liabilities	878,586
Long-term liabilities	
Bank loans	2,200,000
Total liabilities	3,078,586
Equity	
Common shares	248,000
Retained earnings	1,482,394
Total equity	1,730,394
Total liabilities and equity	$ 4,808,980

FIGURE 4.10 **Unaudited financial statements for Claytonhill Beverages (*continued*)**

Required

a. Identify the users of the financial statements and their needs.

b. Given the users' needs, what is the most appropriate base for materiality?

c. Calculate the three levels of materiality and conclude on each.

d. What impact did audit risk have on the materiality calculation?

4.11 Audit risk components and materiality **Moderate** **LO 1, 2**

Carl's Computers imports computer hardware and accessories from China, Japan, Korea, and the United States. It has branches in every provincial capital, and the main administration office and central warehouse is in Montreal. There is a branch manager in each store plus a number (depending on the size of the store) of permanent staff. There are also several casual employees who work on weekends—the stores are open both Saturday and Sunday. Either the branch manager or a senior member of the permanent staff is on duty at all times to supervise the casual staff. Both casual and permanent staff members are required to attend periodic company training sessions covering product knowledge, and inventory and cash-handling requirements.

The inventory is held after its arrival from overseas at the central warehouse and distributed to each branch on receipt of an inventory transfer request authorized by the branch manager. The value of inventory items ranges from a few cents to several thousand dollars. Competition is fierce in the computer hardware industry. New products are continuously coming onto the market, and large furniture and office supply discount retailers are heavy users of advertising and other promotions to win customers from specialists like Carl's Computers. Carl's Computers' management has faced difficulty keeping costs of supply down and has started to use new suppliers for some computer accessories such as printers and ink.

Required

a. Explain the inherent risks for inventory for Carl's Computers. How would these risks affect the financial statement accounts?

b. What strengths and weaknesses in the inventory control system can you identify in the above case?

c. Comment on materiality for inventory at Carl's Computers. Is inventory likely to be a material balance? Would all items of inventory be audited in the same way? Explain how the auditor would deal with these issues.

[4]**4.12** Audit risk and materiality **Challenging** **LO 1, 2**

Gold Explorers Inc. is a major Canadian gold mining corporation. Gold Explorers has mines and development projects in Canada (Northern Ontario and British Columbia), the United States, and South America. Shares of Gold Explorers trade on three major stock exchanges—New York, Toronto, and London. Gold Explorers is known as one of the lowest-cost producers of gold worldwide, and in the current fiscal year it achieved record gold production levels. Due to the record levels, revenues increased this year. Revenues grew from $1,357 million last year to $1,432 million in this year's draft financial statements (all dollar figures are U.S. dollars). Corresponding gross profit figures are $642 million for last year and $678 million for the current year.

Terrence, chair and CEO of Gold Explorers, is known throughout the Canadian mining industry as a man of principle and integrity. He governs Gold Explorers in accordance with three key guiding principles, which he articulated in 1988 when he founded the company. These principles are entrepreneurial management, financial discipline, and corporate responsibility. Adherence to these principles has given Gold Explorers a stable and dedicated workforce, and a strong balance sheet that includes $623 million in cash, virtually no net debt, and shareholders' equity of just over $3 billion ($3,023 million). In addition, Gold Explorers boasts an "A" credit rating and has access to a $1-billion line of credit. Gold Explorers' efforts with respect to corporate responsibility have been recognized internationally, and the company was awarded eight major awards for environmental protection in the past four years. In spite of this, however, Gold Explorers has had to expend some money on site restoration in the past in order to meet the requirements of environmental compliance orders.

Your firm has been Gold Explorers' auditors for the past eight years. In that time, there have been very few misstatements discovered during the audits that have required adjustments to the draft financial statements. In fact, Raj, the partner in charge of the audit, and Margaret, audit manager, have found the audit to be almost routine in the past four years of their involvement with Gold Explorers. However, this year promises to be a little different. Responding to the need for consolidation in the industry, Gold Explorers merged this year in an all-share deal with a major U.S. gold company that had significant mining operations in Canada. Furthermore, immediately prior to year end, Gold Explorers reassessed the carrying value of its capital assets. The reassessment resulted in a $1.1-billion writedown of Gold Explorers' property, plant, and equipment assets to a carrying value of $3,565 million. Even with this writedown, Gold Explorers' total assets remain at a substantial $4,535 million; however, the writedown resulted in a significant net loss before taxes of $944 million in the current year, compared with net incomes before taxes of $441 million and $443 million in the preceding two years.

Required

a. Identify eight factors that Margaret needs to consider that would affect her assessment of audit risk, inherent risk for the financial statements and account balances, and control risk for this year's audit of Gold Explorers. For each factor you identify, indicate which one of the three risks would be affected and state whether the factor is likely to increase or decrease Margaret's assessment of that risk relative to other companies in other industries. In addition, for each factor, explain why the risk will increase or decrease. Set up your answer in the following manner:

FACTOR	TYPE OF RISK	IMPACT (INCREASE/DECREASE)	EXPLANATION

b. Identify the most appropriate basis for determining materiality for this year. Justify the basis of the materiality you selected and explain why other bases are not appropriate.

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4.13 Audit planning **Challenging** **LO 1, 2, 3**

Tom's Trailers Ltd. (TTL), located in London, Ontario, manufactures industrial trailers that are used to ship goods across the country. Originally, Tom Tran owned 60 percent of the common shares of TTL and the other 40 percent was owned equally by Tom's four brothers. Tom's brothers have been happy with their investment in TTL as they have always received a healthy dividend from TTL at the end of each fiscal year. In a strategic decision last year, Tom sold 9 percent of his shares to Junior Strategic Investments Ltd., a venture capital firm, in exchange for a $30-million investment. This investment has been used to fund the purchase of a new production plant in Burnaby, BC, and to fund the research and development of new technologies that would allow TTL to produce better trailers that would hold more. The terms of the agreement with Junior Strategic Investments require TTL to provide audited financial statements within 60 days after its December 31 year end.

[4] Adapted with permission of the Chartered Professional Accountants of Canada, Toronto, Canada. Any changes to the original material are the sole responsibility of the publisher and have not been reviewed or endorsed by the Chartered Professional Accountants of Canada.

The following is select information from the financial statements:

	Dec. 31, 2023 ('000s)	Dec. 31, 2022 ('000s)
Total assets	$ 46,601	$ 34,268
Total revenues	160,100	109,059
Gross profit	30,681	19,306
Earnings before tax	19,212	2,316
Earnings after tax	15,361	1,613

Shane and Wayne Co. has been TTL's accounting firm since its inception; however, it has always performed a review engagement. Based on past engagements, Shane and Wayne is aware that, overall, the controls seem strong at TTL, as there is a formal code of conduct, and there appear to be established lines of authority. However, this year Tom has indicated that he is concerned about the gross margin at the new Burnaby plant. It is much lower than the gross margin at the London plant. The production manager at the Burnaby location is blaming the higher costs on the start-up of the plant.

TTL has a large number of foreign sales and Shane and Wayne noted in previous review engagements that several accounting adjustments were required due to foreign exchange translation errors. In discussions with the client, they also determined that TTL had implemented a new IT system.

Shane and Wayne is starting its audit planning for the upcoming year. The firm uses the guidelines from figure 4.4 for materiality. The firm assesses performance materiality at 65 percent of planning materiality.

Required

a. Discuss the risk of material misstatement and conclude on the detection risk.

b. Assess planning materiality.

4.14 Determining an audit strategy **Moderate** **LO 1, 3**

Niagara Dairy is a boutique cheese maker based in the Niagara region of Ontario. Over the years, the business has grown by supplying local retailers and, eventually, by exporting cheese products. In addition, there is a "farm-gate" shop and café located next to the main processing plant in Niagara-on-the-Lake, which serves tourists who also visit other specialist food and wine businesses in the region. Quality control over the cheese manufacturing process and storage of raw materials and finished products at Niagara Dairy is extremely high. The company is committed to high quality control because poor food-handling practices could cause a drop in cheese quality or contamination of cheese products, which would ruin the business very quickly.

The export arm has been built up to become the largest revenue earner for the business by the younger of the two brothers who have run Niagara Dairy since it was established. Jim Bannock has a natural flair for sales and marketing but is not as good at completing the associated detailed paperwork. Some of the export deals have been poorly documented, and Jim often agrees to different prices for different clients without consulting his older brother, Bob, or informing the sales department. Consequently, there are often disputes about invoices, and Jim makes frequent adjustments to accounts receivable using credit notes when clients complain about their statements. Jim sometimes falls behind in responding to customer complaints because he is very busy juggling the demands of making export sales and running his other business, Café Consulting, which provides contract staff for the café business at Niagara Dairy.

Required

a. Identify the factors that would affect the preliminary assessment of inherent risk and control risk at Niagara Dairy.

b. Explain how these factors would influence your choice between a substantive strategy and the combined audit strategy for sales, inventory, and accounts receivable.

4.15 Preliminary analytics **Moderate** **LO 1, 3**

You are the audit senior of Rhino & Co. and you are planning the audit of Kaine Construction Co. for the year ended March 31, 2023. Kaine specializes in building houses and provides a five-year building warranty to its customers. Your audit manager has held a planning meeting with the finance director. He has provided you with the following notes on his meeting and financial statement extracts:

- Kaine has had a difficult year; house prices have fallen and, as a result, revenue has dropped. In order to address this, management has offered significantly extended credit terms to customers. However, demand has fallen such that there are still some completed houses in inventory where the selling price may be below cost.

- Management needs to meet a target profit before interest and taxation of $0.5 million in order to be paid their annual bonus.
- In addition, to try to improve profits, Kaine changed its main supplier to a cheaper alternative. This has resulted in some customers claiming on their building warranties for extensive repairs.
- To help with operating cash flow, management borrowed $1 million from the bank during the year. This is due for repayment at the end of December 2023.

Financial statement extracts for year ended March 31

	Draft 2023	Actual 2022
Revenue	$12,500,000	$15,000,000
Cost of sales	7,000,000	8,000,000
Gross profit	5,500,000	7,000,000
Operating expenses	5,000,000	5,100,000
Profit before interest and taxes	500,000	1,900,000
Inventory	1,900,000	1,400,000
Receivables	3,100,000	2,000,000
Cash	800,000	1,900,000
Trade payables	1,600,000	1,200,000
Operating loan	1,000,000	–

Required

a. Calculate five ratios that would help the auditor in planning the audit.

b. Using the information and the ratios calculated, identify five audit risks or areas that may require additional audit work.

Source: Adapted from ACCA Audit Framework, Paper 6, June 2013 exam.

4.16 Planning analytical procedures using profitability ratios **Moderate** **LO 4, 5**

Li Chen has calculated profitability ratios using data extracted from his client's pre-audit trial balance. He also has the values for the same ratios for the preceding two years (using audited figures). Table 4.11 presents the data for the gross profit and profit margins.

Li is a little confused because the profit margin shows declining profitability, but the gross profit margin has improved in the current year and is higher in 2023 than in the previous two years.

Required

a. Make a list of possible explanations for the pattern observed in the gross profit and profit margins.

b. Which of your explanations suggests additional audit work should be planned? For each, explain the accounts and/or transactions that would need special attention in the audit.

TABLE 4.11 Gross profit and profit margin

	2023	2022	2021
Gross profit margin	0.45	0.35	0.40
Profit margin	0.09	0.15	0.20

4.17 Analytical procedures for liquidity and solvency issues **Challenging** **LO 4, 5**

Bright Spark Fashion has retail outlets in six large regional cities in eastern Canada. The shops are run by local managers but purchasing decisions for all stores are handled by Ray Bright, the owner of the business. Fashion is an extremely competitive business. Bright Spark Fashion sells only for cash and generates sales through a reputation for low prices for quality goods. The winter range is quite slow-moving, but summer fashion sells very well, providing a disproportionate amount of the business's sales and profits. Ray is constantly monitoring cash flow, and negotiating with suppliers about payment terms and banks about interest rates and extensions of credit.

Jenna Kowalski has the tasks of assessing the liquidity and solvency of Bright Spark Fashion and identifying the audit risks arising from this aspect of the business. She discovers that a major long-term debt is due for repayment two months after the close of the financial year, but Ray is having difficulty obtaining approval from his current bank for a renewal of the debt for a further two-year term. In addition, interest rates have risen since the last fixed rate was agreed upon two years ago, adding two percentage points to the likely rate for the new debt (if it is approved).

The seasonality of the business means that inventory levels fluctuate considerably. At the end of the financial year (December 31), Ray placed prepaid orders for the summer fashion line, and the goods started arriving in the stores in February.

Required

a. What liquidity and solvency issues does Bright Spark Fashion face? Explain the likely impact of each issue on the usual liquidity and solvency ratios.

b. Advise Jenna about the audit risks for Bright Spark Fashion and suggest how she should take these into account in the audit plan.

4.18 Risk assessment **Moderate** **LO 1**

Featherbed Surf & Leisure Holidays Ltd. (Featherbed) is a resort company based on Vancouver Island. Its operations include boating, surfing, fishing, and other leisure activities; a backpackers' hostel; a family hotel; and a five-star resort. Justin and Sarah Morris own the majority of the shares in the Morris Group, which controls Featherbed. Justin is the chair of the board of directors of both Featherbed and the Morris Group, and Sarah is a director of both companies as well as the CFO of Featherbed.

In February 2023, Justin Morris approached your audit firm, KFP Partners, to carry out the Featherbed audit for the year ended June 30, 2023. Featherbed has not been audited before but this year the audit has been requested by the company's bank and a new private equity investor group that has just acquired a 20-percent share of Featherbed.

Featherbed employs 30 full-time staff. These workers are employed in administration, accounting, catering, cleaning, and hotel/restaurant duties. During peak periods, Featherbed also uses part-time and casual workers. These workers tend to be travellers visiting the West Coast who are looking for short-term employment to help pay their travelling expenses.

Justin and Sarah have a fairly laid-back management style. They trust their workers to work hard for the company and they reward them well. The accounting staff, in particular, are very loyal to the company. Justin tells you that some accounting staff enjoy their jobs so much they have never taken any holidays, and hardly any workers ever take sick leave.

There are three people currently employed as accountants, the most senior of whom is Peter Pinn. Peter heads the accounting department and reports directly to Sarah. He is in his fifties and plans to retire in two or three years. Peter prides himself on his ability to delegate most of his work to his two accounting staff, Kristen and Julie. He claims he has to do this because he is very busy developing a policy and procedures manual for the accounting department. This delegated work includes opening mail, processing payments and receipts, banking funds received, performing reconciliations, posting journals, and performing the payroll function. Julie is a recently graduated Chartered Professional Accountant. Kristen works part-time—coming into the office on Mondays, Wednesdays, and Fridays. Kristen is responsible for posting all journal entries into the accounting system and the payroll function. Julie does the balance of the work, but they often help each other out in busy periods.

Required

Using the factors in the above scenario, assess audit risk.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, May 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

Questions 4.19 and 4.20 are based on the following case.

Securimax Limited has been an audit client of KFP Partners for the past 15 years. Securimax is based in Waterloo, Ontario, where it manufactures high-tech armour-plated personnel carriers. Securimax often has to go through a competitive market tender process to win large government contracts. Its main product, the small but powerful Terrain Master, is highly specialized, and Securimax does business only with nations that have a recognized, democratically elected government. Securimax maintains a highly secure environment, given the sensitive and confidential nature of its vehicle designs and its clients.

In September 2023, Securimax installed an off-the-shelf costing system to support the highly sophisticated and cost-sensitive nature of its product designs. The new system replaced a system that had been developed in-house, as the old system could no longer keep up with the complex and detailed manufacturing costing process that provides tender costings. The old system also had difficulty with the company's broader reporting requirements.

The manufacturing costing system uses all of the manufacturing unit inputs to calculate and produce a database of all product costs and recommended sales prices. It also integrates with the general ledger each time there are product inventory movements such as purchases, sales, wastage, and damaged inventory losses.

Securimax's financial year end is December 31.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, May 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

4.19 Assessing inherent risk **Moderate** **LO 1**

Required

Based on the background information, what are the major inherent risks for the financial statements and at the account level in the Securimax audit? Consider both industry and entity risks in your answer.

4.20 Assessing preliminary materiality **Moderate** **LO 2**

Required

Discuss the factors to consider when determining preliminary materiality for Securimax.

Questions 4.21 and 4.22 are based on the following case.

Fellowes and Associates Chartered Professional Accountants is a successful mid-tier accounting firm with a large range of clients across Canada. In April 2023, Fellowes and Associates gained a new client, Health Care Holdings Group (HCHG), which owns 100 percent of the following entities:

- Shady Oaks Centre, a private treatment facility
- Gardens Nursing Home Ltd., a private nursing home
- Total Laser Care Limited, a private clinic that specializes in laser treatment of skin defects

The year end for all HCHG entities is June 30.

On April 1, 2023, Gardens Nursing Home switched from its "homegrown" patient revenue system to HCHG's equivalent system. HCHG is confident that its "off-the-shelf" enterprise system would perform all of the functions that Gardens Nursing Home's homegrown system performed.

Gardens Nursing Home's homegrown patient revenue system comprised the following:

1. **Billing system**—a system that produced the invoice to charge the patient for services provided, such as accommodation, medications, and medical services. This software included a complex formula to calculate the patient bill allowing for government subsidies, pensioner benefits, and private medical insurance company benefit plans.
2. Patient database—a master file that contained personal details about the patient as well as the period of stay, services provided, and the patient's medical insurance details.
3. Rates database—a master file that showed all accommodation billing rates, rebate discounts, and government assistance benefits.

At the request of the board, the group's internal audit unit was involved throughout the entire conversion process. The objective of its engagement, as the board stated, was to "make sure that the conversion worked without any problems."

As part of the planning arrangement for the 2023 financial statement audit, the audit partner, Tania Fellowes, asked her team to speak with a number of Gardens Nursing Home staff about the impact of the switch to the HCHG patient revenue system. Below is an extract of the staff's comments:

- "There were some occasions where we invoiced people who were past patients. This seems to have happened when they shared the same surname as a current patient."
- "We seem to have some patient fee invoices where, for no reason, we have billed patients at a lower room rate than what we have on the rates database."
- "Lately we've had an unusually high number of complaints from recently discharged patients that the fee invoice we sent them does not line up with the agreed-upon medical fund and government subsidy rates. We then found out that halfway through last month someone from the IT team made a software change to fix a bug in the billing calculation formula."

- "There was some sort of power surge last Friday, and we had to re-enter every patient invoice that we had processed in the last two weeks."

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, December 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

4.21 Planning in context of IT system changes **Moderate** **LO 1, 2**

Required

Identify the audit risks associated with the installation of the new IT system for patient revenue for Gardens Nursing Home.

4.22 Determining audit strategy **Moderate** **LO 3**

Required

Comment on the audit strategy likely to be adopted for the audit of patient revenue for Gardens Nursing Home.

Integrative Case Study

4.23 AutoCare Ltd. **Challenging**

AutoCare Ltd. (ACL) is a federally incorporated public company formed in 2014 to manufacture and sell specialty auto products such as paint protection and rust proofing. By 2020, ACL's board of directors felt that the company's products had fully matured and that it needed to diversify. ACL aggressively sought out new "concepts," and in November 2021, it acquired the formula and patent for a new product—synthetic motor lubricant (Synlube).

Synlube is unlike the synthetic motor oils currently on the market. Its innovative molecular structure accounts for what management believes is its superior performance. Although Synlube is more expensive to produce and, therefore, has a higher selling price than its conventional competitors, management believes that its use will reduce maintenance costs and extend the life of the equipment in which it is used.

ACL's main competitor is a very successful multinational conglomerate that has excellent customer recognition of its products and a large distribution network. To create a market niche for Synlube, management is targeting commercial businesses in western Canada that service vehicle fleets and industrial equipment.

ACL's existing facilities were not adequate to produce Synlube in commercial quantities, so in June 2022 ACL began construction of a new blending plant in a western province. The new facilities became operational on December 1, 2022.

ACL has financed its recent expansion with a term bank loan. Management is considering a share issue to solve the company's cash flow problems. ACL's March 31, 2023, draft balance sheet is provided in **Exhibit I**.

Although they had been with the company since its inception, ACL's auditors have just resigned. It is now April 22, 2023. You and a partner meet with the CEO to discuss the services your firm can provide to ACL for the year ended March 31, 2023. During your meeting, you collect the following information:

- ACL has started a lawsuit against its major competitor for patent infringement and industrial espionage. Management has evidence that it believes will result in a successful action and wishes to record the estimated gain on settlement of $4 million. Although no court date has been set, legal correspondence shows that the competitor intends "to fight this action to the highest court in the land."
- The CEO, Arif Saleh, contacted your firm after ACL's former auditors resigned. The previous auditors informed Arif that they disagreed with ACL's valuation of deferred development costs and believed that the balance should be reduced to a nominal amount of $1.

ACL has incurred substantial losses during the past three fiscal years, but revenue for 2023 was $6.2 million.

Required

a. List five procedures that the auditor should perform before deciding to accept ACL as a client.

b. Evaluate four factors that impact the audit risk assessment for the current year and indicate how these factors influence audit risk (that is, increase or decrease audit risk).

c. Conclude on overall audit risk and indicate how this will impact the audit planning.

d. Using at least three of your calculations of materiality, calculate the range of materiality for the current year. Conclude on the most appropriate materiality and include a detailed explanation supporting your decision.

e. Perform planning analytical procedures and identify at least three accounts with unusual fluctuations. For each of the "risky" accounts you identify, indicate a possible client error that may have caused this significant fluctuation as well as a possible business reason for the change.

EXHIBIT I **Draft balance sheet**

AutoCare Ltd.
DRAFT BALANCE SHEET
as at March 31 (in thousands of dollars)

Assets		
	2023 (Unaudited)	**2022** (Audited)
Current		
Accounts receivable	$ 213	$ 195
Inventories	1,650	615
Prepaid expenses	45	30
	1,908	840
Capital assets	2,120	716
Investment in JDP Ltd.	1	1
Deferred development costs	1,979	686
Patent	835	835
	$6,843	$3,078
Liabilities		
Current		
Bank indebtedness	$1,225	$ 462
Accounts payable	607	476
Current portion of long-term debt	400	98
Advances from shareholders	253	—
	2,485	1,036
Long-term debt	3,114	650
	5,599	1,686
Shareholders' equity		
Common shares	2,766	2,766
Deficit	(1,522)	(1,374)
	1,244	1,392
	$6,843	$3,078

Case Study—Cloud 9

PART 1 Materiality

W&S Partners commenced the risk assessment phase of the Cloud 9 audit with procedures to gain an understanding of the client's structure and its business environment. You have completed your research on the key market forces as they relate to Cloud 9's operations. The topics you researched included the general and industry-specific economic trends and conditions; the competitive environment; product, customer, and supplier information; technological advances and the effect of the Internet; and laws and regulatory requirements. The purpose of this research is to identify the inherent risks. The auditor needs to identify which financial statement assertions may be affected by these inherent risks. Identifying the risks will help determine the nature of the audit procedures to be performed.

Management implicitly or explicitly makes assertions regarding the recognition, measurement, presentation, and disclosure of the various elements of the financial statements. Auditors use assertions for account balances to form a basis for the assessment of risks of material misstatement. That is, assertions are used to identify the types of errors that could occur in transactions that result in the account balance. Consequently, further breaking down the account into these assertions will direct the audit effort to those areas of higher risk. The auditors broadly classify assertions as existence or occurrence; completeness; valuation or allocation; rights and obligations; and presentation and disclosure.

An additional task during the risk assessment phase is to consider the concept of materiality as it applies to the client. The auditor will design procedures in order to identify and correct errors or irregularities that would have a material effect on the financial statements and affect the decision-making of the users of the financial statements. Materiality is used in determining audit procedures and sample selections, and in evaluating differences between client records and audit results. It is the maximum amount of misstatement, individually or in aggregate, that can be accepted in the financial statements. In selecting the base figure to be used to calculate materiality, an auditor should consider the key drivers of the business and ask, "What are the end users (that is, shareholders, banks, and so on) of the accounts going to be looking at?" For example, will shareholders be interested in profit figures that can be used to pay dividends and increase share price?

W&S Partners' audit methodology dictates that one planning materiality (PM) amount is to be used for the financial statements as a whole. Further, only one basis should be selected—a blended approach or average should not be used. The basis selected is the one determined to be the key driver of the business.

W&S Partners uses the percentages in **table 4.12** as starting points for the various bases.

These starting points can be increased or decreased by taking into account qualitative client factors, such as:

- the nature of the client's business and industry (for example, rapidly changing through growth or downsizing, or because of an unstable environment)
- whether the client is a public company (or subsidiary of one) that is subject to regulations
- the knowledge of or high risk of fraud

Typically, profit before tax is used; however, it cannot be used if reporting a loss for the year or if profitability is not consistent.

When calculating PM based on interim figures, it may be necessary to annualize the results. This allows the auditor to plan the audit properly based on an approximate projected year-end balance. Then, at year end, the figure is adjusted, if necessary, to reflect the actual results.

Required

Answer the following questions based on the information presented for Cloud 9 in Appendix A to this book and in the current and earlier chapters. You should also consider your answers to the case study questions in earlier chapters.

a. Using the December 31, 2023, trial balance (in Appendix A), calculate planning materiality and include the justification for the basis that you have used for your calculation.

b. Based on your knowledge of the client and its industry, discuss the inherent risks in the audit of Cloud 9. Identify the associated financial accounts that would be affected and provide an assessment of "high," "medium," or "low" in relation to the likelihood and materiality of the risk occurring.

PART 2 Analytical procedures

Required

Answer the following questions based on the information presented for Cloud 9 in Appendix A to this book and in the current and earlier chapters. You should also consider your answers to the case study questions in earlier chapters.

a. Using analytical procedures and the information provided in the appendix, perform preliminary analytics of Cloud 9's financial position and its business risks. Discuss the ratios indicating a significant or an unexpected fluctuation.

TABLE 4.12 Starting percentages for materiality bases

Base	Threshold (%)
Profit before tax	5.0
Revenues	1.0
Total assets	1.0
Equity	3.0

b. Which specific areas do you believe should receive special emphasis during your audit? Consider your discussion of the results of analytical procedures as well as your preliminary estimate of materiality. Prepare a memorandum to Suzie Pickering outlining potential problem areas (that is, where possible material misstatements in the financial report exist) and any other special concerns (for example, going concern). Specify the relevant accounts and the related risks that would require particular attention.

Research Question 4.1

Listed companies are required to make certain annual disclosures about the compensation paid to their top executives. One reason for this is to help interested stakeholders assess the performance of executives. It also helps executives and companies set appropriate compensation levels based on what other companies in the same industry and/or of the same size are paying their executives. These disclosures are reviewed by the auditor.

Required

Obtain the information circulars of five listed Canadian companies in the same industry through the website SEDAR (www.sedar.com). You can search by industry and choose the companies you want to review. Extract the information on executive remuneration and describe the data using graphs and tables. Write a report addressing the following questions (justify your responses by referring to the data where appropriate).

- How are the executives paid (cash, bonuses, and so on)?
- Which companies' executives are paid the most and what is the range of pay?
- Which companies' executives' pay is most linked to the company's profit and/or share price performance? (Explain any assumptions you have to make.)
- Overall, what do you conclude about how Canadian company executives are paid and how clearly the compensation data are reported?

Research Question 4.2

The financial statements for public companies are available through SEDAR (www.sedar.com). This is the official site that provides access to information filed by public companies and investment funds with the Canadian Securities Administrators (CSA). The objective in making public this financial information is to enhance investor awareness of the business and affairs of public companies and to promote confidence in the transparent operation of capital markets in Canada. Achieving this objective relies heavily on the provision of accurate information to market participants.

Required

Go to www.sedar.com and select the most recent set of audited annual financial statements for a Canadian public company. Using this set of financial statements:

a. Assess the inherent risk of the company chosen.

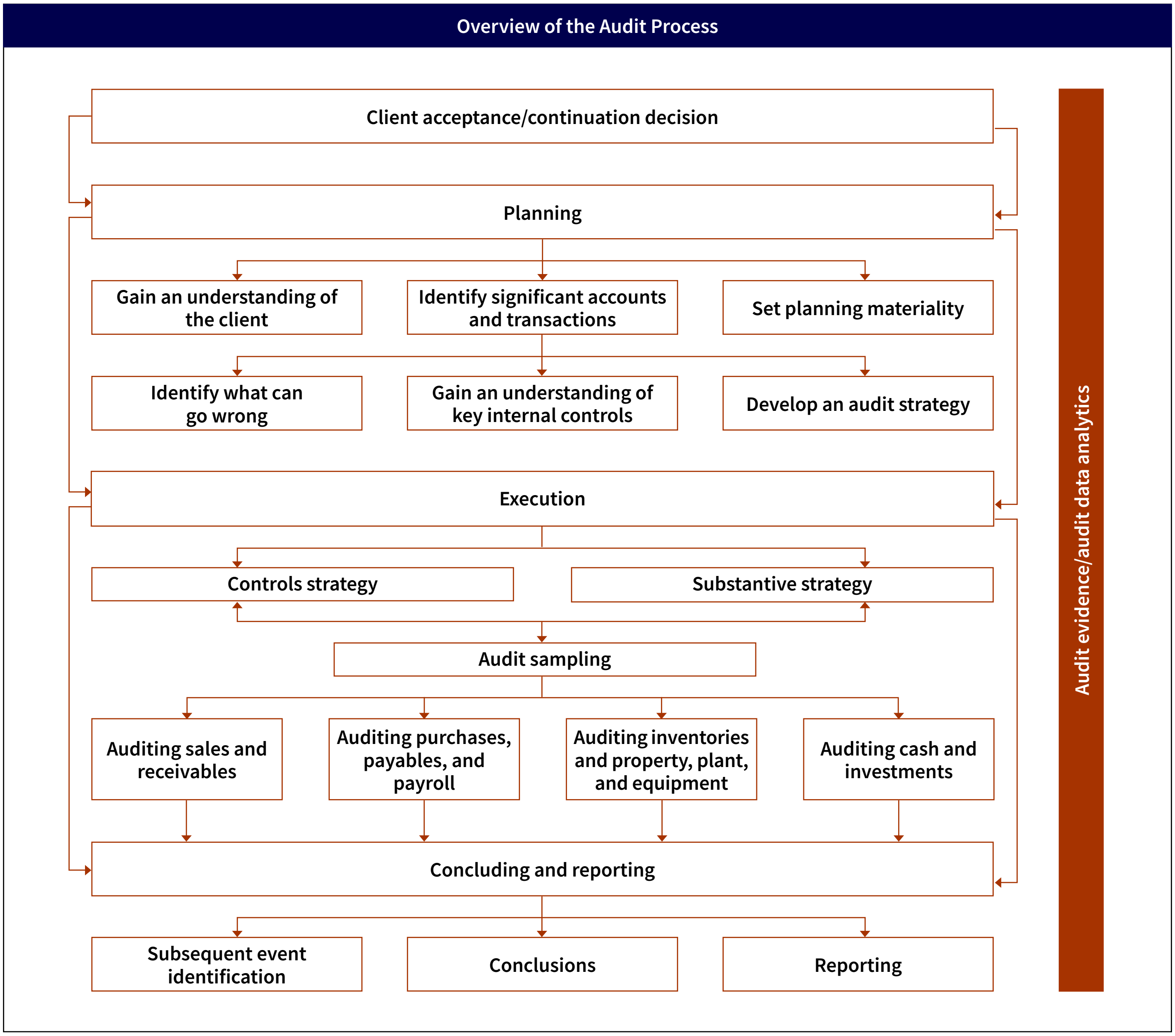
b. Calculate materiality for the engagement.

c. Perform preliminary analytics and summarize your findings.

Further Reading

Chartered Professional Accountants of Canada. *Canadian Professional Engagement Manual*. 2019. www.castore.ca/product/canadian-professional-engagement-manual-members/5.

Audit Evidence



LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
After studying this chapter you should be able to:		Standards addressed in each learning objective are as follows:
1 Explain the audit assertions	**5.1** Assertions	CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
2 Identify and describe different types of audit evidence and assess sufficient appropriate audit evidence	**5.2** Types of Audit Evidence **5.2.1** Sufficient appropriate audit evidence **5.2.2** External confirmations **5.2.3** Documentary evidence **5.2.4** Representations **5.2.5** Verbal evidence **5.2.6** Computational evidence **5.2.7** Physical evidence **5.2.8** Electronic evidence	CAS 315 *Identifying and Assessing the Risks of Material Misstatement* CAS 500 *Audit Evidence* CAS 501 *Audit Evidence—Specific Considerations for Selected Items* CAS 505 *External Confirmations* CAS 580 *Written Representations*
3 Determine the persuasiveness of audit evidence	**5.3** Persuasiveness of Audit Evidence **5.3.1** Internally generated evidence **5.3.2** Externally generated evidence held by the client **5.3.3** Externally generated evidence sent directly to the auditor	CAS 500 *Audit Evidence*
4 Explain the issues to consider when using the work of an expert	**5.4** Using the Work of an Expert **5.4.1** Assessing the need to use an expert **5.4.2** Determining the scope of the work to be carried out **5.4.3** Assessing the competence and capability of the expert **5.4.4** Assessing the objectivity of the expert **5.4.5** Assessing the expert's report **5.4.6** Responsibility for the conclusion	CAS 620 *Using the Work of an Auditor's Expert*
5 Explain the issues to consider when using the work of another auditor	**5.5** Using the Work of Another Auditor	CAS 600 *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*
6 Describe the evidence-gathering procedures most often used by auditors	**5.6** Evidence-Gathering Procedures	CAS 500 *Audit Evidence*

LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
7 Explain how auditors arrive at a conclusion based upon the evidence gathered	**5.7** Drawing Conclusions	CAS 315 *Identifying and Assessing the Risks of Material Misstatement* CAS 330 *The Auditor's Responses to Assessed Risks* CAS 500 *Audit Evidence*
8 Describe how auditors document the details of evidence gathered in working papers	**5.8** Documentation—Audit Working Papers **5.8.1** Permanent file **5.8.2** Current file	CAS 230 *Audit Documentation*

Cloud 9 Integrated Case

At the next planning meeting for the Cloud 9 Ltd. audit, Suzie Pickering presents the results of the analytical procedures performed so far and the working draft of the audit plan. The audit manager, Sharon Gallagher, and the audit senior, Josh Thomas, are also involved in the planning, with special responsibility for the internal control assessment.

The purpose of the meeting is to discuss the available sources of evidence at Cloud 9 and specify these in the detailed audit program. The team also has to make sure that they have enough evidence to conduct the audit. There are two specific issues worrying members of the team. First, there are two very large asset balances on Cloud 9's trial balance that have particular valuation issues. Suzie suggests that an expert valuator will not be required as they can handle the accounts receivable and inventory themselves. Second, Sharon is worried about the auditors of Cloud 9's parent company, Cloud 9 Inc.—the auditors did some audit work on the relationship between the two companies (Cloud 9 Inc. and Cloud 9 Ltd.) during the year, and she hasn't been able to gain access to the confidential report yet.

The questions being considered by the team in the planning meeting include:

- What evidence is available?
- What criteria will the team use to choose between alternative sources of evidence?
- What are the implications of using the work of experts and other auditors?

Chapter Preview

In this chapter, we look at audit evidence. Once an auditor has identified the key risk factors for their client, they will plan their audit to obtain sufficient appropriate audit evidence to ensure that relevant accounts and related disclosures are reported accurately.

We start this chapter by defining and describing audit assertions, which are used when designing and conducting testing. We then consider the different types of evidence that an auditor will gather, including evidence gathered through confirmations, documentary evidence, representations, verbal evidence, computational evidence, physical evidence, and electronic evidence. Each form of evidence is used to substantiate the information provided by the client in its trial balance and its preliminary financial statements. Some forms of evidence are more persuasive than others: internally generated evidence is the least persuasive; externally generated evidence sent directly to the auditor is the most persuasive. Examples are provided of different types of evidence and the evidence that auditors tend to rely on most as providing the most dependable, independent proof that the amounts included in the client's financial statements are fairly presented.

After considering the relative persuasiveness of different types of evidence, we consider special types of evidence. In particular, we consider evidence provided by experts and evidence provided by other auditors. Using the work of these two groups presents particular challenges for an auditor. These challenges are discussed in this chapter.

We then provide an overview of the evidence-gathering procedures used by auditors. These procedures include inspection of records and physical assets, observation of procedures used by clients where no audit trail is left, inquiry of client management and personnel, confirmation of balances with external parties, recalculation to ensure numerical accuracy, re-performance of procedures used by a client, analytical procedures, and a new and emerging area of testing called audit data analytics.

A discussion follows on how the auditor arrives at a conclusion regarding the fair presentation of the financial statements. This conclusion is based upon an auditor's understanding of their client, the risks identified during the risk assessment phase of the audit, and the evidence gathered throughout the remainder of the audit when conducting detailed testing of controls, transactions, and accounts.

Auditors document the details of evidence gathered in their working papers. An auditor's working papers provide proof of audit work completed, procedures used, and evidence gathered. Each accounting firm has its own working paper format and preferences. In this chapter, we provide some examples of a typical audit file and the types of working papers it may contain.

5.1 Assertions

LEARNING OBJECTIVE 1

Explain the audit assertions.

assertions statements made by management regarding the recognition, measurement, presentation, and disclosure of items included in the financial statements

It is the responsibility of those charged with governance to ensure that the financial statements are prepared so as to give a fair presentation of the entity and its operations. When preparing the financial statements, management makes **assertions** about each account and related disclosure in the financial statements. For example, when reporting on inventory, management should ensure that the amount disclosed exists, is owned by the entity, represents a complete list of the inventory owned, and is valued appropriately. When reporting on sales, management should ensure that the amount disclosed represents sales of the entity that occurred during the accounting period. They should also ensure that sales are recorded at the correct amount, represent a complete list of all sales, and are classified correctly.

Auditors use assertions for transactions, account balances, and related disclosures when assessing the risk of material misstatement and when designing their audit procedures. CAS 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* provides a summary of the assertions used by auditors. Transaction-based assertions focus on the transactions that took place during the period as opposed to the account balance. For example, when auditing inventory, the auditor will audit a sample of the transactions that impact the inventory account, such as purchases and sales, but they will also conduct procedures on the ending inventory balance (the account balance). **Table 5.1** shows the assertions used for transactions and events and related disclosures, including income statement items, for an accounting period.

occurrence transactions and events that have been recorded or disclosed have occurred and pertain to the entity

completeness all transactions, events, assets, liabilities, equity items, and disclosures that should have been recorded and disclosed have been recorded and disclosed

accuracy transactions and events have been recorded at appropriate amounts and related disclosures have been appropriately measured and described

When testing for **occurrence**, an auditor searches for evidence to verify that a recorded or disclosed transaction or event, such as a revenue or an expense item, took place and relates to the entity. This assertion is particularly important when the auditor believes that there is a risk of overstatement and that some transactions or events are recorded or disclosed but did not actually occur—for example, false sales recorded to overstate revenue and profit.

When testing for **completeness**, an auditor searches for transactions and events and makes sure these have all been recorded and included in the financial statements. It also includes ensuring that all related disclosures that should be included are included. This assertion is particularly important when the auditor believes there is a risk of understatement and that some transactions or events that should have been recorded or disclosed have not been recorded or disclosed—for example, expenses incurred but not recorded to understate expenses and overstate profit.

When testing for **accuracy**, an auditor searches for evidence that transactions and events have been recorded at appropriate amounts. This assertion is particularly important when the auditor believes there is a risk that the reported amounts are not accurate—for example, when

TABLE 5.1 Assertions about classes of transactions and events, and related disclosures for the period under audit

Occurrence	Transactions and events that have been recorded or disclosed have occurred and pertain to the entity.
Completeness	All transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included are included.
Accuracy	Transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described.
Cut-off	Transactions and events have been recorded in the correct accounting period.
Classification	Transactions and events have been recorded in the proper accounts.
Presentation	Transactions and events are appropriately aggregated or disaggregated and clearly described; related disclosures are relevant and understandable.

a client has complex discounting systems or foreign exchange calculations where errors can easily occur. The auditor also checks that all related disclosures are appropriately measured and described. For example, if an entity discloses the first-in, first-out method (FIFO) as its cost method for inventory, but in fact uses the weighted average cost formula, then the accuracy assertion relating to disclosures would not be met.

When testing for **cut-off**, an auditor searches for evidence that transactions have been recorded in the correct accounting period. This assertion is particularly important for transactions close to year end. For example, a client may record a sale before year end that occurred after year end. Or, a client may record an expense after year end that was incurred before year end. When testing for **classification**, an auditor ensures that transactions and events have been recorded in the proper accounts. When testing for **presentation**, an auditor ensures transactions and events are appropriately aggregated or disaggregated; that is, the required level of detail is presented. The auditor must also ensure that disclosures are relevant and understandable.

Table 5.2 shows the assertions used when testing account balances and related disclosures. When testing for **existence**, an auditor searches for evidence to verify that asset, liability, and equity items included in the account balances that appear in the financial statements actually exist. This assertion is particularly important when the auditor believes there is a risk of overstatement.

cut-off transactions and events have been recorded in the correct accounting period

classification transactions, events, assets, liabilities, and equity interests have been recorded in the proper accounts

presentation transactions, events, assets, liabilities, and equity interests are appropriately aggregated or disaggregated and clearly described; related disclosures are relevant and understandable

existence recorded assets, liabilities, and equity interests exist

TABLE 5.2 Assertions about account balances and related disclosures at year end

Existence	Assets, liabilities, and equity interests exist.
Rights and obligations	The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
Completeness	All assets, liabilities, and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included have been included.
Accuracy, 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, and related disclosures are appropriately measured and described.
Classification	Assets, liabilities, and equity interests have been recorded in the proper accounts.
Presentation	Assets, liabilities, and equity interests are appropriately aggregated or disaggregated and clearly described; related disclosures are relevant and understandable.

rights and obligations recorded assets are owned by the entity and recorded liabilities represent commitments of the entity

When testing for **rights and obligations**, an auditor searches for evidence to verify that recorded assets are owned by the entity and that recorded liabilities represent commitments of the entity. This assertion is particularly important when the auditor believes there is a risk that recorded assets or liabilities are not owned by the entity. This assertion is different from existence, as the assets and liabilities may exist but not be owned by the entity. For example, inventory held on consignment (and therefore not owned by the entity) may be recorded as an asset of the entity.

When testing for completeness, an auditor searches for assets, liabilities, and equity items and ensures that they have been recorded. It also means that the auditor ensures that all related disclosures that should have been included are included. This assertion is particularly important when the auditor believes there is a risk of understatement and the client has omitted some items from the balance sheet. For example, an auditor will search for unrecorded liabilities to address this assertion. An example of the completeness assertion as it relates to disclosures is the way inventories are disclosed. Reporting standards require that inventory disclosures include the cost formula, as well as the carrying amount of inventory in total and by classification. If the cost formula was omitted, the inventory note would not be complete.

accuracy, valuation, and allocation assertion that assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded and related disclosures are appropriately measured and described

When testing for **accuracy, valuation, and allocation**, an auditor searches for evidence that assets, liabilities, and equity items have been recorded at appropriate amounts, allocated to the correct general ledger accounts, and appropriately disclosed. This assertion is particularly important when the auditor believes there is a risk of over- or undervaluation. For example:

- An auditor checks that inventory has been appropriately recorded at the lower of cost and net realizable value (risk of overstatement).
- An auditor tests for the adequacy of the allowance for doubtful accounts (risk of understatement).
- An auditor checks that transactions are allocated to the correct account when auditing research and development expenditures (risk of understatement of the expense account).

Cloud 9 Integrated Case

Ian and Suzie have already talked in general terms about the errors that could occur in Cloud 9's accounts receivable. For example, basic mathematical or other clerical errors could affect the accounts receivable total in either direction. Suzie emphasizes that Cloud 9's management asserts that this error does not exist when they prepare the financial statements—they assert that accounts receivable are valued correctly. The auditor has to gather evidence about each assertion for each transaction class, account, and disclosure in the financial statements. Now that Ian understands this idea better, he is able to identify the assertions that relate to the potential errors in accounts receivable that they discussed earlier:

- There are no mathematical or other clerical errors that could affect the total in either direction—accuracy, valuation, and allocation.
- No accounts receivable were omitted when calculating the total—completeness.
- Accounts receivable represent valid amounts owing for goods sold in the current period—existence.
- All accounts receivable belong to Cloud 9—rights and obligations.
- Bad debts are written off—accuracy, valuation, and allocation. Suzie confirms that there can be more than one instance of a type of assertion for an account.
- Sales from the next period are not included in the earlier period—cut-off. Ian is a bit confused about this one, because cut-off is an assertion for transactions, not assets. Suzie agrees that it is a special sort of assertion that relates to transactions or events but also gives evidence about balance sheet accounts. This is due to double entry accounting, and when auditors test cut-off for sales, they also gather evidence for the balance sheet side of the entry, which is usually accounts receivable.

When testing for classification, an auditor ensures that assets, liabilities, and equity interests have been recorded in the proper accounts. When testing for presentation, an auditor ensures items are appropriately aggregated or disaggregated. Aggregation is how the accounts are grouped together and the amount of detail provided in the financial statements. This involves considering materiality and assessing whether balance sheet items should be grouped together or shown separately. The presentation assertion also requires the auditor to ensure that all disclosures are relevant and understandable.

Before You Go On

5.1.1 List the assertions for classes of transactions and account balances.

5.1.2 What does the accuracy assertion mean?

5.1.3 What is the auditor trying to ensure when conducting cut-off tests?

5.2 Types of Audit Evidence

LEARNING OBJECTIVE 2

Identify and describe different types of audit evidence and assess sufficient appropriate audit evidence.

Audit **evidence** is the information that an auditor uses when arriving at their opinion on the fair presentation of their client's financial statements (CAS 500 *Audit Evidence*). It is the responsibility of management and those charged with governance of a client to ensure that the financial statements are prepared in accordance with Canadian generally accepted accounting principles (GAAP). They are also responsible for ensuring that accurate accounting records are maintained and any potential misstatements are prevented, or detected and corrected. Recall that the auditor is required to maintain an attitude of professional scepticism. With respect to evidence, CAS 315 suggests this involves questioning evidence that appears contradictory, questioning responses from management and those responsible for governance, and being alert to evidence that may indicate fraud or error. It is also the responsibility of the auditor to gather sufficient appropriate evidence to arrive at their opinion. This involves gathering evidence to support the audit assertions for the transactions, account balances, and disclosures. Before considering the different types of evidence that an auditor will use, we start this section with a discussion of what is meant by the term "sufficient appropriate evidence."

evidence information gathered by the auditor that is used when forming an opinion on the fair presentation of a client's financial statements

5.2.1 Sufficient Appropriate Audit Evidence

Sufficient appropriate evidence is a core concept in auditing. Sufficiency relates to the quantity, and appropriateness relates to the quality of audit evidence gathered. These concepts are interrelated, as the quality of evidence gathered will affect the quantity required.

sufficient appropriate evidence quantity (sufficiency) and quality (appropriateness) of audit evidence gathered

Audit risk affects the quantity and quality of evidence gathered by an auditor during the risk response phase of the audit. When there is a significant risk that an account will be misstated and the client's system of internal controls is not considered to be effective at reducing that risk, detection risk is set as low and more high-quality evidence is gathered when conducting substantive tests of that account. This relationship is shown in table 5.3.

When there is a low risk that an account will be misstated and the client's system of internal controls is considered to be adequate for that account, detection risk is set as high and less high-quality evidence is gathered when conducting substantive tests of that account. This relationship is shown in table 5.4.

The risk patterns illustrated in tables 5.3 and 5.4 are extremes. The risk of material misstatement associated with most accounts falls somewhere in between. As such, the

TABLE 5.3 High-risk account

Audit risk $= f$	Inherent risk	Control risk	Detection risk	Evidence required
Risk level	High	High	Low	More

TABLE 5.4 Low-risk account

Audit risk = f	Inherent risk	Control risk	Detection risk	Evidence required
Risk level	Low	Low	High	Less

sufficiency of evidence gathered when conducting substantive procedures is a matter of professional judgement and will vary from account to account and client to client. Nevertheless, there is a direct relationship between the risk of material misstatement (inherent and control risk) and the amount of evidence gathered when testing transactions and balances.

The appropriateness of audit evidence refers to its relevance and reliability. Relevance of information means there is a logical connection to the audit assertions at risk. Therefore, evidence is considered **relevant** if it provides confirmation about an assertion most at risk of material misstatement. For example, if the auditor determines that the primary assertion at risk is the existence of inventory, it would not be appropriate to spend more time gathering evidence in relation to the accuracy, valuation, and allocation assertion than the existence assertion. By identifying the key risk areas for the client, an auditor is able to focus on gathering more (sufficient) high-quality (appropriate) evidence where the risk of material misstatement is believed to be most significant.

relevance extent to which information is logically connected to an assertion

Reliability refers to whether the evidence reflects the true state of the information. In terms of the reliability of information, the auditor should consider the following:

reliability extent to which information reflects the true state of the information

- The source of the information—it is important for the evidence to be unbiased. Information from external third parties, such as that provided from banks and other third parties, is generally reliable, because the respondent or the person from whom the information is sought is independent of the organization.
- The expertise of the respondent—if the respondent does not understand what the confirmation letter is asking for, they will not provide a knowledgeable reply. For example, if a customer is asked to confirm their accounts receivable balance as at year end, but they confirm the balance outstanding at another date, the reliability of the confirmation may be in question.
- The consistency of the information—evidence that is consistent from one source to another is more reliable than evidence that is inconsistent from one source to another. For example, if responses to inquiries of management and internal audit are not consistent, the reliability of the information will be reduced.
- The source of the information and whether it is produced where internal controls operate effectively—for example, if there are good controls over the payroll cycle, then employee time cards, cheque stubs, and journal entries will provide more reliable evidence than if the controls are not effective.
- The form of the evidence—paper and electronic evidence is more reliable than verbal evidence. For example, inspecting a lease agreement to support lease commitment disclosure provides more reliable evidence than discussing the lease requirements with management.
- The way the documents were created and maintained—original documents are less likely to be altered and therefore they are considered more reliable than photocopied, scanned, or other transformed documents.
- The way the evidence is collected—evidence gathered directly by the auditor is considered more reliable than evidence gathered indirectly. For example, a bank confirmation sent directly to the auditor provides more reliable audit evidence than an online bank statement provided by the client.

Table 5.5 provides a summary regarding the reliability of information. The different types of audit evidence described in the remainder of this section are confirmations, documentary evidence, representations, verbal evidence, computational evidence, physical evidence, and electronic evidence.

TABLE 5.5 Summary of information reliability

Less reliable	Characteristic of the information	More reliable
Internally generated	Source	Externally generated
Less knowledgeable	Expertise of respondent	Expert knowledge
Conflicting sources	Consistency of responses	Consistent sources
Ineffective controls	Internal controls	Effective controls
Verbal	Form	Documentary, paper, and electronic
Transformed documents	Preparation and maintenance	Original documents
Indirect	Evidence collection method	Direct

Cloud 9 Integrated Case

Ian thinks he finally understands: in order to limit the risk of an inappropriate audit opinion for Cloud 9, the audit team will assess inherent risk and control risk at the assertion level for account balances and transactions. They make these assessments after gaining an understanding of the client because these risks are influenced by the client's circumstances.

If inherent and control risk are assessed as high, then the audit team will set detection risk as low. This means that they will need to gather more and better-quality evidence than if inherent and control risk are assessed as low. In addition, planning materiality is set based on the needs of the users. The lower the materiality level, the more sufficient and appropriate evidence needs to be gathered.

Suzie thinks the money spent on coffee has been well worth it!

5.2.2 External Confirmations

CAS 505 *External Confirmations* provides guidance on the use of **external confirmations**. An external confirmation is sent directly by an auditor to a third party, who is asked to respond to the auditor on the matter(s) included in the confirmation letter. External confirmations can be sent to the client's bank, lawyers, lenders, debtors, and third parties holding the client's inventory.

external confirmation evidence obtained as a direct written response to the auditor from a third party, in paper form, or by electronic or other medium

A **bank confirmation** is a request for information about the amount of cash held in the bank or in overdraft, details of any loans with the bank, details of any pledges of assets made to guarantee loans, and interest rates charged. This information is used to confirm that the asset "cash at bank" is recorded at the appropriate amount (accuracy, valuation, and allocation assertion) and is in the client's name (rights and obligations assertion) and that all loans with the bank are included in the liability section of the balance sheet (completeness assertion). The bank confirmation also requests details of interest rates paid on cash deposits and term deposits, and interest rates charged on bank overdrafts and loans. This information is used when auditing interest income and interest expense items (accuracy assertion). **Figure 5.1** shows a sample bank confirmation.

bank confirmation a letter sent directly by an auditor to their client's bank requesting information such as the amount of cash held in the bank (or overdraft), details of any loans with the bank, and interest rates charged

An external confirmation may also be sent to a client's suppliers and lenders (**payable confirmation**) to confirm the details of amounts owed to creditors and significant loans. Where payable confirmations are used, vendors provide details of amounts outstanding at year end (completeness and accuracy, valuation, and allocation assertions) and interest rates charged on those amounts (accuracy assertion). They also confirm that the amounts owed are to be paid by the client (rights and obligations assertion). Payable confirmations can only be used if an auditor is certain that the list of vendors supplied by the client is complete, as an incomplete list will not provide evidence regarding the completeness assertion. Also, as the focus is on the completeness assertion, accounts payable confirmations are usually sent to suppliers with small or zero balances (especially if there were significant balances owing in the prior year) to ensure that there are no unrecorded payables.

payable confirmation a letter sent directly by an auditor to their client's vendor or supplier requesting information about amounts owed by the client to the vendor or supplier

BANK CONFIRMATION

(Areas to be completed by client are marked §, while those to be completed by the financial institution are marked †)

FINANCIAL INSTITUTION (Name, branch and full mailing address) § Regional Bank of Canada 1234 West Street Toronto, Ontario M5J 2X8 **CONFIRMATION DATE** § **December 31, 2023** **(All information to be provided as of this date)** (See Bank Confirmation Completion Instructions)	**CLIENT** (Legal name) § Skyward Ltd. Toronto, Ontario The financial institution is authorized to provide the details requested herein to the below-noted firm of accountants § John Smith Client's authorized signature Please supply copy of the most recent credit facility agreement (initial if required) § ______

1. LOANS AND OTHER DIRECT AND CONTINGENT LIABILITIES (If balances are nil, please state)

NATURE OF LIABILITY/ CONTINGENT LIABILITY †	INTEREST (Note rate per contract) RATE †	INTEREST (Note rate per contract) DATE PAID TO †	DUE DATE †	DATE OF CREDIT FACILITY AGREEMENT †	AMOUNT AND CURRENCY OUTSTANDING †

ADDITIONAL CREDIT FACILITY AGREEMENT(S)

Note the date(s) of any credit facility agreement(s) not drawn upon and not referenced above †

2. DEPOSITS/OVERDRAFTS

TYPE OF ACCOUNT §	ACCOUNT NUMBER §	INTEREST RATE §	ISSUE DATE (If applicable)§	MATURITY DATE (If applicable)§	AMOUNT AND CURRENCY (Brackets if Overdraft) †

EXCEPTIONS AND COMMENTS
(See Bank Confirmation Completion Instructions) †

STATEMENT OF PROCEDURES PERFORMED BY FINANCIAL INSTITUTION †
The above information was completed in accordance with the Bank Confirmation Completion Instructions.

______________________ Authorized signature of financial institution

______________________ BRANCH CONTACT - Name and telephone number

Please mail this form directly to our chartered professional accountant in the enclosed addressed envelope.

Name:	Jason Power, Staff Accountant
	W&S Partners
Address:	1200-90 Eglinton Avenue
	Toronto, Ontario
	M4P 2Y3
Telephone:	(416) 236-8743
Fax:	[no fax no.]

Developed by the Canadian Bankers Association and The Chartered Professional Accountants of Canada.

FIGURE 5.1 **Bank confirmation**

Source: CPA Canada PEG, 2019.

External confirmations can be sent to customers with credit terms (**receivable confirmation**) to verify the receivables balance. The auditor will select the specific accounts to whom they will send confirmations. Criteria used when selecting the accounts receivable customers to be sent confirmations include materiality (large trade receivables), age (overdue accounts), and location (if customers are dispersed, a selection from various locations). The primary assertion when using receivable confirmations is existence—they provide audit evidence that the credit customers exist. They also provide some evidence on ownership (rights and obligations assertion), as credit customers confirm that they owe money to the client. As they are also asked to confirm that they owe the amount outstanding at year end, very little evidence is provided regarding the accuracy, valuation, and allocation assertion. Credit customers only confirm the amount owing; they do not confirm their intention to pay the amount due. See **figures 5.2** and **5.3** for examples of accounts receivable confirmations.

receivable confirmation
a letter sent directly by an auditor to their client's credit customers requesting information about amounts owed to the client by the debtor

External confirmations may be used when a client owns inventory that is held on its behalf in another location; that is, the inventory is held in premises not owned by the client. In this case the auditor may send a confirmation asking the third-party owner of the premises where the inventory is held to verify the description and quantity of inventory held. This type of confirmation provides audit evidence that the inventory recorded by the client exists (existence assertion), is complete (completeness assertion), and is owned by the client (rights and obligations assertion).

There are two broad types of external confirmations the audit can select from: positive and negative confirmations. **Positive confirmations** (figure 5.2) ask the recipient to reply in all circumstances. **Negative confirmations** (figure 5.3) ask the recipient to reply only if they disagree with the information provided. If a recipient does not respond to a negative confirmation, it is assumed that they agree with the information provided. This form of

positive confirmation
a letter sent directly by an auditor to a third party, who is asked to respond to the auditor on the matter(s) included in the letter in all circumstances (that is, whether they agree or disagree with the information included in the auditor's letter)

negative confirmation
a letter sent directly by an auditor to a third party, who is asked to respond to the auditor on the matter(s) included in the letter only if they disagree with the information provided

Skyward

January 5, 2024

ACT Supply Company

456 North Avenue

Toronto, Ontario

M8G 4C9

Dear Sir or Madam:

Our auditors, W&S Partners, are auditing our financial statements and wish to obtain direct confirmation of amounts owed to us as at **December 31, 2023**. Compare the information below with your records on that date and confirm that this information agrees with your records on that date or note the details of any discrepancies in the space provided below. Then please sign this request and return it in the enclosed reply envelope directly to our auditors.

Our records on December 31, 2023, showed $87,425 as receivable from you. This is not a request for payment and remittances should not be sent to W&S Partners.

Your prompt attention to this request will be appreciated.

Sincerely,

John Smith
Controller

(Please do not detach)

CONFIRMATION

The information as stipulated above by Skyward is correct except as noted below.

____

____

Signed: ______________________ Date: ______________

Title: ______________________ Customer #: ACT-1

Company: ______________________

FIGURE 5.2 **Accounts receivable—positive confirmation**

Skyward

January 5, 2024
ACT Supply Company
456 North Avenue
Toronto, Ontario
M8G 4C9

Dear Sir or Madam:

Our auditors, W&S Partners, are auditing our financial statements and wish to obtain direct confirmation of amounts owed to us as at **December 31, 2023**. If the information is incorrect, please report the details of any discrepancies directly to our auditors in the space provided below. Then sign this request and return it in the enclosed reply envelope directly to our auditors. If no differences are reported to the auditors, this statement will be considered correct.

Our records on December 31, 2023, showed the attached list of invoices totalling $4,790 as receivable from you. Please note that these invoices may not represent the entire balance owed to us as of that date. This is not a request for payment and remittances should not be sent to W&S Partners.

Your prompt attention to this request will be appreciated.

Sincerely,

John Smith
Controller

(Please do not detach)

CONFIRMATION

The information as stipulated above by Skyward is correct except as noted below.

____

____

Signed: ______________________________ Date: ______________

Title: ______________________________ Customer #: ACT-1

Company: ______________________________

FIGURE 5.3 **Accounts receivable—negative confirmation**

request is of limited benefit when the assertion being tested is existence. A negative confirmation may be used when an auditor has conducted detailed testing for existence using alternative procedures such as inspecting signed receiving reports. In this case, the negative confirmation is used to corroborate other evidence. Positive confirmations provide superior evidence, as a non-response from a negative confirmation request may provide false reassurance. For example, a client may record fake sales to customers that do not exist close to year end to boost revenue. A non-response from a non-existent customer may be interpreted by an auditor as confirmation that the customer agrees with the amount outstanding. In this case, the conclusion would be unjustified.

When an auditor sends a receivable confirmation, they ordinarily include the amount recorded in their client's records for each accounts receivable customer to confirm. There is a risk that a customer may sign and return the confirmation to the auditor without checking the balance outstanding. As the primary assertion being tested when using this audit procedure is existence, rather than accuracy, valuation, and allocation, the auditor will perform other procedures to provide evidence on the valuation of the trade receivables balance. If an auditor were to send a confirmation to credit customers requesting that they provide the balance outstanding, there is a risk that credit customers would not respond, as locating the amount owed takes some effort to find, which would reduce the overall response rate and the amount of evidence available for the existence assertion. Professional Environment 5.1 describes how today's technologies have raised new issues regarding confirmations.

5.1 Professional Environment Technology Tests the Audit Confirmation Process

Years ago there was only one way to view a photograph: it had to be developed in a dark room and printed on paper. Similarly, there was only way for an auditor to obtain audit confirmations: they had to be sent and received by mail. But, like most things in our world today, technology has influenced not only audit practice and standards, but also the audit confirmation process, as confirmations may now be returned electronically using email or other electronic means.

Confirmations are an optional procedure—a tool available for auditors to use as part of a package of audit procedures. An auditor may elect to use them, as they generally provide external third-party evidence, which is considered high-quality evidence. However, there are concerns about the reliability of documents received electronically. This can be seen in CAS 500, which indicates that audit evidence is more reliable if provided by original documents rather than photocopies or documents that have been filmed, digitized, or otherwise transformed into electronic form (CAS 500, para. A35). CAS 505 *External Confirmations* includes similar guidance: "Responses received electronically, for example, by facsimile or electronic mail, involve risks as to reliability because proof of origin and authority of the respondent may be difficult to establish, and alterations may be difficult to detect" (CAS 505, para. A12).

Therefore, while electronic confirmations are acceptable, the auditor may take additional precautions to ensure the reliability of the confirmations received. This may include the need to validate the source of the reply received in electronic format. This may be possible for the auditor by establishing a secure environment for electronic responses—for example, by the use of encryption, electronic digital signatures, and procedures to verify website authenticity. However, if this is not possible and the auditor has doubts about the reliability of any form of evidence obtained through the confirmation procedure, CAS 505 requires the auditor to consider alternative procedures—for example, telephone contact with the respondent (CAS 505, para. A14).

Q: During the COVID-19 pandemic, many auditors were unable to attend year-end inventory counts and it was suggested that drones and cameras could be used as substitutes. Similar to electronic confirmations, how would the use of technology impact the reliability of the evidence gathered regarding the existence and valuation of the inventory?

Sources: CAS 500 *Audit Evidence*; CAS 505 *External Confirmations*; CPA Quebec News and Publications. "How Reliable Are Electronic Confirmations?" November 30, 2015, www.cpaquebec.ca/en/public-and-media/media-centre/news-and-publications/how-reliable-are-electronic-confirmations/.

Cloud 9 Integrated Case

Suzie explains to Ian that they can use external confirmations to gather sufficient and appropriate evidence about Cloud 9's outstanding accounts receivable balances and the existence and rights and obligations assertions. However, the confirmations will not be sufficient for valuation purposes, as a reply from a customer to confirm that the account receivable exists does not mean that the customer is going to be able to pay the balance owing when it is due. They will use other documents to provide evidence about the accuracy, valuation, and allocation assertion for accounts receivable.

Suzie also suggests that bank confirmations will be useful on the Cloud 9 audit for the rights and obligations, existence, and accuracy, valuation, and allocation assertions for bank accounts. Because they will also ask the banks to supply any information they have about any other bank accounts or loans, bank confirmations will also be useful for gathering evidence about the completeness assertion for these accounts. Suzie suggests that they not rely on payable confirmations. This is because the biggest issue with these liabilities is discovering any omitted liabilities, not confirming the existence of the liabilities the client has already disclosed to them.

Suzie incorporates her ideas on confirmations into the draft audit plan.

5.2.3 Documentary Evidence

Documentary evidence includes invoices, suppliers' statements, bank statements, minutes of meetings, correspondence, and legal agreements. It may be internally generated or externally generated. Internally generated documents are produced by the client. Externally generated documents are generated by third parties. The persuasiveness of audit evidence varies depending on its source. This issue is explained in detail in section 5.3 of this chapter.

documentary evidence information that provides evidence about details recorded in a client's list of transactions (for example, invoices and bank statements)

There are a number of ways that documentary evidence can be used during an audit. An auditor can trace details recorded in a client's accounting records to supporting (external) documents to verify the amount recorded. For example, details of the price paid for inventory may be traced to a supplier's invoice to verify the amount recorded. This provides evidence on the accuracy of the purchase price (accuracy assertion). Recorded investments may be traced to share certificates or their electronic equivalent to gain evidence that the investments exist (existence assertion) and that they are owned by the client (rights and obligations assertion).

Documents can be read and details traced to a client's accounting records and financial statements to ensure that items are included correctly (classification assertion). An auditor may ensure that all inventory confirmed as held by a third party is included in the client's records (completeness assertion). An auditor may ensure that all loans confirmed by external parties are included in the client's records (completeness assertion). Details of lease agreements can be read to ensure that leases are disclosed accurately in the body and the notes to the financial statements (classification and presentation assertions). The minutes of board meetings are read to ensure that relevant issues are adequately disclosed in the notes to the financial statements (presentation assertion).

Cloud 9 Integrated Case

An example of documentary evidence that will be useful for auditing Cloud 9's accounts receivable is cash receipts from credit customers after year end. If the customer pays the account owed at year end, there is little doubt about its valuation at year end. However, sales returns or evidence of disputes with customers during the post–year-end period provide evidence that valuation and existence are in doubt.

Also, Suzie recommends in the draft audit plan that the complex inventory transactions (importing from overseas plants with payment in U.S. dollars) can be audited through the relevant documents showing dates of shipping and arrival and details of the goods. She is particularly concerned about auditing the "goods in transit" balance using this evidence. The foreign exchange rates (used because the goods are purchased in U.S. dollars but the accounts are kept in Canadian dollars) are vital pieces of evidence that will be used to establish the correct valuation of the inventory balances, accounts payable, and cost of sales.

Sharon and Josh note in the plan that there are many other documents that will be used as evidence, including the board meeting minutes, lease agreement (for the premises), sponsorship agreements, loan agreements, and other documents supporting the accounting records.

5.2.4 Representations

CAS 501 *Audit Evidence—Specific Considerations for Selected Items* requires an auditor to gather sufficient appropriate audit evidence regarding any legal matters involving their client. Evidence is gathered from board meeting minutes, discussions with client personnel, and representation letters from the client's lawyers and management. When an auditor has reason to believe that there are legal issues that may impact the financial statements, such as the client being sued by a third party, or when a law firm is engaged by the client for the first time, a legal letter is requested from the legal firm(s) that the client deals with. An auditor will come to this conclusion after inquiries of client personnel, reading board meeting minutes, reading other documentation such as contracts and leases, reviewing legal expenses, and reading correspondence between the client and third parties.

legal letter a letter sent to a client's lawyer asking them to confirm the details of legal matters outstanding identified by management

A **legal letter** is generally sent by the client to its lawyers asking them to complete the letter and return it directly to the auditor. According to CAS 501, the legal letter can include any legal matters involving the client, and the lawyer's opinion on the client's description of any outstanding legal matters and whether the client's evaluation of those matters appears reasonable. It can include a request to provide details of any legal matters on which the lawyer is in disagreement with the client. Schedule A of CAS 501 contains examples of a request for a legal letter from a client to its lawyer. **Figure 5.4** contains an example of a legal (solicitor's) letter where there are claims or possible claims.

management representation letter a letter from the client's management to the auditor acknowledging management's responsibility for the preparation of the financial statements and details of any verbal representations made by management during the course of the audit

CAS 580 *Written Representations* requires that an auditor attempt to obtain written representations from their client's management. A **management representation letter** generally includes an acknowledgement that management is responsible for the preparation of the financial statements. Management is responsible for ensuring that the statements give a fair presentation of the company's financial position and comply with Canadian accounting standards. The letter will include written details of any verbal representations made by management during the course of the audit. Because verbal evidence is weaker than written evidence, an auditor will seek written confirmation of any significant discussions in the management representation letter.

The management representation letter can also include an undertaking that laws and regulations have been complied with, that there have been no material frauds or errors that would impact the financial statements, and that the internal controls system is effective. The letter can acknowledge that the auditor was provided with access to all documents, records,

Skyward

Privileged and Confidential

Sandra Carson
Jones and Jones LLP
192 Park Avenue
Suite 3500
Toronto, Ontario
M7J 2K8

February 5, 2024

Skyward Ltd. (the "Company")

Dear Ms. Carson:

We write this letter to you at the request of our auditors, pursuant to the Joint Policy Statement, effective December 1, 2016, between the Canadian Bar Association and the Auditing and Assurance Standards Board.

In connection with the preparation and audit of our financial statements for the fiscal period ended December 31, 2023, we seek your confirmation with respect to our evaluation of claims and possible claims on which your firm has represented or advised the following:

- Skyward Ltd.

Please provide us, and our auditors, with your acknowledgment of receipt of this inquiry letter. Based on an examination of your records, we seek your confirmation, as of February 15, 2024 of the following:

(a) Are the claims and possible claims properly described?

(b) Do you consider that our evaluations are reasonable?

(c) Are you aware of any claims not listed below which are outstanding? If so, please include in your response letter the names of the parties and the amount claimed.

If there are possible claims omitted from this inquiry letter (other than any exclusions described below) we ask that you contact us to discuss such items and the application of the Joint Policy Statement to those possible claims.

Description	**Evaluation**
Always Right Inc. vs. Skyward: Customer seeking damages of $1,000,000 for product that they claim was defectively manufactured and resulted in lost sales. At this point in time, no proceedings have commenced and Always Right has not been able to provide support that product was not damaged after shipment.	Likelihood that obligation exists is minimal and reliable estimate of any possible obligation or potential settlement cannot be determined.

We would appreciate a response on or before February 22, 2024.

We understand that you will normally require five business days after the effective date of response to prepare your letter.

If you are unable to meet the response date, please advise us and our auditors as soon as practicable.

Please address your reply, marked "Privileged and Confidential," to this company, and send a signed copy of the reply directly to our auditors, W&S Partners, 1200-90 Eglinton Avenue, Toronto, Ontario M4P 2Y3.

Yours truly,

John Smith

c.c.: W&S Partners

FIGURE 5.4 **Example of a legal letter**

Source: Adapted from CPA Handbook, CAS 501 Appendix A, Schedule A.

and other evidence as requested. It can include an undertaking that the financial statements include the required disclosures in relation to related parties, stock options, and contingent liabilities and that the company owns all assets listed. Appendix 2 of CAS 580 contains an example of a management representation letter. Figure 5.5 provides an example of a management representation letter.

FIGURE 5.5 **Example of a management representation letter**

FJR Construction Company

April 30, 2024 (*same date as Auditor's Report*)
To W&S Partners, Chartered Professional Accountants

Dear W&S Partners:

This representation letter is provided in connection with your audit of the financial statements of **FJR Construction Company** for the period ended December 31, 2023, for the purpose of expressing an opinion as to whether the financial statements are presented fairly, in all material respects, in accordance with Canadian accounting standards for private enterprises.

In making the representations outlined below, we took the time necessary to appropriately inform ourselves on the subject matter through inquiries of entity personnel with relevant knowledge and experience, and, where appropriate, by inspecting supporting documentation.

We confirm that (to the best of our knowledge and belief):

Financial Statements

We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated March 15 for:

(a) Preparing and fairly presenting the financial statements in accordance with Canadian accounting standards for private enterprises

(b) Providing you with:
- Access to all information of which we are aware that is relevant to the preparation of the financial statements, such as accounting records, supporting data, meeting minutes (such as shareholders, board of directors and audit committees), and information of any other matters that is relevant to the preparation of the financial statements
- Additional information that you have requested from us for the purpose of the audit; and
- Unrestricted access to persons within the entity from whom you determined it to be necessary to obtain audit evidence.

Ensuring that all transactions have been recorded in the accounting records and are reflected in the financial statements.
- Designing and implementing such internal control as we determined is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. We have also communicated to you any deficiencies in the design and implementation or the maintenance of internal control over financial reporting of which management is aware.

Fraud and Non-Compliance

We have disclosed to you:

a. All of our knowledge in relation to actual, alleged or suspected fraud affecting the entity's financial statements involving:
   i. Management;
   ii. Employees who have significant roles in internal control; or
   iii. Others where the fraud could have a material effect on the financial statements;

b. All of our knowledge in relation to allegations of fraud or suspected fraud communicated by employees, former employees, analysts, regulators or others;

c. All known instances of non-compliance or suspected non-compliance with laws and regulations, including all aspects of contractual agreements that should be considered when preparing the financial statements;

d. All known, actual, or possible litigation and claims that should be considered when preparing the financial statements; and

e. The results of our risk assessments regarding possible fraud or error in the financial statements.

Related Parties

We confirm that there were no related-party relationships or transactions that occurred during the period.

(*continued*)

Estimates

We acknowledge our responsibility for determining the accounting estimates required for the preparation of the financial statements in accordance with Canadian accounting standards for private enterprises. Those estimates reflect our judgment based on our knowledge and experience of past and current events, and on our assumptions about conditions we expect to exist and courses of action we expect to take. We confirm that the significant assumptions and measurement methods used by us in making accounting estimates, including those measured at fair value, are reasonable.

Subsequent Events

All events subsequent to the date of the financial statements and for which Canadian accounting standards for private enterprises requires adjustment or disclosure have been adjusted or disclosed.

Commitments and Contingencies

There are no commitments, contingent liabilities/assets or guarantees (written or oral) that should be disclosed in the financial statements. This includes liabilities arising from contract terms, illegal acts or possible illegal acts, and environmental matters that would have an impact on the financial statements.

Adjustments

We have reviewed, approved and recorded all of your proposed adjustments to our accounting records. This includes journal entries, changes to account coding, classification of certain transactions and preparation of, or changes to, certain accounting records. (*a list of the proposed adjustments is attached as an appendix to this letter*).

Misstatements

The effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A list of the uncorrected misstatements, including the reasons why they were not corrected, is attached to this letter.

Yours very truly,

Jose Parra
Chief Financial Officer

Jack Green
Chief Executive Officer

FIGURE 5.5 **Example of a management representation letter (*Continued*)**

Source: Adapted from Sample Letters PEG Forms, Form AL 4.1, 2019 Canada PEG.

Cloud 9 Integrated Case

Sharon notes in the draft audit plan that a management representation letter will be obtained toward the end of the audit to confirm all verbal discussions held up to that point. The legal letter will also be obtained toward the end of the audit to ensure that there are no pending legal cases that would complicate matters.

5.2.5 Verbal Evidence

Throughout the audit, an auditor meets with client management and staff to discuss various issues. **Verbal evidence** is used when gaining an understanding of the client and its internal controls system. Rarely is verbal evidence alone adequate, but it can be used to corroborate other forms of evidence. Verbal evidence is documented in the auditor's working papers so that a record is kept of all key discussions with the client.

verbal evidence responses of key client personnel to auditor inquiries throughout the course of the audit

5.2.6 Computational Evidence

computational evidence evidence gathered by an auditor checking the mathematical accuracy of the numbers that appear in the financial statements

Computational evidence is gathered when an auditor checks the mathematical accuracy of the numbers that appear in the financial statements (accuracy, valuation, and allocation assertion). This involves re-adding the entries included in a client's journals and ledgers. It involves recomputing more complex calculations, such as foreign currency translation, employee benefits, interest on loans outstanding, and fair value modelling. When conducting complex recomputations, an auditor traces the amounts included in the calculations to externally prepared documentary evidence, where available, as well as checking that the formulas used are applied appropriately.

5.2.7 Physical Evidence

physical evidence a client's tangible assets, such as its inventory and fixed assets

inspection an evidence-gathering procedure that involves checking documents and physical assets

An auditor gathers **physical evidence** through **inspection** of a client's tangible assets, such as its inventory and fixed assets. An auditor traces recorded amounts to assets to gain evidence that the assets exist (existence assertion). For example, an auditor will select inventory items from client ledgers for testing and trace the quantities recorded to the physical items, and then count the items on hand to check that the quantities recorded are accurate. This test is done to ascertain whether the quantities recorded are accurate and that assets physically exist.

An auditor also traces details of tangible assets on hand back to the recorded amount (completeness assertion). For example, an auditor selects physical inventory items, counts the number on hand, and traces them back to client records to make sure that the records are complete. This test is done to ascertain whether quantities on hand are accurately included in the client's records.

An auditor inspects a client's physical assets to ascertain whether machinery is functioning, inventory appears to be in good repair, and fixed assets are well looked after. This evidence is used to determine whether assets should be written down below current book value (accuracy, valuation, and allocation assertion). If inventory appears dusty, perhaps the client is having difficulty selling those goods. If machinery is not being used, perhaps it is obsolete or redundant. If the auditor does not have the expertise to ascertain the value of a client's assets, they may ask an independent expert for some help. The process for using the work of an expert is discussed in section 5.4 of this chapter.

Cloud 9 Integrated Case

Suzie will head the team gathering evidence about inventory. There are some issues with Cloud 9's inventory controls, including difficulties in delivering merchandise from the warehouse to the store in a timely manner. Suzie is also concerned about the thefts at Cloud 9's retail store. Although Cloud 9's management has been very open in disclosing the thefts, Suzie is concerned about what this means for the quality of the inventory controls. She plans to inspect inventory and gather physical evidence of its existence and quality (because obsolescence is another major concern).

Sharon will also assign a team to inspect the furniture and equipment and the leasehold improvements, as there have been some major additions this year (because of the new store opening).

Ian is a little concerned about being asked to gather physical evidence. "I don't understand how physical evidence can sometimes relate to the existence assertion and at other times relate to the completeness assertion. How do I know when the evidence relates to one assertion and not the other?" he asks Suzie.

Suzie tries to explain that it depends on the process. If you start with the accounting records and then gather physical evidence to support the records, you are gathering evidence about existence. For example, the furniture and equipment ledger account has a record stating that Cloud 9 owns a photocopier. The record contains information about brand, size, and other details. Can you trace the records to the physical item—that is, can you find the photocopier in the office? If so, you have evidence that it exists. (You would also do separate tests for its valuation and rights and obligations.) However, if you start with the photocopier, for example, you see a photocopier in the office, and your question is then whether the item is in the accounting records—that is, are the accounting records complete? In this case, you start with the physical item and trace it to the records. If the photocopier is entered in the ledger (furniture and equipment), you have evidence about the completeness of the accounting records.

5.2.8 Electronic Evidence

electronic evidence data held on a client's computer, files sent by email to the auditor, and items scanned and faxed

Electronic evidence includes data held on a client's computer, files sent by email to the auditor, and items scanned and faxed. Transactions are commonly initiated and stored electronically. They leave no paper trail. To access the details of these transactions, an auditor must access their client's computer system, where details are kept. It is now common for companies to send their auditors copies of their accounting records and files by email. The auditor then searches for corroborating evidence to verify the amounts included in those files.

If a company initiates and completes a transaction electronically, its auditor will use the electronic evidence to establish that the transaction occurred (occurrence assertion). For example, a client emails a supplier placing an order; the supplier replies via email confirming that the order has been received; the supplier provides details regarding the estimated delivery date and the amount to be invoiced upon delivery of the goods; the client's receiving department notifies the accounting department that the goods ordered have been received; finally, the client initiates an electronic transfer of funds from its bank account to its supplier's bank account.

The extent to which an auditor can rely on electronic evidence produced by their client's computer system will depend a great deal on the internal controls in place. Information technology creates risks within a client's accounting system. An auditor must consider those unique risks and assess the effectiveness of their client's internal controls in mitigating them.

Cloud 9 Integrated Case

Josh is an expert on the computer systems Cloud 9 uses to process transactions, and the audit plan will show him as leading the team assessing the controls and performing the associated tests.

Before You Go On

5.2.1 What is a bank confirmation?

5.2.2 List three things that may be included in a management representation letter.

5.2.3 Which assertion is tested when an auditor traces details of tangible assets on hand back to the recorded amount?

5.3 Persuasiveness of Audit Evidence

LEARNING OBJECTIVE 3

Determine the persuasiveness of audit evidence.

As detailed earlier, when an auditor accesses their client's records, they then search for evidence to prove that recorded amounts are accurate. Evidence relates to each of the headings used in the previous section of this chapter. Specifically, an auditor verifies amounts recorded in their client's records using confirmations, documentary evidence, representations, verbal evidence, computational evidence, physical evidence, and electronic evidence.

There are three broad categories of corroborating evidence. Each category varies in its persuasiveness. The categories are internally generated evidence, externally generated evidence held by the client, and externally generated evidence sent directly to the auditor. Each category will now be discussed in turn.

5.3.1 Internally Generated Evidence

Internally generated evidence held by the client includes records of cheques sent, copies of invoices and statements sent to customers, purchase orders, company documentation regarding policies and procedures, contracts, minutes of meetings, journals, ledgers, trial balances, spreadsheets, worksheets, reconciliations, calculations, and computations. This evidence may be held electronically (soft copy) or in paper form (hard copy). Auditors document in their working papers details of their meetings with client management and staff to gain an understanding of the client's business and system of internal controls. As previously stated, internally generated evidence is the least persuasive, as it can only be used to verify that a client has accurately converted this information into the financial statements. That is, as the client generates and holds this evidence, it is possible that evidence may be manipulated or omitted. **Figure 5.6** shows common types of internally generated documents used as evidence by the auditor.

internally generated evidence information created by the client (for example, customer invoices, purchase orders)

The following is a list of internally generated documents frequently used by the auditor as evidence. Sample documents are provided in Appendix 5A.

Trial balance A listing of the accounts and balances at the end of the accounting period. The balances are used to prepare the financial statements. See **figure 5A.1**.

General ledger Transaction details are posted to the general ledger, with each general ledger account reflecting the account opening balance, the transactions processed during the period, and the ending balance. The ending balance is reflected in the trial balance. See **figure 5A.2**.

Client-prepared schedules Schedules based on or extracted directly from an accounting system, providing accounting information organized in various formats, such as by customer, supplier, and inventory classification. For example, an accounts receivable trial balance will show the balance outstanding by customer and by days outstanding. The total balance of the schedule should agree to the related general ledger balance. See **figure 5A.3**.

Master files Where the permanent information is maintained. For example, the accounts receivable master file includes customer names, addresses, contact details, and credit limits. See **figure 5A.4**.

Purchase requisition A request for goods that is prepared and submitted to the purchasing department. See **figure 5A.5**.

Purchase order Prepared once goods have been sourced, and serves as authorization for the purchase. Indicates the supplier, date, items ordered, quantity, and agreed-upon purchase price. See **figure 5A.6**.

Receiving report Serves as proof that goods ordered were received, and notes the quantity, date, and receiver. See **figure 5A.7**.

Shipping document Sent with goods being shipped, indicating what the receiving company is, what is being shipped, and the shipping terms. See **figure 5A.8**.

Invoice Indicates the amount owing for goods received. See **figure 5A.9**.

Remittance advice Sent with payment, indicating the invoice being paid. See **figure 5A.10**.

FIGURE 5.6 **Internally generated evidence commonly used by the auditor**

5.3.2 Externally Generated Evidence Held by the Client

externally generated evidence information created by a third party (for example, supplier statements, bank statements)

Externally generated evidence held by the client includes supplier invoices and statements, customer orders, bank statements, contracts, lease agreements, and tax assessments. These sources of evidence are quite persuasive, as they are produced by third parties. It is, however, possible for the client to manipulate these documents, which reduces their reliability to the auditor. Also, if the client provides the auditor with photocopies of information from these external sources, rather than originals, the reliability is reduced.

5.3.3 Externally Generated Evidence Sent Directly to the Auditor

Externally generated evidence sent directly to the auditor includes bank confirmations, customers' confirmations, correspondence with the client's lawyers, including confirmations and representations, and expert valuations. These sources of evidence are considered to be the most reliable and best quality, as they are independent of the client. As this evidence is generated by third parties and sent directly to the auditor, the client does not have an opportunity to alter it. Further, externally generated evidence is considered the most persuasive when the source of that evidence is considered to be reliable, trustworthy, and independent of the client.

Cloud 9 Integrated Case

Whenever Suzie's draft audit plan shows the team using inquiry (or verbal evidence), it also includes additional requirements to obtain evidence from another source. This is because the evidence obtained from the client is less persuasive than evidence gathered directly by an auditor or externally sourced evidence that has passed through the client's hands.

Before You Go On

5.3.1 What are the three broad categories of corroborating evidence?

5.3.2 What is the risk when using evidence that is held by the client?

5.3.3 Which is the least persuasive evidence?

5.4 Using the Work of an Expert

LEARNING OBJECTIVE 4

Explain the issues to consider when using the work of an expert.

It may be necessary to engage the services of an **expert** if an auditor does not have the requisite skills and knowledge to assess the validity of an account or a transaction. An expert is someone with the skills, knowledge, and experience required to aid the auditor when gathering evidence. An expert may be a member of the audit firm who is not a member of the audit team, an employee of the client, or a person independent of both the audit firm and its client. Experts commonly used by auditors include valuators for things such as real estate, works of art, collections, and jewellery, and actuaries to calculate liabilities related to employee future benefits and oil and gas reserves.

expert someone with the skills, knowledge, and experience required to aid the auditor when gathering sufficient appropriate evidence

CAS 620 *Using the Work of an Auditor's Expert* provides guidelines for auditors when using the work of an expert. An auditor first assesses whether an expert is required. If it is decided that an expert is required, the auditor then determines the scope of work to be carried out. When selecting an expert to complete the work, the auditor assesses the competence and capability of the expert to do so and their objectivity. Once an expert has completed the work, the auditor assesses the work and draws conclusions based on the assessment. The ultimate responsibility for drawing conclusions based on gathered evidence rests with the auditor. Each of the stages in using an expert is now discussed.

5.4.1 Assessing the Need to Use an Expert

When gathering evidence, an auditor may decide that they do not have the expertise necessary to test and evaluate the accuracy of reported information. They may decide that they require assistance in the form of an expert opinion or report to corroborate other evidence obtained. For example, an appraiser may be engaged to provide an opinion on the value of a client's property, a geologist may be engaged to evaluate the quantity and quality of mineral deposits, a vintner may be engaged to assess the quality and value of wine stocks, or an actuary may be engaged to verify insurance premiums.

The need to engage the services of an expert depends on the knowledge of the audit team, the significance and complexity of the item being assessed, and the availability of appropriate alternative corroborating evidence. If the audit team has experience with the item being audited and can draw on their knowledge from previous audits of that client or similar companies in the same industry, there is less need to use an expert. The greater the risk of material misstatement of the item under consideration, the more likely that an auditor will turn to an expert for their advice. To summarize, the less knowledge an audit team has of the item under consideration, the greater the risk of material misstatement, and the less corroborating evidence available, the more likely that an auditor will conclude that an expert opinion is required.

5.4.2 Determining the Scope of the Work to Be Carried Out

Once it has been determined that an expert opinion is required, the scope of the work to be carried out is determined by the auditor and communicated to the expert. This involves setting the nature, timing, and extent of work to be completed by the expert. It is important for the auditor to be involved in setting the scope of the work required, as the judgement of the expert forms part of the audit evidence upon which the auditor forms their audit opinion.

Written instructions to an expert can cover the issues that the expert is to report upon, such as the market price of properties owned by the client; the details to be included in the report, such as the computations used in arriving at the expert's opinion; the sources of data to be used, such as market interest rates or market prices of shares; clarification of the way that the auditor intends to use the information included in the expert's report; and notice of the requirement that the expert's report and the data used in compiling the report must remain confidential.

5.4.3 Assessing the Competence and Capability of the Expert

Before contacting an expert, an auditor assesses their capacity to complete the work required. This involves an evaluation of the expert's qualifications as a member of a relevant professional (or similar) body. The reputation of the expert within their field and the extent of their experience in providing the type of opinion or report sought by the auditor are also assessed. It is important that the expert's knowledge and experience be appropriate.

5.4.4 Assessing the Objectivity of the Expert

Objectivity refers to the ability to form an opinion or arrive at a conclusion without the influence of personal preferences. An expert is expected to be more objective if they are not associated with the client. An association will exist when the expert is an employee of the company or is connected with the client in some other way. (For example, the expert is related to one of the key personnel of the client or financially linked with the client.)

When an expert is an employee of the client or is in some other way connected with the client, an auditor assesses the objectivity of the expert with reference to their professional status, their reputation, and the auditor's prior experience with the expert. If an expert's opinion has proven to be accurate in the past, it increases the reliability the auditor may attribute to the expert's opinion in the current audit. Nevertheless, the less independent the expert is from the client, the more corroborating evidence the auditor will require.

5.4.5 Assessing the Expert's Report

It is important that an expert's report be written in such a way that an auditor, who is not an expert in the field being reported on, can understand the technical content of the report. The report should detail each stage of the process used in arriving at the overall opinion or conclusion of the report. It should include information about the data sources or estimation models used or the calculations conducted. The auditor assesses the appropriateness of the data sources used—it is essential that the expert use data sources that are reputable and reliable. The auditor assesses the consistency of any assumptions made with those made in prior years and with other known information. The auditor assesses the consistency of information included in the expert's report with their understanding of the client. Finally, the auditor assesses the consistency of the conclusions drawn with corroborating evidence gathered by the audit team.

5.4.6 Responsibility for the Conclusion

The responsibility for arriving at an overall conclusion regarding the fair presentation of a client's financial statements rests with the auditor. When an auditor decides to use an expert, that responsibility is not reduced in any way. It is the responsibility of the auditor to assess the quality of the evidence provided by an expert and determine whether it is reliable and objective. An auditor does this by following the process outlined above. They will determine the need for an expert, the scope of the expert's work, and the competence and objectivity of the expert. Finally, the auditor will assess the quality of the expert's report and the reliability of the information included in it.

Cloud 9 Integrated Case

Suzie will take responsibility for obtaining an expert opinion on derivatives, if Cloud 9 has any. She knows that W&S Partners has other staff (who are not part of the audit team) who can provide additional expertise. She understands that derivatives have become a big issue in audits in recent years, and so an external expert's opinion could be required. She has some experience using a derivatives expert on prior audits of clients in the footwear and clothing industry, and she will ask Jo Wadley (the partner) to recommend a suitable expert if needed.

Before You Go On

5.4.1 What factors may influence an auditor's decision on the need to use an expert?

5.4.2 How might an auditor assess the capacity of an expert?

5.4.3 Why is it important that an expert's report include details of data sources used?

5.5 Using the Work of Another Auditor

LEARNING OBJECTIVE 5

Explain the issues to consider when using the work of another auditor.

CAS 600 *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* provides guidance when using the work of another audit firm. The auditor who is responsible for signing the audit report (the **group engagement partner**) may need to rely on evidence provided by another auditor for certain components of a client's financial statement. This occurs when a client operates in a number of locations, has divisions or subsidiaries spread around the country or the globe, or has significant assets in other locations.

group engagement partner the auditor responsible for signing the audit report

When making a client acceptance or continuance decision, an auditor will consider their capacity to undertake the audit. They should also consider the proportion of the financial statements for which they will have to rely on another auditor (**component auditor**). The group engagement partner's firm should audit the majority of a client's financial statements and be knowledgeable about the components of the financial statements that they do not audit themselves. If this is not the case, the firm should not accept or continue to audit the client.

component auditor an auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit

When assigning work to a component auditor, the group engagement partner will consider the capacity of the other auditor to undertake the work. The group engagement partner will also consider the reputation of the component auditor and ensure that they are a member of a reputable professional body. It is the responsibility of the group engagement partner to ensure that the work completed by a component auditor meets the group engagement partner's requirements and standards.

CAS 600 sets out the responsibilities of the group engagement partner when using the work of a component auditor. The group engagement partner determines the work to be conducted by a component auditor. The two auditors may discuss the detailed procedures to be used, and the group engagement partner then reviews the main conclusions drawn in the working papers of the component auditor. The extent of review of the component auditor's work depends on a number of factors. The group engagement partner will spend more time if the component of the client's financial statements being audited by a component auditor is material and/or at risk of material misstatement. The group engagement partner will spend less time if the component auditor has a good reputation and/or has done audit work for the group engagement partner in the past.

The group engagement partner uses the evidence provided by a component auditor when drawing a final conclusion on the fair presentation of a client's financial statements. The findings of a component auditor on a component of the financial statements will be placed in the context of the audit as a whole. If the group engagement partner is concerned about the conclusions arrived at by a component auditor, they will discuss the findings with the component auditor. They may also discuss the implications of those findings with those charged with governance at the client to gain a more complete understanding of the component of the financial statements audited by the component auditor. If the group engagement partner decides that the conclusions arrived at by the component auditor indicate a material misstatement in the component audited, and if the impact of the misstatement is material to the financial statements taken as a whole, the group engagement partner will consider issuing a modified audit opinion.

If the group engagement partner is concerned that a component auditor has not been able to gather sufficient appropriate audit evidence regarding the component of the financial statements audited, he or she will ask that further evidence be gathered. If the component auditor cannot access sufficient evidence, the engagement partner will consider issuing a modified audit opinion due to a scope limitation. This will occur when the group engagement partner is unable to obtain additional evidence on the elements of the component audited by a component auditor.

Cloud 9 Integrated Case

Sharon knows that Cloud 9 Inc.'s auditor completed some work that was relevant to Cloud 9 before W&S Partners was appointed to the Cloud 9 audit. She has not yet seen these audit findings and does not know whether they will affect their work. She is keen to see them because she believes that some of the findings relate to the inventory management software system (Swift). Because they don't yet have enough information to make a judgement about the usefulness of the other auditor's work, Sharon decides to include in the plan some time for a discussion between the partner (Jo Wadley) and Cloud 9 management to discuss the other auditor's findings, and whether the audit team can have access to these findings.

Before You Go On

5.5.1 Who is the group engagement partner?

5.5.2 What are some of the factors that a group engagement partner will consider when assigning work to a component auditor?

5.5.3 If the group engagement partner believes that the component auditor has not gathered sufficient appropriate audit evidence, what kind of audit report may be issued?

5.6 Evidence-Gathering Procedures

LEARNING OBJECTIVE 6

Describe the evidence-gathering procedures most often used by auditors.

The evidence-gathering procedures described in this section are carried out at various phases of the audit, when planning, gaining an understanding of the client, gaining an understanding of a client's system of internal controls, testing those controls, conducting detailed substantive testing, and drawing the final conclusions. CAS 500 provides guidelines, summarized below, on the primary evidence-gathering procedures used by auditors.

Confirmations generally provide evidence that items such as cash and accounts receivable exist (existence assertion). As previously discussed, external confirmations are written inquiries sent by the auditor directly to a third party, who is asked to respond to the auditor on the matter included in the confirmation letter. As confirmations are costly, they will be used when alternative evidence is limited.

Inspection involves examining records and documents and physically examining assets. An auditor will inspect records and documents for a variety of reasons. When testing controls, an auditor will inspect documents for evidence that, for example, calculations have been checked, balances have been reconciled, inputs have been agreed to outputs, and management has authorized significant purchases. Records and documents are inspected when conducting substantive testing to check, for example, the dates of transactions (cut-off assertion), that purchases were made by the client (rights and obligations assertion), and that a transaction occurred (occurrence assertion).

Tangible assets are physically inspected to provide evidence that they exist (existence assertion) and appear to be in good repair or are damaged or past their use-by date (accuracy, valuation, and allocation assertion). When a client conducts an inventory count, the auditor will attend and perform test counts (existence and completeness assertions).

Client staff are observed undertaking various procedures when there is no other way of establishing that a process is being used by the client. For example, an auditor will observe the opening of mail and the conduct of an inventory count to determine whether the appropriate procedures are being followed. Importantly, **observation** only provides evidence of a process at the time the auditor observes it being carried out. An auditor will need to determine whether there is evidence that the procedures observed have been applied consistently throughout the period under audit.

Inquiry is used when gaining an understanding of the client and to corroborate other evidence gathered throughout the audit. The results of inquiries of client personnel and third parties are documented by the auditor. If the evidence is particularly important, an auditor may document that information more formally and ask the other party to the discussion to sign an agreement that the auditor has recorded the discussion accurately.

Recalculations are used to check the mathematical accuracy of client files and records. This will involve checking additions and more complex computations. Simple additions can be checked using computer-assisted audit techniques, where client data are copied into an auditor's computer and additions are recalculated using the auditor's software package. More complex calculations will be recalculated individually.

Re-performance means following a process used by a client. When testing controls, client procedures are re-performed to check that controls are effective. When conducting substantive testing, client estimations are re-performed to verify amounts calculated by the client. For example, when testing the allowance for doubtful accounts, an auditor will re-perform the aging of the accounts receivable to arrive at an estimated allowance amount.

Analytical procedures are used to appraise relationships between financial and non-financial information. During the risk assessment phase of the audit, unusual fluctuations are identified. During the risk response phase of the audit, analytical procedures are used to evaluate the information included in the financial statements (substantive analytical procedures). For example, hospital ward revenue can be estimated by counting the number of beds in the wards and then multiplying by the average occupancy rate and the amount charged per day. At the reporting phase of the audit, analytical procedures are used to assess whether the financial statements reflect the auditor's understanding of the client.

A new and emerging evidence-gathering procedure is **audit data analytics**. Audit data analytics can be used as risk assessment procedures, tests of controls, and tests of details. Audit data analytics are procedures performed to identify exceptions, outliers, trends, patterns, and other useful information from large datasets. These procedures are usually performed using computer software, and the results are usually documented as a graph, chart, or table. They often allow the auditor to test large populations very quickly. In fact, sometimes, the auditor can test an entire population in minutes. However, as with electronic evidence, the extent to which an auditor can rely on a client's data will depend a great deal on the internal controls the client has in place. An auditor must consider the effectiveness of their client's internal controls over data gathering before planning an audit data analytic. This includes assessing the quality of the data with respect to accuracy, completeness, and reliability. These evidence-gathering procedures will be discussed in greater detail in Chapter 9.

observation an evidence-gathering procedure that involves watching a procedure being carried out by another party

inquiry an evidence-gathering procedure that involves asking questions verbally or in written form to gain an understanding of various matters throughout the audit

recalculation an evidence-gathering procedure that involves checking the mathematical accuracy of client records

re-performance an evidence-gathering procedure that involves redoing processes conducted by the client

analytical procedure an evaluation of financial information by studying plausible relationships among both financial and non-financial data

audit data analytics the examination of large datasets, usually using computer software, for exceptions, outliers, trends, and other useful information

Before You Go On

5.6.1 Why might an auditor inspect documents when testing controls?

5.6.2 Provide some examples of how an auditor might use observation as part of their evidence-gathering procedures.

5.6.3 At which phase(s) of an audit will an auditor utilize a re-performance procedure? Explain.

5.7 Drawing Conclusions

LEARNING OBJECTIVE 7

Explain how auditors arrive at a conclusion based upon the evidence gathered.

Sufficient appropriate audit evidence must be gathered to enable an auditor to draw a conclusion on which to base their opinion regarding the fair presentation of the client's financial statements (CAS 500). The decision as to what constitutes sufficient appropriate audit evidence is a matter of professional judgement, as it is based upon an auditor's understanding of their client and the significant risks identified when planning the audit and evidence gathered when executing the audit (CAS 315 *Identifying and Assessing the Risks of Material Misstatement*; CAS 330 *The Auditor's Responses to Assessed Risks*).

If an auditor believes that a client has internal controls that can reduce the likelihood of a material misstatement for an identified risk, they will test those controls. This means that evidence will be gathered to establish whether the internal controls are effective. Once testing of controls is complete, an auditor will gather further evidence through their substantive testing of transactions and balances.

If an auditor decides that a client does not have in place appropriate controls for the identified risk, an auditor will adopt a substantive approach. The auditor will increase their reliance on evidence gathered through their detailed substantive tests of transactions and account balances.

After gathering all of the required evidence through their tests of controls and substantive testing, an auditor will form an opinion regarding the fair presentation of the client's financial statements. See Professional Environment 5.2 for a review of the importance of professional scepticism when forming conclusions.

5.2 Professional Environment — Professional Scepticism in the Spotlight

There is a focus on improving audit quality, as high-quality audits are key to efficiently running capital markets. One element that has come under the microscope in the discussion of audit quality is the concept of professional scepticism. Professional scepticism includes being alert to audit evidence that contradicts other audit evidence, or information that brings into question the reliability of documents or responses to inquiries to be used as audit evidence.

Despite the requirement for professional scepticism, audit regulators have reported a lack of such scepticism as it relates to audit documentation in some cases. Regulators have found that some auditors are accepting management assertions without gathering further corroborating evidence, even when contradictory audit evidence exists. Furthermore, it has been found that some auditors are failing to test the reliability of source documents and are signing off on audit programs that lack the detail needed to adequately demonstrate the work performed.

One area of particular concern is when a client has an operation in a foreign jurisdiction. For example, the auditor of Sino-Forest, a Canadian reporting issuer that held significant forestry assets outside of Canada, was accused of failing to meet auditing standards. The company collapsed after allegations of fraud surfaced. It was claimed the auditor did not do enough to verify the existence and ownership of the forestry assets. There was even evidence that some within the firm were concerned about this, as an email between staff indicated the hired expert "could show us trees anywhere and we would not know the difference." Several key documents were not in English and not translated. This all led observers and regulators to question whether adequate professional scepticism had been exercised.

With both professional scepticism and documentation in the spotlight, it is easy to see how both play a decisive role in supporting audit quality.

Q: What can auditors do to improve auditing in foreign jurisdictions?

Sources: Eric Turner, "Watch Your Step—Wading through the "Mind" Field of Skepticism," *CPA Magazine*, May 17, 2012; IAASB, "Professional Skepticism in an Audit of Financial Statements," Staff Questions and Answers, February 2012; Peter Koven and Barbara Shecter, "OSC Accuses Ernst & Young as Firm Settles Sino-Forest Class Action Suit," *Financial Post*, December 3, 2012.

Cloud 9 Integrated Case

Suzie and Ian have already begun gathering evidence by performing the analytical procedures on Cloud 9's interim results and prior-period statements. Further evidence gathering at the risk assessment phase will be performed by Josh and Sharon when they begin their assessment of the internal controls system by inspecting the relevant documents. They will also gather evidence from observing personnel performing their duties and making inquiries of members of Cloud 9's staff and management. In addition, Jo Wadley held discussions with the previous auditors (Ellis & Associates) before accepting the client. The record of these discussions, plus others that Jo Wadley has held with the Cloud 9 management, are already in the evidence files.

Ian has some questions about the evidence; in particular, why the audit team is bothering to gather verbal evidence, which has low persuasiveness. Suzie explains that all forms of evidence have their limitations. Observation is useful to see how staff perform their tasks (as opposed to what the manuals say they should be doing), but people often "behave" better when they are being watched. Documents can be lost or altered, or misinterpreted, and not everything is written down. Electronic evidence is hard to audit if the system does not have a "hack-proof" audit trail. Signatures on documents do not mean that the author actually read the document properly; people can pre- or post-date documents. The auditor has to judge the appropriateness and sufficiency of the evidence by considering it as a whole and be prepared to follow up any problems or discrepancies until any doubts are satisfactorily resolved.

Before You Go On

5.7.1 How does an auditor decide how much evidence is sufficient?

5.7.2 What will an auditor do if they believe that a client has internal controls that can reduce the likelihood of a material misstatement?

5.7.3 What will an auditor do if they decide that a client does not have in place appropriate controls for the identified risk?

5.8 Documentation—Audit Working Papers

LEARNING OBJECTIVE 8

Describe how auditors document the details of evidence gathered in working papers.

CAS 230 *Audit Documentation* requires an auditor to document each stage of the audit in their **working papers** to provide a record of work completed and evidence gathered in forming their audit opinion. The documentation includes the names of the preparers of the documentation, as well as the names of the reviewers of the work performed by the preparers. Documentation is cross-referenced between working papers that summarize the components of an account balance and working papers that provide details of the testing of that balance.

working paper paper or electronic documentation of the audit created by the audit team as evidence of the work completed

An auditor will document each stage of the audit and the procedures used. During the risk assessment phase of an audit, an auditor will document their understanding of the client, the risks identified, analytical procedures used to aid in risk identification, their materiality assessment, their understanding of the client's system of internal controls, their understanding of the client's information technology, related parties identified, their financial reporting framework, and any going concern matters. During the risk response phase, an auditor will document their audit program, details of tests undertaken, copies of significant documents sighted, correspondence with the client's lawyers and bankers, confirmations received from accounts receivable customers, and inquiries of management.

Documentation will vary from client to client. It will depend upon, for example, the audit procedures used, the risks identified, the extent of judgement used, the persuasiveness of the evidence gathered, the nature and extent of exceptions noted, and the audit methodology utilized (CAS 230, para. A2).

An audit working paper generally includes:

- the client name
- the period under audit
- a title describing the contents of the working paper
- a file reference indicating where the working paper fits in the audit file
- initials identifying the preparer of the working paper together with the date the working paper was prepared
- initials identifying the reviewer(s) of the working paper together with the date(s) the working paper was reviewed
- cross-referencing between working papers indicating where further work and evidence are summarized elsewhere

Working papers are used to document the details of each audit. The two main files held for each client are the permanent file and the current file. The permanent file includes documents that pertain to a client for more than one audit. The current file includes the details of work completed and evidence gathered that relate to the current audit.

5.8.1 Permanent File

permanent file file that contains client information that is relevant for more than one audit

The **permanent file** includes client information and documentation that apply to more than one audit. The information included in the permanent file is checked and updated at the beginning of each audit. The permanent file contains the client's head office address, other locations (where relevant), and contact details (telephone, fax, and email). Key personnel are detailed, and an organizational chart will also often be included in the permanent file. A client's organizational chart includes details of key roles within the organization (such as the CEO) and the names of the people who undertake those roles. The file may also include the details of the client's bank(s) and lawyer(s).

The permanent file will include copies of long-term contracts and agreements. These documents will be used to calculate interest payable on outstanding long-term loans, and will enable the assessment of any lease obligations. Debt covenants will be included in the permanent file. An auditor can check the details of these agreements to assess their client's compliance with covenants. If a client has long-term commitments with customers and suppliers, an auditor will include the relevant documentation in the permanent file. Key long-term investments will be described, including the details of the broker used for these transactions.

The permanent file will include details of the client's board of directors and its subcommittees (such as the audit committee). It will include the minutes of significant meetings held by the client, such as its board of directors' meetings. It may include details of bonus and option arrangements for senior client staff.

The permanent file will detail a client's principal accounting policies and methodologies. Prior financial statements and audit reports will be included. Details of prior analytical procedures will be included and added to so that the auditor can observe changing trends. Flowcharts and narratives detailing a client's system of internal controls will be included and amended as required during the risk assessment phase of each audit.

Reports sent to the client during previous audits will be included in the permanent file. For example, management letters that detail deficiencies in internal controls identified by the auditor in previous years will be included and referred to by the auditor. An auditor will read these reports and discuss their contents with the client's management.

Cloud 9 Integrated Case

Cloud 9 Ltd.'s permanent file contains the basic information about the company (that is, address and key senior staff and their employment contracts) plus the copy of the engagement letter appointing W&S Partners and stating the scope of the audit. Sharon and Suzie have gathered copies of some of the relevant agreements and will add these and more (that is, those relating to leases, sponsorship, and loans) to the permanent file.

5.8.2 Current File

The **current file** includes client information and documentation that apply to the current audit. Contents of the current file will vary from client to client, depending on the accounts in the client's financial statements and the client's activities. The current file will include the details of all testing and evidence gathered in preparing the audit report.

current file file that contains client information that is relevant for the duration of one audit

The current file will also include correspondence between the auditor and the client and the client's bankers and lawyers that pertains to the current audit period. Correspondence with other auditors, experts, and relevant third parties will be included. The engagement letter will be included in the current file, along with the management letter, detailing any deficiencies uncovered in the client's system of internal controls. Representation letters and confirmation letters may also be included in the current file.

The current file will include extracts from the minutes of meetings, such as the board of directors' meetings that pertain to the current audit. The file will include details of the audit planning process and the audit program, as well as detailed descriptions of evidence gathered, testing conducted, and audit procedures performed. It will detail analytical procedures, tests of controls, detailed substantive testing undertaken, and the planning, performing, and conclusion of any audit data analytics performed, as well as the conclusions drawn at the completion of testing. The current file includes testing of any subsequent events and a copy of the final audit opinion.

Overview of Working Papers

There are many different ways of preparing working papers, although most have common elements. The working papers that follow are prepared by W&S Partners using common auditing conventions and referencing. **Table 5.6** lists common notations found in audit working papers.

Working papers are prepared and stored electronically. Once the audit is concluded, any hard copy working papers are archived in a hard copy file (in the filing room) and soft copy files and working papers are archived in a location that keeps them secure for the required record-keeping period (up to 10 years).

Each audit will have a unique title for ease of identification, which will include the client name and the year end of the financial statements being audited. Each current file created for an audit will be divided into unique sections, with each section representing a different element of the audit, typically a group of similar accounts. Each section comprises a series of working papers that provide evidence of the work conducted on the audit. Working papers generally include details such as the client name, the period under audit, a file reference, cross-references to other parts of the audit file, details of the testing conducted, comments and conclusions drawn, and details of the preparer (generally a junior member of the audit team for routine audit tasks or a senior for complex audit tasks) and reviewers (senior members, managers, and partners).

TABLE 5.6 Common working paper notations

Common Working Paper Notations	Meaning
PY	Agreed to prior year working paper file
^	Footed, summed down a column
~~^~~	Crossfooted, summed across a row
TB	Agreed to trial balance
G/L	Agreed to general ledger
~~c~~	Recalculated
CK	Agreed to cheque
I	Agreed to invoice
~~m~~	Not material
NFWCN	No further work considered necessary
PBC	Prepared by client

Examples of Working Papers

The following are a series of fictional working papers prepared by W&S Partners for a client, New Millennium Ecoproducts. The working paper examples are for the audit period ended December 31, 2023. New Millennium Ecoproducts was founded by brothers Tomas and Charles Tyshynski, avid environmentalists. The company's vision is to produce everyday products in a sustainable way, providing an affordable alternative for environmentally conscientious customers. New Millennium operates from three locations and produces a wide range of household products, which it sells to supermarkets and specialty stores.

At the front of every audit file is a copy of the client's trial balance. The trial balance is referenced into the appropriate lead schedule throughout the audit file. Every balance sheet account will have a lead schedule that includes the summary of the account balance and typically also includes a summary of the work performed, any material issues or audit adjustments identified, and the overall conclusion relating to that account balance. Every audit section is assigned a title. Section titles vary between firms; however, most firms use letters and/or numbers to denote different sections. For example, for W&S Partners, accounts receivable is labelled the C section; inventory accounts is labelled the F section; property, plant, and equipment is labelled the U section; accounts payable is labelled the BB section; and so on.

The first working paper example is the accounts receivable C-Lead schedule in figure 5.7.

	A	B	C	D	E	F	G	H	I	J	K	L	M
1	**New Millennium Ecoproducts**												
2	**Year End: December 31, 2023**							**Prepared by**		**Reviewed by**		**C-Lead**	
3	**Accounts Receivable Lead Schedule**							OV		VW			
4								03-04-2024		17-04-2024			
5													
6	**Account**		**Prelim**	**Adj's**		**Dec. 31, 2023 Yr Adjusted**		**Dec. 31, 2022**		**$ Change**		**% Change**	
7													
8	1050 Accounts Receivable	TB	761,513.07	0.00	C-10	761,513.07	^	981,977.51	PY	-220,464.44	^1	-22	⊖
9	1056 Employee Receivable		433.94	0.00	m	433.94		0.00		433.94		0	
10			761,947.01	0.00		761,947.01		981,977.51		-220,030.50		-22	
11			ʌ			ʌ				ʌ			
12	1066 Allowance: Doubtful Accounts		-17,791.20	0.00	C-11	-17,791.20		-22,598.00		4,806.80	m	-21	m
13			-17,791.20	0.00		-17,791.20		-22,598.00		4,806.80		-21	
14			ʌ			ʌ							
15	Accounts Receivable		744,155.81	0.00		744,155.81	FS	959,379.51		-215,223.70		-22	
16			ʌ			ʌ		ʌ					
17													
18	**Conclusion: Based on the work performed, the balance appears reasonable as at December 31, 2023.**												
19													
20	1 Accounts receivable decreased compared to the prior year due to increased efforts to collect at year end. In particular, New Millennium collected $160K from ABC Company on December 20, 2023 and 60K from XYZ Company on December 23, 2023.												
21													
22	Legend												
23													
24	m Not material												
25	PY Agreed to prior year working paper file												
26	ʌ Footed, summed down a column												
27	^ Cross-footed												
28	⊖ Calculated												
29													

FIGURE 5.7 Accounts receivable lead schedule

In the top left corner of the lead schedule is the client name, period end, and working paper title. The reference for this working paper is provided in the top right-hand corner (C-Lead), along with details of the working paper preparer and reviewer(s) with the dates prepared and reviewed.

Details of the accounts receivable follow. The lead schedule notes the following for each item listed:

- account number, per the client records
- account name, per the client records
- preadjusted (preliminary) balance per the client's trial balance (TB), any adjustments, and the adjusted current year balance
- the prior year balance, per the prior year audit file (PY)
- variance and percentage change: the calculated difference between the prior year and current year balances
- the cross-reference to the working paper where supporting evidence is kept for each balance

The detailed audit work on the accounts receivable accounts is documented on subsequent working papers and referenced to the lead schedule. For example, the audit work on the accounts receivable account number 1050 is documented on working paper C-10. It is referenced on the lead schedule to make it easy to refer from one working paper to another. The work performed on the allowance for doubtful accounts appears on working paper C-11. The final section of the lead schedule includes an overall conclusion on the account balances and whether any adjustments were found.

The second working paper example is the confirmations and related alternative procedures working paper from the accounts receivable (C) section of the audit file (**figure 5.8**).

	A	B	C	D	E	F	G	H	I	J	K	L	M
1	**New Millennium Ecoproducts**						C-10						
2	**Year End: December 31, 2023**				**Prepared by**		**Reviewed by**						
3	**Accounts Receivable Confirms and Other Procedures**				OV		[illegible]						
4					**03-04-2024**		**17-04-2024**						
5	Confirmation date:	Dec. 31, 2023											
6	Date sent:	Jan. 15, 2024											
7	First follow-up:	Feb. 28, 2024											
8													
9	Account Number	Customer Name	Amount Owing as of Confirm Date		Date Received		Balance Confirmed	Variance	Subsequent Cash Receipts		Agreed to Invoice and Shipping Documents		
10			SL										
11	123456	Cleaner King	198,258		Mar. 28, 2024	C-11	178,362	19,896	19,896	[1] ɣ			
12	678900	Fresh and Clean	259,983		Feb. 15, 2024	C-12	259,983	-					
13	234987	Swept Away	56,925		Jan. 27, 2024	C-13	56,925	-					
14	654098	EcoCarpetCare	69,532				-	69,532	64,921	[1] ɣ	2,500	√	
15	1248098	Pete's Cleaning	89,411		Mar. 2, 2024	C-14	89,411	-					
16													
17	Total		674,109				584,681	89,428	84,817		2,500		
18													
19	Dollar coverage										671,998		
20	Total AR										**761,513**	C-10	
21	Percent coverage										**88%**		
22													
23	1- Not an error, this is a timing difference. A payment made by the customer before the confirmation date was received by the client just after the confirmation date												
24	Legend												
25	SL Agreed to AR sub-ledger												
26	ɣ Agreed to cheque copy, remittance advice, bank deposit, and bank statement												
27	√ Agreed to shipping report signed by external carrier that goods were shipped before year end												
28													

FIGURE 5.8 **Accounts receivable confirmations and other procedures**

The top left-hand corner notes the engagement client name, period end, and working paper title (confirmations and other procedures). In the top right of the working paper is the working paper reference (C-10), along with details of the working paper preparer and reviewer. Next, the date of the confirmation is noted. In this case, the confirmation was conducted for the balance at year end. The date is then noted when the confirmations were sent to New Millennium customers to confirm their accounts receivable. The first request was sent on January 15, 2024. A second request was sent on February 28, 2024, to customers that did not reply to the first request.

The balance in the accounts receivable accounts confirmed on that date is noted by the customer and cross-referenced to the accounts receivable subsidiary ledger (SL).

The table contains details of the customers that were sent confirmation requests:

- account or invoice number, per the accounts receivable SL
- customer name, per the accounts receivable SL
- balance owing at confirmation date, per the accounts receivable SL
- the date the auditor received a response from the customer
- the balance outstanding at the confirmation date according to the customer correspondence (filed and cross-referenced to working papers C-11, C-12, C-13, and C-14)
- any variance between the client records and the customer correspondence, which is calculated by the auditor
- documented alternative procedures performed where a customer has not responded or there is a variance, which involve the following:
  - The auditor searches the cash receipts journal for evidence that the customer has paid the amount outstanding, which provides evidence that the amount existed at the confirmation date. The auditor notes the amount received by the client, the date the cash was received, and whether the amount agrees to a copy of the cheque or remittance advice, as well as the bank deposit slip and the subsequent bank statement, which indicates that the invoice was paid by the customer subsequent to the confirmation date.
  - When the customer has not paid the amount outstanding at the date of confirmation, the auditor searches for evidence that the sale occurred. In this case, the auditor agrees the amount to shipping reports signed by external carriers, which indicates that the item was shipped prior to the confirmation date.

The working paper then indicates the dollar value of the total accounts receivable that was confirmed, the total verified by subsequent receipts, and the amount vouched to invoices and shipping documents. These are totalled and used to determine the amount of work (or coverage) performed on the accounts receivable (AR) balance. This will help to determine if still more work is required on the existence assertion for the accounts receivable.

The bottom part of the working paper includes the auditor's comments on any unresolved items after the testing is completed. In this case, the auditor concludes that a payment made by the customer before the confirmation date was received by the client just after the confirmation date. This timing difference does not affect the existence of a receivable as at the end of December. A legend is also included so any reviewer can understand the symbols and the actual work performed.

The third working paper example is the observation of physical inventory counts working paper from the inventory (F) section of the audit file (**figure 5.9**). In the top left-hand corner is the client name, period end, and working paper title (observation of inventory count). In the top right of the working paper is the working paper reference (F-10) and details of the working paper preparer and reviewers.

The next section of the working paper notes the location of the inventory count, the date of the inventory count, and the inventory balance on the date of the count. The inventory balance on the date of the count is cross-referenced to another part of the audit file (the inventory lead schedule F-Lead).

Ahead of attending the inventory count, the audit team will review and comment on the client's procedures for conducting their count. The details of that review are cross-referenced in the working paper to the location of that documentation in the audit file (F-9).

New Millennium Ecoproducts
Year End: December 31, 2023
Observation of Inventory Count

F-10

Prepared by	Reviewed by
OV	[illegible]
03-04-2024	17-04-2024

Location of count: Edmonton, Alberta
Date of count: Dec. 31, 2023
Account balance at the count 486,900 F-LEAD

Client count procedures: Please see memo to file WP F-9 for details of client count

Test counts:

Test #	Tag Reference	Item #	Measurement	Quantity per W&S	Quantity per Client Count		Variance		Final Quantity		Variance	Comments
Sheet to Floor												
1	1045	A1008	Case	10	10	@	-		10	#	-	
2	2587	T1090	Each	20	25	@	5.00	1	25	#	-	
3	1902	P2311	Kg	50	50	@	-		50	#	-	
4	7678	R4523	Each	37	37	@	-		37	#	-	
5	3478	F5498	Each	22	22	@	-		22	#	-	
Floor to Sheet												
1	4598	G7821	Case	18	18	@	-		18	#	-	
2	2308	D0901	Each	20	23	@	3.00	1	23	#	-	
3	5601	T5699	Each	12	12	@	-		12	#	-	
4	7890	R1209	Kg	80	80	@	-		80	#	-	
5	2385	H6777	Each	55	55	@	-		55	#	-	

1 In two samples, our count differed from the client's.
Per further discussion with the client, their count was accurate.

Legend
@ Agreed to count sheet
# Agreed to inventory compilation

FIGURE 5.9 **Observation of inventory count**

Next are the details of the items among New Millennium's varied inventory that were selected for testing by the auditor. The number of items selected and the nature of the items selected will depend upon the audit strategy.

The working paper example includes details of five inventory items selected for testing of existence (count sheets to floor) and five items selected for testing of completeness (floor to count sheets). The extent of testing will depend on the risk assessment and other audit procedures included in the audit plan for inventory. For each inventory item selected, the auditor notes in the working paper the following:

- item number
- mode of measurement (in this case, units, cases, or kilograms, but it could be any other weight or length depending on the nature of the inventory being counted)
- quantity counted by the auditor (W&S Partners)
- quantity counted by the client per the client count sheet
- any variance in the counts
- final quantity per the inventory compilation at the conclusion of the count agreed by the auditor to the client inventory compilation

- any variance between the quantity per the compilation and the quantity per the final verified amount
- comments by the auditor on the variances

The final working paper we illustrate here is **figure 5.10** on the auditor's testing of New Millennium's accounts payable controls set up by the Tyshynski brothers. Like the previous examples, the working paper includes in the top left corner the name of the client, the client year end, and the working paper reference. The right-hand corner includes the working paper reference number (Control-BB) and the sign-off of the preparer and the reviewer.

The next portion of the controls testing working paper lists the procedures to be performed. This is followed by a table itemizing the details of the items included in the sample, such as the invoice number, the purchase order number, the invoice amount before and after taxes, and the results of the procedures performed. The details of the procedures are indicated by a series of letters (S, T, U, V, W, and X) and tick marks (✓) explained in the legend created by the preparer. A column is provided to allow for comments on any exceptions found. The extent of testing would be determined by the audit team. The example shows a test of five for simplicity. This is followed by an overall conclusion as to whether the control is effective.

New Millennium Ecoproducts		Control-BB	F-10
Year End: December 31, 2023		**Prepared by**	**Reviewed by**
Control Testing: Purchases and Payables		OV	*[illegible]*
		03-04-2024	**17-04-2024**

Procedures:

1. Obtained a sample of invoices.
2. Agreed the selected cheque numbers to the cheque stub attached to each invoice bundle to ensure that correct sample was pulled.
3. Agreed invoice PO number, supplier name, selling price, quantity purchased, and total price to information in PO system (payables CEVA); (purchase existence, completeness).
4. Agreed the sales price of purchased units in PO with the invoice from supplier (purchases valuation, accuracy).
5. Vouched invoice details to G/L detail.

Cheque #	Expense Type	Invoice #	PO #	Supplier Name	Supplier #	Work Order #	Subtotal Amount	GST/PST	Total Amount	S	T	U	V	W	X	Notes
10156	e			Laurel Wiecek			202.54		202.54				√	√	√	
10836	m	66953	11788	Braid EcoSystems	1810	22666	690.04	82.80	772.84	√	√	√	√	√	√	
15386	m	TL-075284	11449	Armstrong Electric	2012011	22625	788.75	94.65	883.40	√	√	√	√	√	√	
18888	m	3102650	16754	Parkhill Repairs	2210	22698	10,591.55	1,270.99	11,862.54	√	√	√	√	√	√	
21098	a	12673	19823	Dhaliwal Cleaning	2600	22901	1,425.20	171.02	1,596.22	√		√	√	√	√	

Conclusion: Based on the work performed, the controls over the purchases and payables can be relied upon.

Annotation

√	=	Completed with **NO** exception
m	=	Materials purchase
a	=	Administrative expenses
e	=	Expense report

Legend

S	Agreed invoice's stamped PO# with PO# in system
T	Agreed purchased units # from PO to packing slip and invoice; recalculated
U	Agreed purchase price in PO system to selling price on invoice
V	Checked invoice stamp for sign-off
W	Vouched through to G/L
X	Traced the account coding to verify it was correct

FIGURE 5.10 **Controls testing: Purchases and payables**

Cloud 9 Integrated Case

The first major item in the current file for Cloud 9 is the audit plan. In addition, every task that is performed during the audit will be documented. Ian and the other junior staff are still struggling with how to correctly complete the papers. They often forget to complete all the relevant fields and Sharon, Suzie, and Josh are continually sending papers back to them with requests to clarify some of their comments. However, embedding the working papers in Excel has made life easier than in the past, when everything was paper-based, because an error message will be generated if certain key fields are not completed.

Before You Go On

5.8.1 What is a current file?

5.8.2 What is a permanent file?

5.8.3 What will an auditor document during the risk assessment phase of the audit?

Summary

1 Explain the audit assertions.

When preparing the financial statements, management will make assertions about each account and related disclosures in the notes. Auditors use these assertions to assess the risk of material misstatement and design audit procedures. The assertions used when testing transactions and events and related disclosures, including income statement items, are occurrence, completeness, accuracy, cut-off, classification, and presentation. The assertions used when testing balance sheet items and related disclosures are existence; rights and obligations; completeness; accuracy, valuation, and allocation; classification; and presentation.

2 Identify and describe different types of audit evidence and assess sufficient appropriate audit evidence.

The different types of audit evidence include external confirmations, documentary evidence, representations, verbal evidence, computational evidence, physical evidence, and electronic evidence. External confirmations are sent directly by an auditor to a third party. Documentary evidence may be generated internally by the client or externally by third parties. Representation letters are requested from a client's lawyers or management. Verbal evidence is the discussions between the auditor and client personnel or third parties. Computational evidence is gathered when an auditor checks the mathematical accuracy of figures included in the financial statements. Physical evidence involves the inspection of tangible assets. Electronic evidence includes data held on a client's computer, files sent by email to the auditor, and items scanned and faxed.

Sufficiency refers to the quantity of evidence gathered. Appropriateness refers to the relevance and reliability of audit evidence gathered.

3 Determine the persuasiveness of audit evidence.

The persuasiveness of evidence used to corroborate the details included in a client's accounts varies. Internally generated evidence held by the client is the least persuasive, as the client can alter or hide this evidence. Externally generated evidence held by the client is more persuasive, as it is created by an independent third party. Externally generated evidence sent directly to the auditor is the most persuasive, as the client does not handle this evidence.

4 Explain the issues to consider when using the work of an expert.

When an auditor decides to use the work of an expert, the report produced by the expert forms part of the evidence used by an auditor when forming their audit opinion. An expert is someone with the skills, knowledge, and experience required to help an auditor. The auditor determines the scope of the work to be carried out, and assesses the capability of the expert, the objectivity of the expert, and the expert's report.

5 Explain the issues to consider when using the work of another auditor.

An auditor may need to use the work of another auditor when their client operates in a number of locations, has divisions or subsidiaries spread around the country or the globe, or has significant assets in other places. When this is the case, the principal auditor may need to rely on evidence provided by another auditor for certain components of the client's financial statements.

6 Describe the evidence-gathering procedures most often used by auditors.

An auditor will inspect records, documentation, and tangible assets. They will observe client staff undertaking various procedures. An auditor will make inquiries of client personnel and third parties. Confirmations are sent to third parties, including banks, lawyers, lenders, and debtors. An auditor will recalculate numbers appearing in client files and records to check mathematical accuracy. They will re-perform some processes used by the client to check the effectiveness of internal controls and the validity of amounts estimated by client personnel. Analytical procedures are used throughout the audit to appraise the relationships between financial and non-financial information. Audit data analytics can be used to gather evidence by examining large datasets using software, to identify outliers, patterns, or trends and to present the results in a graph, chart, or table.

7 Explain how auditors arrive at a conclusion based upon the evidence gathered.

The final audit procedure is to assess the evidence gathered throughout the audit and draw a conclusion on the fair presentation of a client's financial statements.

8 Describe how auditors document the details of evidence gathered in working papers.

Audit evidence is documented in an auditor's working papers. Audit working papers include the client's name, the period under audit, a title describing the contents of the working paper, a file reference indicating where the working paper fits in the audit file, the initials of the preparer of the working paper together with the date the working paper was prepared, the initials of the reviewer(s) of the working paper together with the date(s) the working paper was reviewed, and cross-referencing between working papers indicating where further work and evidence are summarized elsewhere. Working papers are stored in either the permanent file or the current file. The permanent file includes client information and documentation that apply to more than one audit. The current file includes client information and documentation that apply to the current audit.

Key Terms

Self-Test Questions

Answers to the Self-Test Questions are available on *WileyPLUS*.

5.1 The assertion of cut-off:

a. reflects that all assets and liabilities that should have been recorded are recorded.

b. ensures that events have been recorded in the correct accounts.

c. is an assertion made by the auditor to help determine audit testing.

d. reflects that all events have been recorded in the correct accounting period.

5.2 The quantity of evidence that an auditor will gather:

a. varies with audit risk.

b. is the same for all audits because it has to be appropriate.

c. depends on the size of the audit team.

d. all of the above.

5.3 An external confirmation sent to a customer:

a. provides strong evidence for the accuracy, valuation, and allocation assertion when the customer agrees with the balance owing.

b. requests information about due dates.

c. primarily focuses on accounts where there are small or zero balances.

d. provides evidence for the existence assertion.

5.4 When an auditor gathers documentary evidence or physical evidence to support an entry in the client's records, the auditor is gathering evidence to support the:

a. completeness assertion.

b. existence assertion.

c. both (a) and (b).

d. neither (a) nor (b).

5.5 When an auditor inspects tangible assets on hand and traces the details to the details recorded in the client's records, the auditor is gathering evidence to support the:

a. completeness assertion.

b. existence assertion.

c. both (a) and (b).

d. neither (a) nor (b).

5.6 Generally the most persuasive form of evidence is:

a. internally generated evidence.

b. externally generated evidence held by the client.

c. externally generated evidence sent directly to the auditor.

d. none of the above; they are equally persuasive.

5.7 If an expert is engaged to assist with the audit:

a. it means the auditor does not have the requisite skill and knowledge to assess the item.

b. it means the auditor should not have taken on the audit because they are not qualified.

c. CPA Canada must be contacted and permission obtained before the expert starts work.

d. the auditor does not have to take responsibility for the fair presentation of the item in the financial statements.

5.8 Inspecting documents, such as an invoice for the purchase of fixed assets, provides the auditor with evidence relevant to the:

a. rights and obligations assertion, because the document will show the client's name as the purchaser.

b. occurrence assertion, because the document will show that the transaction took place on the specified date.

c. accuracy assertion, because the document will show the purchase amounts.

d. all of the above.

5.9 Analytical procedures are used to gather evidence:

a. at the risk assessment phase to gain an understanding of a client.

b. at the risk response phase to evaluate information included in the financial statements.

c. at the reporting phase to assess whether the financial statements reflect the auditor's understanding of their client.

d. all of the above.

5.10 The working papers for a client contain both a permanent and a current file. The difference between the two files is that:

a. the permanent file is kept by the audit partner in charge and cannot be altered after the first audit engagement is completed, but the current file can be updated.

b. the permanent file is provided to the client and the current file is not.

c. the permanent file includes documents that relate to the client and are relevant for more than one audit, and the current file includes the details of work completed and evidence gathered that relate to the current audit.

d. all of the above.

Review Questions

5.1 In what ways are the occurrence and existence assertions similar?

5.2 Explain the difference between the completeness and existence assertions.

5.3 Explain how gathering physical evidence by inspecting a client's tangible assets assists in the audit of the completeness and existence assertions.

5.4 Define what is meant by sufficient and appropriate evidence.

5.5 What external parties could an auditor send a confirmation to?

5.6 What is the purpose of a management representation letter?

5.7 If an auditor does not have sufficient knowledge and skill in an area, the auditor can ask for the assistance of an expert. This creates a problem: how does an auditor know if the expert's work is correct if the auditor is not also an expert? Explain.

5.8 Under what circumstances does an auditor use the work of a component auditor? Why doesn't the group engagement partner do all of the work?

5.9 What is the difference between recalculation and re-performance? Explain using examples.

5.10 Review the examples of working papers provided in the chapter. List *six* things that should be included in every working paper.

Professional Application Questions

Basic Moderate Challenging

5.1 Identifying audit assertions Basic **LO 1**

Required

For each of the following items, identify the related assertion:

a. Inventory is recorded at the lower of cost and net realizable value.

b. All delivery vans recorded in the accounting records are owned by the entity.

c. All payroll-related accruals at year end are recorded.
d. The accounts receivable sub-ledger agrees to the general ledger control account.
e. All sales were recorded in the correct period.
f. There is no inventory on consignment.
g. Purchases made after year end were recorded in the prior year.
h. There is no impairment of goodwill.
i. There are 10 delivery vans in the parking lot.
j. There are no undisclosed contingent liabilities.

5.2 Audit assertions **Basic** **LO 1**

Required

State the assertion that is violated in the following sentences:

a. The client fails to accrue management bonuses in the current year.
b. The client does not adjust its inventory to the lower of cost and market.
c. The client books revenue in the current year when it has not yet been earned.
d. The client issues a payroll cheque to an employee who no longer works for the entity.
e. The client forgets to include goods on consignment in its inventory count at year end.
f. The client fails to disclose its related party payables separately.
g. The client records its depreciation expense in its rent expense account.
h. The client forgets to record its allowance for doubtful accounts.
i. The client forgets to count inventory that is recorded in its books.
j. The client accidentally records its telephone bill twice for the month of November.

5.3 Account balances at risk **Moderate** **LO 1**

Tropical Cruises is a new client of MMM Partners. Tropical Cruises is a low-cost cruise ship operator, travelling between Canada and the United States. The planning for the first audit is under way. The auditors have become aware that police in two countries are investigating several Tropical Cruises employees for stealing food and other supplies from the ships' kitchens and selling it at local markets. The police have charged 10 cabin stewards of Tropical Cruises with theft and fraud.

Required

a. What account balances are at risk? Explain.
b. What key assertions for the above accounts are likely to be affected?

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, May 2010. Provided courtesy of Chartered Accountants Australia and New Zealand.

5.4 Assertions **Basic** **LO 1**

A client has a material balance in property, plant, and equipment. The discussions with management indicate that there is a risk the client will capitalize some repair costs to minimize the impact on expenses. Repairs are likely to be material because of the extreme weather conditions affecting operations and machinery operating conditions. Extensive repairs were due to commence in the month prior to year end, with completion around two months later.

Required

Based on the above information, what accounts and assertions are likely to be affected? Explain.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, December 2010. Provided courtesy of Chartered Accountants Australia and New Zealand.

[1]**5.5** Confirmations **Basic** **LO 1**

The following are *independent* questions.

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[1] Adapted with permission of the Chartered Professional Accountants of Canada, Toronto, Canada. Any changes to the original material are the sole responsibility of the publisher and have not been reviewed or endorsed by the Chartered Professional Accountants of Canada.

Required

a. List *four* factors that make audit evidence more reliable.

b. Explain the difference between positive and negative confirmations for accounts receivable.

Source: This item was originally published by Certified General Accountants Association of Canada (CGA Canada), as an examination question.

5.6 Identifying assertions and supporting evidence Moderate LO 1

You are engaged to examine the financial statements of Lauzon Inc. for the year ended December 31.

On October 1, Lauzon Inc. borrowed $250,000 from a local bank to finance a plant expansion. The loan agreement provided for the annual payment of principal and interest over three years. Lauzon's existing plant was pledged as security for the loan.

Unfortunately, Lauzon ran into some difficulties in acquiring the new plant site. Thus, the plant expansion was delayed. Lauzon then proceeded to "plan B," which was to invest the borrowed funds in stocks and bonds. As a result, on October 20, the entire amount borrowed was invested in securities.

Required

Identify the assertions applicable to the above, and describe the relevant evidence that needs to be obtained to support them for the audit of investments in securities at December 31.

5.7 Types and persuasiveness of audit evidence Moderate LO 1, 2, 3, 6

Jenna is working on the audit of a client's accounts receivable. During the risk assessment stage, she conducted an audit data analytic using data provided directly by the client, by grouping Accounts Receivable by days overdue to assess the risk of the accuracy, valuation, and allocation assertion and an overstatement of accounts receivable. During the past few weeks, she has conducted interviews with the accounts receivable manager, the CFO, and staff working in the accounts receivable department. She has also overseen the external confirmations of accounts receivable, 30 percent of which required the recipient to respond as to whether or not the amount stated was correct. Jenna also conducted a review of subsequent cash receipts from the client's customers. She vouched a sample of accounts receivable balances back to the underlying invoices, cash receipts, and sales returns, and traced a sample of these documents to the accounts receivable ledger.

Required

a. List the types of audit evidence gathered by Jenna and comment on the persuasiveness of each type.

b. Link each type of evidence to the relevant accounts receivable assertions.

5.8 Identifying types of audit evidence Basic LO 2

Required

Identify the type of audit evidence being used in each situation described below:

a. The auditor tests cash remittance advices to ensure that allowances and discounts are appropriate and that receipts are posted to the correct customer accounts in the right amounts. In addition, the auditor reviews the documents supporting unusual discounts and allowances.

b. The auditor examines vehicle insurance policies and checks insurance expense for the year. In addition, the auditor reviews the changes and ending balances in capital asset accounts.

c. The auditor observes the auditee taking a physical inventory count. In addition, a letter is received from a public storage facility stating the amounts of the auditee's inventory stored in it. The company uses a weighted average cost flow assumption, which is tested by the auditor's computer software program.

d. Using audit software, an auditor selects vendors' accounts payable with debit balances from the client's computer and compares these amounts and their calculation with cash disbursements and vendor credit memos.

5.9 Assertions and evidence Basic LO 1, 2, 3

The auditor is planning for the audit of a specialty retail store. Inventory is material, and items range in value from $1 to over $500. The nature of the store means that the type of merchandise changes every season, and many items are specially ordered with special branding and promotional packaging. Orders are placed six months in advance from overseas suppliers. Large deposits are required to be paid when orders are placed. The auditor believes that the account balances for inventory and prepayments are at risk of material misstatement.

Required

a. Identify the key assertions at risk in relation to inventory and prepayments.

b. For each assertion in part (a), identify a type of evidence that would be persuasive.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, December 2010. Provided courtesy of Chartered Accountants Australia and New Zealand.

5.10 Misstatement risk for depreciation **Moderate** **LO 1, 2, 3**

Yellow Aviation is an existing client of PPP Partners. The auditors are aware that the impact of a global economic slowdown on airlines has been severe, with predictions of a prolonged downturn. Also, as a result of the crisis, airlines have been heavily discounting flights. The client's policies include the following:

Aircraft maintenance costs policy

The standard cost of major airframe and engine maintenance checks is capitalized and depreciated over the shorter of the scheduled usage period to the next major inspection or the remaining life of the aircraft.

Yellow Aviation's latest financial data show the aircraft and engines at cost (including major maintenance costs) to be at a similar level as last year while depreciation costs have decreased by 7 percent.

Required

a. What key assertions for the above accounts are likely to be affected?

b. Explain what evidence would be persuasive in this case.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, May 2010. Provided courtesy of Chartered Accountants Australia and New Zealand.

5.11 Revenue assertions **Moderate** **LO 1, 2, 3**

The audit program for the revenue account for a client has been drafted. The following item appears:

Item	Assertion	Detailed Audit Procedure
1	Completeness	Select a sample of sales from the sales journal and ensure each sales invoice is supported by an authorized delivery slip and approved customer order.

Required

a. Does the procedure address the stated assertion? Explain.

b. If your answer to part (a) is no, provide the correct assertion or explain what work would be required to address the assertion.

c. Explain what type of evidence is obtained by performing the stated procedure. How persuasive is it?

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, July 2010. Provided courtesy of Chartered Accountants Australia and New Zealand.

5.12 Revenue assertions **Moderate** **LO 1, 2, 3**

The audit program for the revenue account for a client has been drafted. The following item appears:

Item	Assertion	Detailed Audit Procedure
2	Cut-off	Select a sample of sales invoices recorded a few days prior to the year end and then agree dates on the invoices to the dates on the delivery documents signed by the customer.

Required

a. Does the procedure address the stated assertion? Explain.

b. If your answer to part (a) is no, provide the correct assertion or explain what work would be required to address the assertion.

c. Explain what type of evidence is obtained by performing the stated procedure. How persuasive is it?

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, July 2010. Provided courtesy of Chartered Accountants Australia and New Zealand.

5.13 Revenue assertions **Moderate** **LO 1, 2, 3**

The audit program for the revenue account for a client has been drafted. The following item appears:

Item	Assertion	Detailed Audit Procedure
3	Accuracy	Select a sample of sales from the sales journal and agree the sale price to the authorized price list.

Required

a. Does the procedure address the stated assertion? Explain.

b. If your answer to part (a) is no, provide the correct assertion or suggest additional work.

c. Explain what type of evidence is obtained by performing the stated procedure. How persuasive is it?

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, July 2010. Provided courtesy of Chartered Accountants Australia and New Zealand.

5.14 Communication with lawyers **Basic** **LO 1, 2, 6**

Conversations between the board of directors of Acme Ltd. and the engagement partner of the financial audit, Angelo Del Santo, have revealed that Acme uses three legal firms. Ball and Partners performs all legal work related to property transfers, mortgages, and planning applications. Brond Associates handles all employment matters, such as claims for unfair dismissal and complex employment contracts. Zimmerman and Co. is retained for all other matters, such as agreements relating to products and suppliers and any international matters.

Required

a. What type of communication should Angelo and his audit team have with each legal firm? Explain.

b. What procedures could Angelo perform to find out whether any other legal firms have performed work for Acme during the financial year?

5.15 Bank reconciliations **Basic** **LO 1, 2, 4**

Mohammad Amed is responsible for preparing bank reconciliations at Ajax Ltd. Ajax has many bank accounts, including separate accounts for each major branch, imprest accounts for salaries and dividends, and accounts kept in foreign currency for overseas divisions. Mohammad maintains records including bank statements and weekly bank reconciliations for each account. In addition, there are files containing correspondence with banks about disputed transactions, dishonoured cheques from Ajax's customers, and other bank-initiated transactions such as fees and interest.

Required

a. Comment on the persuasiveness of the evidence in Mohammad's files for Ajax's financial statement audit.

b. Explain how an auditor would obtain more persuasive evidence for the relevant assertions for the bank accounts at Ajax.

5.16 Using an expert **Basic** **LO 4**

SolarTubeGen is a start-up company in the renewable energy sector. The founder, Fritz Herzberg, has developed cutting-edge technology to convert the energy in the sun's rays to electricity via a novel system of mirrors designed to focus the sun's rays onto tubes containing a patented type of gas, which then heats and expands to drive turbines. KenKen Partners has won the contract for the first statutory audit of SolarTubeGen on the basis of its expertise in the energy sector. However, the lead partner, Ken Kennedy, recognizes that the success of the audit is dependent on the correct assessment of the technology being used at SolarTubeGen. Ken specified in the successful tender documents that the audit will use an external expert to help with valuation of the company's assets.

Fritz Herzberg is very protective of his company's intellectual property and is resistant to Ken's first suggested expert, Manfred Hamburg. Fritz believes that Manfred Hamburg is hostile toward him because they clashed when they both worked for a German company making photovoltaic cells in the 1990s. Fritz has suggested another expert, Lily Beilherz, with whom he has had good working relations over the past 20 years.

Required

Advise Ken Kennedy about the choice of an expert for the audit of SolarTubeGen. What must he consider when making his choice?

5.17 Considering the work of other auditors **Challenging** **LO 5**

Securimax Limited has been an audit client of KFP Partners for the past 15 years. Securimax is based in Waterloo, Ontario, where it manufactures high-tech armour-plated personnel carriers. Securimax often has to go through a competitive market tender process to win large government contracts. Its main product, the small but powerful Terrain Master, is highly specialized, and Securimax does business only with nations that have a recognized, democratically elected government. Securimax maintains a highly secure environment, given the sensitive and confidential nature of its vehicle designs and its clients.

Clarke Field has been the engagement partner on the Securimax audit for the past five years. Clarke is a specialist in the defence industry and intends to remain as review partner when the audit is rotated next year to a new partner (Sally Woodrow, who is to be promoted to partner to enable her to sign off on the audit).

Securimax has a small internal audit department that is headed by an ex-partner of KFP, Rydell Crow. Rydell joined Securimax six years ago, after leaving KFP and completing his Chartered Professional Accountant's qualifications. Rydell is assisted by three junior internal auditors, all of whom are completing undergraduate business studies at the University of Waterloo.

Securimax's financial year end is December 31.

Required

Discuss the effect, if any, of CAS 600 on Clarke Field's consideration of Securimax's internal audit department for the financial statement audit.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, May 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

5.18 Gathering evidence **Moderate** **LO 2, 6**

Max Fillion is a junior auditor who has just started with the team conducting the audit of a new client in the construction industry. Max is "shadowing" Susan Wong, an experienced auditor. Susan is showing Max how to be a member of an audit team and is trying to teach Max about the benefits of getting to know the client. Susan is also trying to help Max develop experience in picking up subtle signals about the client's problems and what the client might be trying to hide from the auditor.

Max is getting a little frustrated with the "shadowing" assignment. He can't understand why Susan is spending so much time talking to the client's staff and touring the various construction sites and offices. When Susan is not doing this, she is working on a spreadsheet of the client's previous financial statements and unaudited interim data. Max wants to know when they are going to do some "real" work and start gathering audit evidence. Susan tells Max that they have already started.

Required

a. Discuss Susan's comment that they have already started the audit. What evidence have they gathered so far?

b. Explain what work is being done with the spreadsheets of financial data. Give some specific examples for this client. How is this type of work relevant to all phases of the audit?

5.19 Documentation **Moderate** **LO 7, 8**

Jennifer Daoust is reading the documents prepared by the members of the team working on the audit of receivables for a large client. Jennifer is the senior manager assisting the engagement partner, Ruby Rogers. Jennifer and Ruby have worked together on many audits and Jennifer knows the types of questions that Ruby will ask about the working papers if they are not up to the standard required by CAS 230. Jennifer is trying to make sure that all documents are up to the required standard before Ruby sees them tomorrow.

Jennifer is particularly concerned about the documents relating to the receivable confirmations. This is because the audit assistant who wrote up the confirmation results said that no further work was required. On review of the results, Jennifer discovered that the audit assistant had incorrectly treated "no reply" results as acceptable for a positive confirmation, when they are acceptable only for a negative confirmation. Jennifer had ordered further work be done to follow up these "no reply" results.

Required

a. What is the minimum standard that the audit documentation must meet?

b. How would you treat the corrections made to the audit assistant's recommendations and the additional work on receivable confirmations in the working papers? Explain. Refer to both CAS 505 and CAS 230 in your answer.

5.20 Documenting the audit **Moderate** **LO 8**

Featherbed Surf & Leisure Holidays Ltd. is a resort company based on Vancouver Island. Its operations include boating, surfing, fishing, and other leisure activities; a backpackers' hostel; a family hotel; and a five-star resort. Justin and Sarah Morris own the majority of the shares in the Morris Group, which controls Featherbed. Justin is the chair of the board of directors of both Featherbed and the Morris Group, and Sarah is a director of both companies as well as the CFO of Featherbed.

While performing the Featherbed audit, you discover that Wave Travel Agency, which specializes in group travel to Vancouver Island, has an account with Featherbed. The review of the aging of the accounts receivable balance shows that Wave Travel Agency's balance is large and material and is now more than 60 days overdue. However, no allowance has been made for the outstanding account. You consult Featherbed's accounting staff, Julie and Kristen, about the account and they mention that there are rumours that Wave Travel Agency is suffering financial difficulties.

You are aware that CAS 230 has specific requirements about documenting audit work. In particular, paragraph 9 states:

In documenting the nature, timing and extent of audit procedures performed, the auditor shall record:

a. The identifying characteristics of the specific items or matters tested;
b. Who performed the audit work and the date such work was completed; and
c. Who reviewed the audit work performed and the date and extent of such review.

In addition, paragraph 10 states:

The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place.

Required

Explain how you would apply the mandatory requirements of the above paragraphs of CAS 230 in relation to the potential bad debt.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, May 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

Questions 5.21 and 5.22 are based on the following case.

Fellowes and Associates Chartered Professional Accountants is a successful mid-tier accounting firm with a large range of clients across Canada. In April 2023, Fellowes and Associates gained a new client, Health Care Holdings Group (HCHG), which owns 100 percent of the following entities:

- Shady Oaks Centre, a private treatment centre
- Gardens Nursing Home Ltd., a private nursing home
- Total Laser Care Limited, a private clinic that specializes in the laser treatment of skin defects

The year end for all HCHG entities is June 30.

You are performing the audit field work for the 2023 year for Shady Oaks Centre. The fieldwork must be completed in time for the audit report to be signed on August 21, 2023. You have been asked to circulate the receivable confirmations. Shady Oaks Centre's trade receivables arise from the use of clinic facilities (including the provision of medical professionals, treatment rooms, and supplies) by medical practitioners in private practice. The trade receivables balance was $3,974,569 as at June 30, 2023, and was considered material.

The centre's payment terms are 14 days from the date of the invoice. Sixty percent of the balance is represented by invoices outstanding from five different medical practitioners. The remaining 40 percent is made up of numerous smaller amounts, most of which have been outstanding for more than 60 days. Any allowance for doubtful accounts is taken directly against the trade receivables account and not shown separately.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, December 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

5.21 Confirmation evidence **Moderate** **LO 2, 3, 6**

Required

Discuss the strengths and weaknesses of accounts receivable confirmations as audit evidence for Shady Oaks Centre.

5.22 Adequacy of documentation and audit evidence **Challenging** **LO 2, 6, 8**

Required

Is it possible for Fellowes and Associates to use only accounts receivable confirmations as audit evidence and adhere to the mandatory requirements in CAS 230? Explain.

5.23 Location of file documentation **Basic** **LO 8**

Required

For each of the following documents, state whether it would be located in the auditors' permanent file or the current file.

a. Articles of incorporation
b. Bank confirmation for the current year
c. Management representation letter for the current year
d. Long-term debt agreement
e. Organization chart
f. Process documentation for payroll
g. Details of employment contracts regarding stock options
h. Engagement letter
i. Board of directors minutes for the current year
j. Audit program for cash

5.24 Working paper errors and omissions **Basic** **LO 8**

Required

The working paper in **figure 5.11** was prepared by James Parkhill, a first-year accountant. Find *seven* errors or omissions that James made while completing this working paper.

	A	B	C	D	E	F	G
1	**New Millennium Ecoproducts**						
2	**Year End: December 31, 2023**						
3	Cash						
4							
5							
6							
7							
8	**Account**	**Prelim**	**Adj's**	**Reported**		**Rep 12/22**	**% Chg**
9							
10							
11	1004 CIBC - C$ 0910934	501,631.48	0.00	**501,631.48**	A-10	207,013.35	**142**
12	1005 CIBC - U.S.$ 0981298	47,803.91	0.00	**47,803.91**	A-12	128,193.65	**-63**
13	1006 CIBC Bank - C$ savings	163,173.08	0.00	**163,173.08**	A-14	162,497.05	**0**
14	1060 Petty Cash	500.00	0.00	**500.00**		400.00	**-100**
15		**713,108.47**	**0.00**	**713,108.47**		**498,104.05**	**43**
17							
18	Comment: The controller reconciles the bank on a monthly basis.						

FIGURE 5.11 **Working paper**

5.25 Integrative case study— IndaCar **Challenging**

IndaCar Inc. (IC) operates a high-end car rental agency that specializes in the rental of unique vehicles and is located next to Lester B. Pearson International Airport in Toronto. IC is a private Canadian company that is wholly owned by Jake Bouvier.

Daytona Lemans LLP, Chartered Professional Accountants (DL), has reviewed IC's annual financial statements since IC was founded five years ago and has experienced no significant problems when performing the previous review engagements. You just found out you are the manager on the job for this year.

As a result of IC's success in Toronto, Jake is exploring the possibility of expanding IC's operations to include the Vancouver and Calgary airports. Jake expects that he will be using IC's fiscal 2023 financial statements to attract equity investors to partially finance this expansion.

To maximize IC's share value attractiveness to potential investors, Jake is wondering if he should have the financial statements audited.

Jake commented that he received a tip from one of the employees at the Pearson location that the manager is stealing cash. He wants to know if the regular audit engagement is likely to identify whether cash is being stolen and what procedures the auditor is likely to perform in this risk area.

You have reviewed the fiscal 2022 engagement file in order to familiarize yourself with the client and to review the planning documentation prepared for the previous year's engagement.

IndaCar Inc. Balance Sheet As at December 31 (in thousands of dollars)		
	2023 (unaudited)	**2022** (reviewed)
Assets		
Cash	$ 1,453	$ 162
Accounts receivable	1,142	130
Inventory	1,270	1,140
Prepaid expenses	112	3
	3,977	1,435
Property, plant, and equipment (net)	20,657	14,465
Investments	2,000	–
	22,657	14,465
	$26,634	$ 15,900
Liabilities		
Bank operating loan	$ 90	$ 100
Accounts payable and accrued liabilities	1,225	166
	1,315	266
Long-term debt	1,260	200
	2,575	466
Shareholders' equity		
Common shares	100	100
Retained earnings	23,959	15,334
	24,059	15,434
	$26,634	$ 15,900

EXCERPTS FROM THE INCOME STATEMENT For the years ended December 31 (in thousands of dollars)		
	2023 (unaudited)	**2022** (reviewed)
Revenues		
Car rentals	$22,710	$14,300
Investment income	6,085	4,485
	28,795	18,785
Expenses		
Vehicle operations, including depreciation	10,670	8,870
Rent and administration	995	810
Wages and salaries	7,200	6,675
Total expenses	18,865	16,355
Income before income tax	9,930	2,430
Income tax	1,305	780
Net income	$ 8,625	$ 1,650

Required

a. Advise Jake on the costs and benefits of upgrading from a review engagement to an audit engagement.

b. In planning the audit, the auditor must consider audit risk. Using the above case facts, make an inherent risk assessment.

c. If the auditor decides that control risk is high, what type of audit will DL perform? How will this impact the amount of audit work?

d. Calculate and conclude on the most appropriate planning materiality, and include a detailed explanation supporting your decision.

e. For the following accounts, what assertions will the auditor be most concerned with? What evidence should the auditor gather to verify management's assertions?

1. Accounts receivable
2. Property, plant, and equipment
3. Accounts payable
4. Long-term debt
5. Car rental sales

Case Study—Cloud 9

W&S Partners will need the assistance of auditors in China and the United States and may need derivatives experts to complete the Cloud 9 audit.

The other auditors will be asked to provide evidence about the inventory shipped to Canada from the production plants in these countries. Although the inventory is shipped FOB (free on board) shipping point, there have been several occasions where the shipping agent was unable to place the inventory on a ship. In these cases, the inventory is stored in the shipping agent's warehouse until a vessel is made available. Suzie has some concerns about the quality of the warehouses, because if the goods are damaged they could become worthless and the value of "goods in transit" will be overstated.

Answer the following questions based on the information presented for Cloud 9 in Appendix A at the end of this book and the current and earlier chapters. You should also consider your answers to the case study questions in earlier chapters.

Required

a. Explain the procedures for engaging component auditors to perform the work on the inventory in China and the United States.

b. It has been determined that Suzie does not need to engage a derivatives expert. However, Weijing Fei, who is studying to be a CPA, asks Suzie a number of questions about when an expert is used in an audit. Suzie asks you to answer the following questions regarding the qualities the expert should possess. What procedures with respect to an expert must be performed by an auditor? What should the expert be told about the engagement? What must the expert give to the auditor so that she can be sure she has sufficient appropriate evidence with respect to the subject matter? Can the expert do all the work on the account or transactions, or must the auditor perform any other procedures?

c. Assume you are engaging the component auditors. Create a memo to the working paper file for this task.

Research Question 5.1

Obtain the latest annual report (from www.sedar.com) of a large multinational Canadian company (for example, one of the large banks or mining companies).

Required

a. What information is given in the annual report about the use of any component auditors, other than the Canadian audit firm issuing the audit report? If any other auditors are mentioned, what work do you think these auditors performed?

b. Is there any information given in the annual report about the auditor's use of an expert? What sort of work would an expert have performed for the audit of your chosen company?

Appendix 5A: Sample Documents Auditors Frequently Encounter

Note: This appendix includes a sample of common documents an auditor may request from a client. It is provided for demonstration purposes. The documents are stand-alone documents.

Soft Soles Inc.
Trial Balance
December 31, 2023

Account Number	Account Description	Debits	Credits	Account Number	Account Description	Debits	Credits
1020	Cash Operating Account	84,679.00	0.00	2375	HST Paid on Purchases	123,450.00	0.00
1030	Cash Savings Account	2,400.00	0.00	2620	Bank Loans	0.00	787,500.00
1050	Petty Cash	786.00	0.00	3350	Common Shares	0.00	100.00
1055	Cash-Store Locations	500.00	0.00	3560	Retained Earnings—Previous Year	0.00	599,622.45
1200	Accounts Receivable	153,469.50	0.00	4200	Sales	0.00	2,057,500.00
1205	Allowance for Doubtful Accounts	0.00	14,518.05	4440	Interest Revenue	0.00	4,543.00
1320	Prepaid Expenses	3,004.00	0.00	5020	Cost of Sales (COS) Stores	1,028,750.00	0.00
1520	Inventory	52,100	0.00	5300	Freight Expense	11,511.00	0.00
1530	Goods in Transit	4,530.00	0.00	5410	Wages & Salaries	653,345.00	0.00
1540	Allowance for Obsolescence	0.00	417.00	5610	Accounting & Legal	16,536.00	0.00
1820	Office Furniture & Equipment	17,689.00	0.00	5615	Advertising & Promotions	15,643.00	0.00
1825	Accum. Deprec.—Furn. & Equip.	0.00	12,838.00	5620	Bad Debts	5,423.00	0.00
1860	Building	13,248.00	0.00	5625	Business Fees & Licences	1,357.00	0.00
1865	Accum. Deprec.—Building	0.00	3,606.00	5660	Depreciation Expense	2,580.00	0.00
1880	Land	1,704,933.00	0.00	5680	Income Taxes	27,807.00	0.00
2100	Accounts Payable	0.00	56,984.00	5685	Insurance	2,065.00	0.00
2120	Other Accrued Expenses	0.00	49,875.00	5690	Interest & Bank Charges	563.00	0.00
2130	Warranty Provision	0.00	9,145.00	5700	Office Supplies	2,450.00	0.00
2160	Corporate Taxes Payable	0.00	35,854.00	5760	Rent	23,187.00	0.00
2170	Vacation Payable	0.00	15,654.00	5765	Repairs & Maintenance	2,643.00	0.00
2180	EI Payable	0.00	14,935.00	5780	Telephone	1,458.00	0.00
2185	CPP Payable	0.00	20,909.00	5784	Travel & Entertainment	1,654.00	0.00
2190	Federal Income Tax Payable	0.00	35,833.00	5790	Utilities	8,973.00	0.00
2370	HST Charged on Sales	0.00	246,900.00			3,966,733.50	3,966,733.50

FIGURE 5A.1 **Trial balance at year end**

Soft Soles Inc.
Excerpt from General Ledger from the month of January 2023
Sorted By: Transaction Number

	Date	Comment	Source #	Trans. No.	Debits	Credits	Balance
1020 Cash Operating Account							80,000.00 Dr
	1/7/2023	Bank deposit	1	J11	18,450.00	0.00	98,450.00 Dr
	1/13/2023	Bank deposit	1	J17	14,679.00	0.00	113,129.00 Dr
	1/13/2023	Soft Soles Inc.	1	J18	0.00	35,575.00	77,554.00 Dr
	1/23/2023	Bank deposit	1	J20	44,751.50	0.00	122,305.50 Dr
					77,880.50	35,575.00	
1030 Cash Savings Account							2,400.00 Dr
1040 Petty Cash							200.00 Dr
1055 Cash- Store Locations							500.00 Dr
1200 Accounts Receivable							65,222.00 Dr
	1/3/2023	Sports Galore	1	J1	565.00	0.00	65,787.00 Dr
	1/3/2023	Cross Country Sports	200	J5	13,750.00	0.00	79,537.00 Dr
	1/4/2023	Grandview Sportswear	201	J6	39,000.00	0.00	118,537.00 Dr
	1/5/2023	Meyer Sports	202	J7	20,450.00	0.00	138,987.00 Dr
	1/7/2023	Meyer Sports	203	J11	0.00	18,450.00	120,537.00 Dr
	1/9/2023	Rebel Sports	207	J12	18,439.50	0.00	138,976.50 Dr
	1/9/2023	Meyer Sports	208	J13	19,500.00	0.00	158,476.50 Dr
	1/9/2023	Rebel Sports	209	J14	7,125.00	0.00	165,601.50 Dr
	1/9/2023	The Soccer Store	210	J15	19,500.00	0.00	185,101.50 Dr
	1/11/2023	Cross Country Sports	211	J16	20,580.00	0.00	205,681.50 Dr
	1/13/2023	Meyer Sports	1	J17	0.00	4,000.00	201,681.50 Dr
	1/13/2023	Rebel Sports	2	J17	0.00	10,679.00	191,002.50 Dr
	1/13/2023	Soccer Stars	3	J19	24,725.00	0.00	215,727.50 Dr
	1/23/2023	Grandview Sportswear	5	J20	0.00	23,225.00	192,502.50 Dr
	1/23/2023	Cross Country Sports	6	J20	0.00	21,256.50	171,246.00 Dr
					183,634.50	77,610.50	

FIGURE 5A.2 **Partial general ledger from the month of January 2023**

Soft Soles Inc.
Aged Overdue Sales Invoices Summary
As at December 31, 2023

Name	Total Due	Total Current	Total Overdue	1 to 30 Overdue	31 to 60 Overdue	61 to 90 Overdue
Cross Country Sports	26,979.00	26,979.00	0.00	0.00	0.00	0.00
Grandview Sportswear	31,000.00	30,000.00	1,000.00	1,000.00	0.00	0.00
Meyer Sports	26,239.00		26,239.00	0.00	23,239.00	3,000.00
Rebel Sports	35,225.00	13,850.00	21,375.00	11,375.00	5,000.00	5,000.00
Sports Galore	21,526.50	11,526.50	10,000.00	10,000.00	0.00	0.00
The Soccer Store	12,500.00	12,000.00	500.00	500.00	0.00	0.00
Total outstanding:	153,469.50	94,355.50	59,114.00	22,875.00	28,239.00	8,000.00

FIGURE 5A.3 **Accounts receivable trial balance**

Soft Soles Inc.
Customer Master File

Customer Number	Name	Contact	Street	City	Province	Postal Code	Balance Approved Credit Limit
12001	Cross Country Sports	Jack Williams	106 Ave	Vancouver	British Columbia	V2S 9G2	25,000.00
12002	Grandview Sportswear	Frank Johnstone	2315 Erie Road	Toronto	Ontario	L4S 9G3	15,000.00
12003	Meyer Sports	Franklin White	100 Brand Road	Winnipeg	Manitoba	R3W 1Q6	50,000.00
12004	Rebel Sports	Elizabeth Franklin	PO Box 22, Station A	Toronto	Ontario	L4D 9G3	25,000.00
12005	Sports Galore	John Johnson	65 How Street	Guelph	Ontario	N3E 9H2	10,000.00
12006	The Soccer Store	Cindy Black	66 Charlottetown Place	St. John’s	NL	A1A 9N0	15,000.00

FIGURE 5A.4 **Master file**

Soft Soles Inc.
PURCHASE REQUISITION

		Req. No.	322
		Date:	Jan. 2, 2023
SUPPLIER NAME	**ADDRESS - CITY, PROVINCE, POSTAL CODE:**		
Skyward Ltd.	Toronto, Ontario		

Department	Purchasing
Method of Shipment	
Ship to Attention of:	Merchandising Division
Required Delivery Date:	Jan. 16, 2023
Authorization Number	TBD

Item	Quantity	Part No.	Description	UM	Price	Total
238902	100		Cloud Comfort Walking Shoe	ea		

REQUESTED BY: John King, Merchandising Manager

APPROVED BY:

FIGURE 5A.5 **Purchase requisition**

PURCHASE ORDER

Soft Soles Inc.
100 Anywhere Street
Vancouver, BC

P.O. NO. 322
DATE January 6, 2023
CUSTOMER ID CLO9

VENDOR
Skyward Ltd.
Toronto, Ontario
(416) 999-9999

SHIP TO
Soft Soles Inc.
100 Anywhere Street
Vancouver, BC
604-555-5566

SHIPPING METHOD	SHIPPING TERMS	DELIVERY DATE
Courier		1/16/23

QTY	ITEM #	DESCRIPTION	JOB	UNIT PRICE	LINE TOTAL
100 each	238902	Cloud Comfort Walking Shoe		$ 50.00	$ 5,000.00
				SUBTOTAL	$ 5,000.00
				GST 5%	250.00
				PST 7%	350.00
				TOTAL	**$ 5,600.00**

1. Please send two copies of your invoice.
2. Enter this order in accordance with the prices, terms, delivery method, and specifications listed above.
3. Please notifiy us immediately if you are unable to ship as specified.
4. Send all correspondence to:

Soft Soles
100 Anywhere Street
Vancouver, BC

Authorized by *Date*

FIGURE 5A.6 **Purchase order**

Receiving Report

Soft Soles Inc.
100 Anywhere Street
Vancouver, BC
604-555-5566

Date: January 12, 2023

Received from: Skyward Ltd.
Toronto, Ontario
Phone 416-999-9999
Fax 416-999-9991

Item #	Description	Quantity
238902	Cloud Comfort Walking Shoe	100 ea

Received by
Isha Manjoo

FIGURE 5A.7 **Receiving report**

Skyward

Packaging Slip/Shipping Document

Skyward Ltd.
Toronto, Ontario
Phone 416-999-9999
Fax 416-999-9991

Date: January 12, 2023
Customer ID: SoftSo

Ship to: Soft Soles Inc.
100 Anywhere Street
Vancouver, BC
604-555-5566

Bill to: Same as Ship To

Order Date	Order Number	
1/6/23	322	

Item #	Description	Quantity
238902	Cloud Comfort Walking Shoe	100 ea

Please contact Customer Service at (416) 999-9999 with any questions or concerns.

Thank you for your business!

FIGURE 5A.8 **Packaging slip/shipping document**

Skyward

Skyward Ltd.
Toronto, Ontario
Phone 416-999-9999 Fax 416-999-9991

INVOICE

Date: 01/16/2023
Invoice # 214

Bill To:
Soft Soles Inc.
100 Anywhere Street
Vancouver, BC
604-555-5566

Ship To:
Same as Bill to

Comments or Special Instructions: None

QUANTITY	DESCRIPTION	UNIT PRICE	AMOUNT
100	238902 Cloud Comfort Walking Shoe	$ 50.00	$ 5,000.00
		SUBTOTAL	$ 5,000.00
		GST 5%	250.00
		PST 7%	350.00
		SHIPPING & HANDLING	–
		TOTAL	$ 5,600.00

Make all cheques payable to Skyward Ltd.
If you have any questions concerning this invoice, call Accounts Receivable, Skyward, 604-999-9998

THANK YOU FOR YOUR BUSINESS!

FIGURE 5A.9 **Sales invoice**

Skyward

Date: 1/16/2023
Statement # 101

Skyward Ltd.
Toronto, Ontario
Phone 416-999-9999
Fax 416-999-9991

To:
Soft Soles Inc.
100 Anywhere Street
Vancouver, BC
604-555-5566

Please Attach with Payment

Remittance:

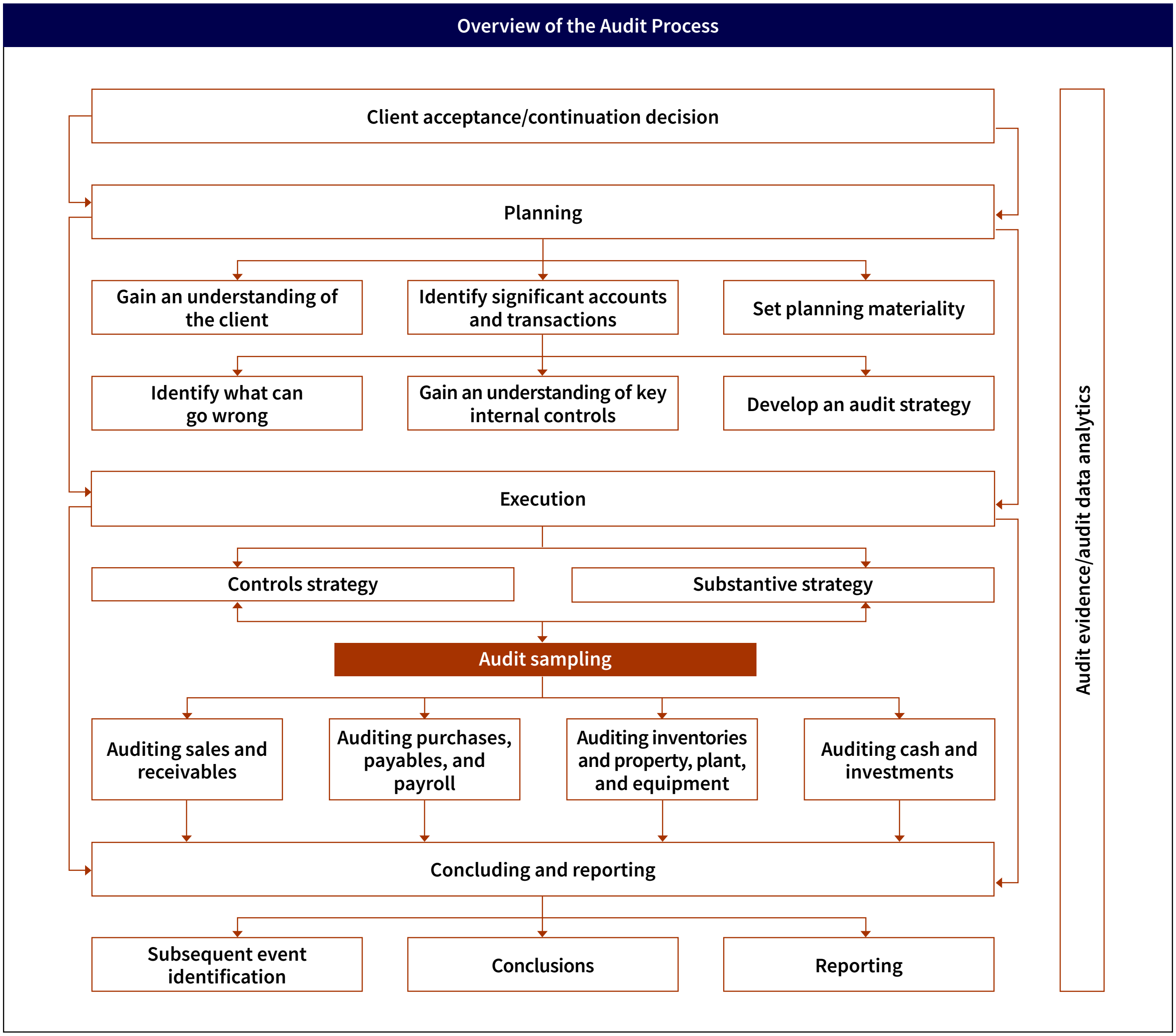
Statement #	101
Date	
Amount Enclosed	

Make all cheques payable to Skyward Ltd.

Thank you for your business!

FIGURE 5A.10 **Remittance advice**

Sampling and Overview of the Risk Response Phase of the Audit



LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
After studying this chapter, you should be able to:		Standards addressed in each learning objective are as follows:
1 Explain when and how audit sampling is used in an audit	**6.1** Audit Sampling	CAS 530 *Audit Sampling*
2 Understand the difference between sampling and non-sampling risk	**6.2** Sampling and Non-Sampling Risk **6.2.1** Sampling risk and tests of controls **6.2.2** Sampling risk and substantive procedures **6.2.3** Non-sampling risk	CAS 530 *Audit Sampling*
3 Differentiate between statistical and non-statistical sampling	**6.3** Statistical and Non-Statistical Sampling	CAS 530 *Audit Sampling*
4 Describe sampling methods and the factors to be considered when choosing a sample	**6.4** Sampling Techniques and Factors Affecting Sampling **6.4.1** Sampling techniques **6.4.2** Factors to consider when selecting a sample	CAS 530 *Audit Sampling*
5 Determine the factors that influence the sample size when testing controls	**6.5** Factors that Influence the Sample Size—Testing Controls	CAS 530 *Audit Sampling*
6 Determine the factors that influence the sample size when doing substantive testing and consider techniques used to perform substantive tests	**6.6** Factors that Influence the Sample Size—Substantive Testing **6.6.1** Factors that influence sample size when performing substantive tests **6.6.2** Techniques for performing substantive tests	CAS 530 *Audit Sampling*
7 Outline how to evaluate the results of tests conducted on a sample	**6.7** Evaluating Sample Test Results	CAS 530 *Audit Sampling*
8 Understand the difference between tests of controls and substantive tests	**6.8** Tests of Controls and Substantive Procedures **6.8.1** Tests of controls **6.8.2** Substantive procedures	CAS 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Canadian Auditing Standards* CAS 300 *Planning an Audit of Financial Statements*
9 Explain the factors that impact the nature, timing, and extent of audit testing	**6.9** Nature, Timing, and Extent of Audit Testing **6.9.1** Nature of audit testing **6.9.2** Timing of audit testing **6.9.3** Extent of audit testing	CAS 330 *The Auditor's Responses to Assessed Risks*

Cloud 9 Integrated Case

Another issue that arises at the Cloud 9 Ltd. audit planning meeting is the appropriate scheduling of the control and substantive tests and the sampling criteria. After the meeting finishes, Ian Harper asks Suzie Pickering to coffee again. He wants her to explain how they can plan these tests and write a detailed audit program, including instructions on how to select the sample.

Suzie is happy to drink more coffee and meets Ian that afternoon at their local café. "The sort of tests we have to do, and when and how we do them, depends on the quality of the client's accounting records. However, before we talk about that, we should probably talk about how we use sampling. In most cases, we don't test every transaction or control. We use sampling, conduct the tests on the sample, and then project the results back to the population." Ian indicates he understands the idea of sampling—it saves a lot of time and money. "But do you understand the risks involved in sampling?" Suzie asks.

Chapter Preview

The purpose of this chapter is to provide an overview of audit sampling and to introduce, compare, and contrast tests of controls and substantive testing.

Audit sampling involves the selection of transactions or accounts within a balance for testing. It is used when the auditor plans on testing less than the entire population of transactions or accounts in a balance available for testing. When selecting a sample, it is important that the items chosen for testing be representative of the entire population of transactions and accounts available for testing. Sampling risk is the risk that the sample chosen is unsuitable and, as a consequence, the auditor arrives at an inappropriate conclusion after testing the sample. Non-sampling risk refers to other factors that result in an auditor arriving at an inappropriate conclusion. Both sampling and non-sampling risk are explained in this chapter.

Sampling can be conducted using statistical or non-statistical methods. These terms are explained and the benefits and drawbacks of each group of techniques are discussed in this chapter. We then provide an overview of different techniques that are used to select a sample during an audit.

The sample size chosen will be affected by a range of factors. Those factors will be different if the sample is selected for tests of controls or for substantive procedures. The factors that influence the final sample size when testing controls or conducting substantive tests are explained in this chapter. Finally, we explain how the results of testing are evaluated when a sample is used. It is vital that an appropriate assessment method be used to generalize the findings for a sample to the entire population. The next section of this chapter provides an overview of the risk response phase of the audit. This phase involves the testing of controls and conducting substantive procedures in line with the auditors' strategy.

6.1 Audit Sampling

LEARNING OBJECTIVE 1

Explain when and how audit sampling is used in an audit.

CAS 530 *Audit Sampling* provides guidance on **audit sampling**. When creating an **audit plan** and designing audit procedures, an auditor decides how to select appropriate items for testing. If a population consists of a small number of large-dollar items, the auditor may test an entire group of transactions (for example, the purchase of machinery) or all items within an account balance (for example, motor vehicles). In these cases, sampling is not required. Similarly, software systems now exist that allow the auditor to perform audit data analytics and examine entire populations. For example, during the risk assessment stage, software now makes it possible for the auditor to examine entire populations using graphs and charts. In these cases, sampling is also not required. However, where there are numerous transactions or items within an account balance available for testing, and it is not possible or appropriate to test the entire population, an auditor should use audit sampling to test that population.

audit sampling the application of audit procedures to less than 100 percent of items within a population

audit plan details of the audit procedures to be used when testing controls and when conducting detailed substantive procedures

How does the auditor decide whether to use an audit data analytic and test the entire population or to use audit sampling? The first consideration is the quality of the data. To perform an audit data analytic, the auditor must have good quality data. This means the data are accurate, complete, and produced from a system of effective internal controls. If a dataset includes numerous errors or it is not complete, then the controls over the data are not effective and an audit data analytic is likely not appropriate. So, when there are issues with data quality, audit sampling would be more appropriate. The second consideration is that the auditor must also consider the availability of the data and whether it is efficient to perform an audit data analytic. If the data are not readily available, or if it will take enormous amounts of time to prepare the data for testing, then it may be more efficient to use audit sampling. The third consideration is that the nature of the account and data may determine the type of test. If an account consists of a large dataset in electronic form, an audit data analytic may be a good choice. If the population is small or the data are not available in an electronic format, then sampling would be a better choice. Lastly, there are times when auditing standards require sampling. For example, if material, an auditor is required to inspect a client's inventory and perform test counts. Sampling would be used to select the population of inventory items to examine.

In situations when the auditor uses sampling, an auditor must decide how to select a sample that is representative of the entire population of items available for testing.

As defined previously, audit risk is the risk that an auditor expresses an inappropriate opinion when the financial statements are materially misstated. There are two elements to that risk: the risk associated with using sampling for testing, known as sampling risk, and other risks, known as non-sampling risks.

Before You Go On

6.1.1 What is audit sampling?

6.1.2 When is it appropriate to use audit sampling?

6.1.3 How does audit sampling relate to audit risk?

6.2 Sampling and Non-Sampling Risk

LEARNING OBJECTIVE 2

Understand the difference between sampling and non-sampling risk.

sampling risk the risk that the sample chosen by the auditor is not representative of the population available for testing and, as a consequence, the auditor arrives at an inappropriate conclusion

Sampling risk is the risk that the sample chosen by the auditor is not representative of the population of transactions or items within an account balance available for testing and, as a consequence, the auditor arrives at an inappropriate conclusion (CAS 530). There are two consequences of sampling risk: the risk that the audit will be ineffective and the risk that the audit will be inefficient.

6.2.1 Sampling Risk and Tests of Controls

When testing controls, sampling risk is the risk that an auditor relies on their client's system of internal controls when they should not do so (that is, the auditor concludes that the client's internal controls are effective when they are ineffective), and the risk that an auditor concludes that the client's internal controls are less reliable than they really are (that is, the auditor concludes that the client's internal controls are ineffective when they are effective). **Table 6.1** provides details of sampling risk when testing controls and the implications of that risk for the audit.

TABLE 6.1 Sampling risk when testing controls

Sampling Risk	Implications for the Audit
The risk that the auditor concludes that the client's system of internal controls is effective when it is ineffective	An increased audit risk (that is, the risk that the auditor will issue an inappropriate audit conclusion)
The risk that the auditor concludes that the client's system of internal controls is ineffective when it is effective	An increase in audit effort when not required (that is, there is a risk that the audit will be inefficient)

In the top section of table 6.1, the auditor has tested their client's system of internal controls and concluded that the system is effective when it is, in fact, ineffective at preventing and detecting potential material misstatements. Another way of stating this risk is that an auditor has concluded that the client's system of internal controls is *more* effective than it is. As a consequence, the auditor places too much reliance on the client's system of internal controls to identify and rectify material misstatements.

This can happen when the items selected for testing the effectiveness of the internal controls are not representative of all items available for testing. For example, a manager is away on vacation for two weeks during the year and another member of the client's personnel acts as manager during their absence. The auditor selects items for testing throughout the year, but the sample does not include transactions processed while the manager was on vacation. There is a risk that the auditor concludes that the controls that involve the manager's supervision and authorization are effective throughout the year, when they may not have worked effectively during the two-week vacation period.

From the audit risk model, we know that when an auditor concludes that their client's system of internal controls is effective at preventing and detecting material misstatements, control risk will be assessed as low and the audit strategy will be to reduce reliance on detailed substantive testing of transactions and balances. By conducting fewer substantive procedures, there is an increased risk that the auditor's detailed substantive procedures will not detect a material misstatement (that is, there is a risk that the audit will be ineffective if the auditor's original risk assessment was wrong).

In the bottom section of table 6.1, the auditor has tested their client's system of internal controls and concluded that the system is ineffective when it is, in fact, effective at preventing and detecting potential material misstatements. Another way of stating this risk is that an auditor has concluded that the client's system of internal controls is *less* effective than it is. As a consequence, the auditor does not place sufficient reliance on the client's system of internal controls. This can happen when the items selected for testing the effectiveness of the internal controls are not representative of all items available for testing. For example, a client has a control procedure requiring authorization of purchases in excess of $200,000. The auditor selected purchase orders from one division of the company. The auditor has found the control to be ineffective because the manager has not signed all purchase orders selected. In this example, the auditor runs the risk of placing less reliance on this control than strictly necessary because they did not select the sample from across all divisions, where the control may be working more effectively.

From the audit risk model, we know that when an auditor concludes that their client's system of internal controls is ineffective at preventing and detecting potential material misstatements, control risk will be assessed as high and the audit strategy will be to increase reliance on detailed substantive testing of transactions and balances. By conducting more substantive procedures when control risk is lower than assessed, the audit will be inefficient because the auditor will spend more time conducting substantive procedures than is necessary.

6.2.2 Sampling Risk and Substantive Procedures

When conducting substantive tests, sampling risk is the risk that an auditor concludes that a material misstatement does not exist when it does or an auditor concludes that a material

TABLE 6.2 Sampling risk when conducting substantive tests

Sampling Risk	Implications for the Audit
The risk that the auditor concludes that a material misstatement does not exist when it does	An increased audit risk (that is, the risk that the auditor will issue an inappropriate audit conclusion)
The risk that the auditor concludes that a material misstatement exists when it does not	An increase in audit effort when not required (that is, there is a risk that the audit will be inefficient)

misstatement exists when it does not. **Table 6.2** provides details of sampling risk when conducting substantive tests and the implications of that risk for the audit.

In the top section of table 6.2, the auditor has conducted substantive procedures on a sample and concluded that there is no material misstatement when there is a material misstatement. As a consequence, the auditor will conclude that the financial statements are fairly presented when they contain a material misstatement (that is, the audit is ineffective). For example, a client has warehouses in four major cities. The auditor has selected a sample of inventory items for testing. The entire sample of inventory selected for testing is located in the one warehouse near the client's head office. The auditor has not tested material inventory items held at the other three warehouses. As a consequence, the auditor has not detected a significant error in valuing inventory at one of the warehouses. If the auditor had selected a sample for testing from each warehouse, the risk of arriving at an incorrect conclusion would have been reduced, though not eliminated (that is, sampling risk can be reduced though it can never be removed).

In the bottom section of table 6.2, the auditor has conducted substantive procedures on a sample and concluded that there is a material misstatement when there is no material misstatement. As a consequence, the auditor will conduct more extensive testing, reducing audit efficiency. For example, an error occurred when processing credit sales and a customer was charged twice for the same item by mistake. The auditor detects this error and concludes that, if this error was to be repeated throughout the remainder of the population of credit sales, trade receivables would be materially misstated. As a consequence, the auditor increases testing to uncover the cause of the error. If the error is an anomaly and not repeated throughout the population, the audit will be inefficient.

6.2.3 Non-Sampling Risk

non-sampling risk the risk that the auditor reaches an inappropriate conclusion for any reason not related to sampling risk

Non-sampling risk is the risk that an auditor arrives at an inappropriate conclusion for a reason unrelated to sampling issues. This can occur when an auditor uses an inappropriate audit procedure, relies too heavily on unreliable evidence, or spends too little time testing the accounts most at risk of material misstatement.

When testing controls, non-sampling risk is the risk that an auditor designs tests that are ineffective and do not provide evidence that a control is operating properly. For example, a client uses passwords to restrict access to its computer programs. To test that the passwords are operating effectively, an auditor observes client personnel accessing programs using their passwords. This test is not effective in assessing whether the client's programs prevent access to users with invalid passwords, since the test is focused on users with valid passwords. An effective test would be to enter invalid passwords to see if access is denied. In another example, an auditor is aware that the client has a new credit policy, which places more restrictions on sales to credit customers with amounts overdue. To test the new policy, the auditor reads the client's policy manual, finds the details of the policy change, and concludes that the internal control procedure is effective. Reading the policy manual is not a test of the control. The auditor would need to select some overdue accounts receivable and check that the new policy had been enforced.

When conducting substantive procedures, there are a number of non-sampling risks. One non-sampling risk is the risk that an auditor relies too heavily on less persuasive evidence. For example, an auditor may rely too heavily on management representations without gathering independent corroborating evidence. Non-sampling risk is also the risk that an auditor spends most of their time testing assertions where the risk of material misstatement is low and ignores or spends insufficient time testing assertions most at risk of material misstatement. For example, a client sells pearls. There is a significant risk that recorded inventory does not exist, yet the auditor spends more time testing for completeness.

Cloud 9 Integrated Case

Ian is a bit disappointed. "I thought that, if you took a random sample and did not find any errors, you could conclude that there was definitely no error in the overall population. But you are saying that there is still a risk that the population has errors."

"That's right," says Suzie. "Unless you test every item in the population, you will still have a statistical chance of making the wrong conclusion simply because you took a sample. Also, if you take a sample in a way that is biased, it is difficult to conclude that the sample results say anything at all about the population. That's why it is so important that junior staff don't just take the nearest, or most convenient, box of documents to test. Another big trap is that some part of the accounting period has different conditions, such as that a key member of the client's staff is on holidays. The auditor has to recognize this and make sure that the relevant period is included in the sample. We know that Cloud 9 opened its new Toronto store on the first of June. Obviously, inventory levels will be different around this time, so we have to plan to handle these different conditions with our sampling."

Before You Go On

6.2.1 What is sampling risk?

6.2.2 How does sampling risk relate to tests of controls and substantive testing?

6.2.3 What is non-sampling risk?

6.3 Statistical and Non-Statistical Sampling

LEARNING OBJECTIVE 3

Differentiate between statistical and non-statistical sampling.

According to CAS 530, **statistical sampling** involves random selection and probability theory to determine the sample size and evaluate the results, including sampling risk. Any sample selection method that does not incorporate random selection and probability theory is not statistical sampling; for example, when an auditor uses judgement alone to select the sample size and the items to include in the sample for testing. An advantage of statistical sampling is that it allows an auditor to measure sampling risk; that is, the risk that the sample chosen by the auditor is not representative. Sometimes a disadvantage of statistical sampling is the cost involved in using this technique.

statistical sampling an approach to sampling where random selection is used to select a sample and probability theory is used to evaluate the sample results

Non-statistical sampling is easier to use than statistical sampling, costs less, requires less staff training, and allows an auditor to select a sample that they believe is appropriate. Most audit firms use a combination of statistical and non-statistical sampling because both methods provide appropriate audit evidence and allow the auditor to form a conclusion on the items being tested. The next section of this chapter includes a discussion of various statistical and non-statistical sampling techniques.

non-statistical sampling any sample selection method that does not have the characteristics of statistical sampling

Before You Go On

6.3.1 What is statistical sampling?

6.3.2 What is non-statistical sampling?

6.3.3 What are the advantages and disadvantages of statistical and non-statistical sampling?

6.4 Sampling Techniques and Factors Affecting Sampling

LEARNING OBJECTIVE 4

Describe sampling methods and the factors to be considered when choosing a sample.

In this section, we discuss a range of sampling techniques available to auditors. They include random selection, systematic selection, haphazard selection, block selection, and judgemental selection.

6.4.1 Sampling Techniques

Random Selection

random selection the process whereby a sample is selected free from bias and each item in a population has an equal chance of selection

stratification the process of dividing a population into groups of sampling units with similar characteristics

As explained earlier, statistical sampling requires that a sample be selected randomly and the results of the test be evaluated using probability theory. **Random selection** requires that the person selecting the sample must not influence the choice of items selected. The resulting sample is then free from bias and each item within the population has an equal chance of being selected for testing. Random number generators can be used to select a sample (see **figure 6.1**).

Stratification can be used ahead of random selection to improve audit efficiency. This means that an auditor partitions a population ahead of sampling by identifying subpopulations with similar characteristics. For example, for accounts receivable, the auditor may stratify high-dollar items or balances that are overdue. After stratifying a population, items can be randomly selected within each stratum. Thus, stratification can be used to ensure that the sample includes items that have the characteristics required by the auditor, such as material or risky items, and remains a statistical sampling technique when items are randomly selected.

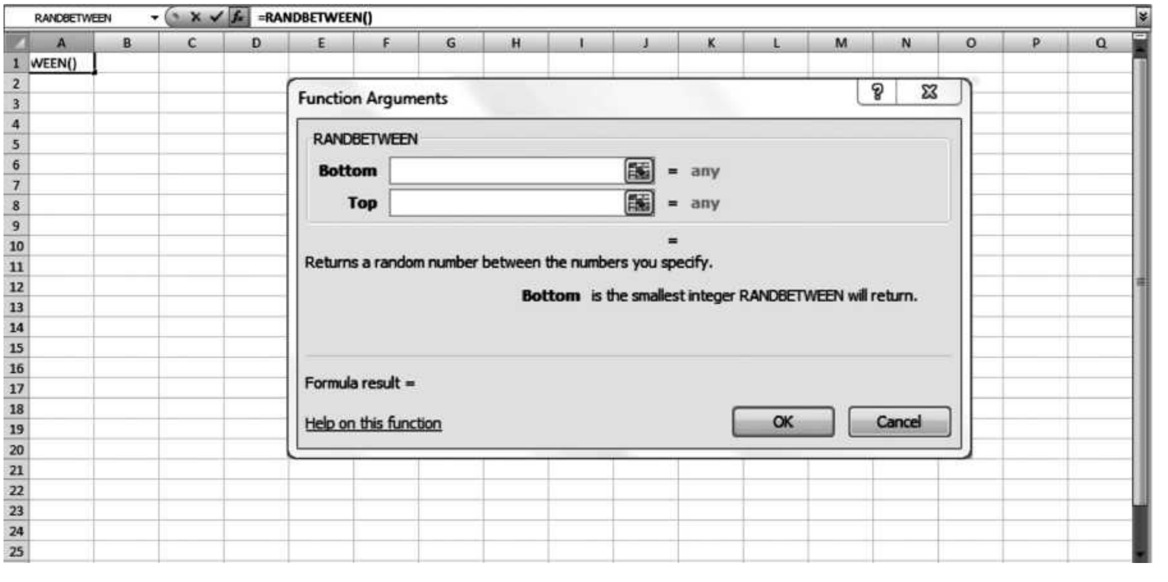


FIGURE 6.1 Random number generator

Systematic Selection

Systematic selection involves the selection of a sample for testing by dividing the number of items in a population by the sample size, resulting in the sampling interval (n). Once the sampling interval has been determined, a starting point is selected, which is an item in the population below the sampling interval. Then the sample is selected by selecting the first item and then every nth item after that.

systematic selection the selection of a sample for testing by dividing the number of items in a population by the sample size, giving the sampling interval (n) and then selecting every nth item in the population

For example, a client has 600 creditors. The auditor has decided that the sample size when testing creditors is 20. To determine the sampling interval, the following formula is used.

$$\text{Sampling interval} = \frac{\text{Population size}}{\text{Sample size}} = \frac{600}{20} = 30$$

This means that every 30th item will be selected for testing. An item within the first 30 in the list of creditors is selected as the starting point. From then on, every 30th item is selected for testing. If the first item selected is 15, then the following items will be tested: 15, 45, 75, 105, 135, 165, 195, 225, 255, 285, 315, 345, 375, 405, 435, 465, 495, 525, 555, and 585. If the starting item is selected randomly and the population is not arranged in any particular order, systematic selection can be considered a statistical sampling technique.

The risk in using systematic selection is that items will be listed in such a way that, by selecting every nth item, the auditor is selecting items that are related in some way. For example, if the sampling interval is seven and items in the population represent the daily sales of a particular product, then the auditor will select sales made on the same day each week. This risk can be reduced by reviewing the items in a population before calculating the sampling interval.

Haphazard Selection

Haphazard selection involves the selection of a sample by an auditor without using a methodical technique. While this technique appears to have much in common with random selection, there is a risk that an auditor will avoid selecting some items or ensure other items are included in the sample. For example, an item that is going to be difficult to test because the documentation is held in another location may be purposefully omitted by the auditor, while an item that looks large or unusual and catches the auditor's eye may be purposefully included. This is a non-statistical technique as human bias may impact the sample selected, and therefore prevent it from being a true random sample.

haphazard selection the selection of a sample without use of a methodical technique

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"We are going to use random selection for sales invoices and cash receipts at Cloud 9," Suzie tells Ian. "This way, we will be sure we do not influence the items selected in any way. We will be sure the sample will be free from bias and each item within the population has an equal chance of being selected. We will use firm software to generate the sample size required and the items to be tested."

Block Selection

Block selection involves the selection of items that are grouped together within the population of items available. This is a non-statistical technique as many populations of items are sorted in a sequence, which makes the selection of groups of items in a block inappropriate. For example, transactions are generally grouped in date order. By using block selection, the items selected will not be representative of transactions made throughout the year.

block selection the selection of items that are grouped together within the population of items available

For example, a client has 600 creditors. They are listed alphabetically. The auditor has decided that the sample size when testing creditors is 20. Using block selection, the auditor selects the first creditor starting with D and includes the next 20 creditors in the sample.

Judgemental Selection

judgemental selection the selection of items that an auditor believes should be included in the sample for testing

Judgemental selection involves the selection of items that an auditor believes should be included in the sample for testing. When testing controls, judgement may be used to ensure that transactions processed when a new computer is installed are included in the sample. When conducting substantive testing, judgement may be used to include in the sample large or unusual items. This is a non-statistical sampling technique.

Professional Environment 6.1 gives some idea of how auditors apply sampling in real life.

6.1 Professional Environment Sampling in Practice

How do auditors use sampling in practice? Hall et al. conducted a survey of U.S. accountants in public practice, industry, and government to find the answer to this question. Although their study was conducted in 1997 and the results are not necessarily representative of today's practices, their discussion on the advantages and disadvantages of statistical and non-statistical sampling and their impact on the risk of an inappropriate audit opinion still applies.

The researchers asked auditors how they determined sample sizes, selected samples, and evaluated these samples. The auditors were asked if they used statistical selection techniques (such as simple random, stratified, and systematic dollar-unit as described below) and non-statistical selection techniques (such as haphazard, block, and systematic).

The results showed that auditors use non-statistical selection methods 85 percent of the time and only 15 percent of the selections were made using statistical methods. The most common non-statistical sample selection method was haphazard selection. This is a technique where the sample is selected without a method. The choice of items is not supposed to be based on its characteristics, such as colour, size, or convenience of location. However, very few of the auditors reported receiving any training in methods to counter the bias introduced by non-statistical sampling and none reported using any bias-reducing techniques. The results suggest that auditors might not fully understand the influence of sample selection bias on their audit conclusions.

The most common statistical sample selection method according to the study is dollar-unit sampling. This is an approach where the unit sampled is not the transaction or document but the individual dollars making up the transaction or balance. The dollar-unit sampling method means that the auditor samples the dollars in the transactions rather than the transactions themselves. Dollar-unit sampling gives large transactions a greater chance of being sampled than small transactions.

Consider the following example of sales transactions reported by a client:

#1	$2
#2	$2,000
#3	$20,000

The auditor wants to take a random sample and inspect the underlying documents. If the unit of sampling is the sales transaction, the $20,000 transaction has the same chance of being selected as the $2 transaction. However, if dollar-unit sampling is used, then every sales dollar has the same chance of being selected. The chance of the $20,000 transaction being selected is 10,000 times greater than the $2 transaction. Given that auditors are typically concerned about overstatement of sales, dollar-unit sampling has the advantage of being more likely to select potentially overstated transactions.

Q: Is dollar-unit sampling an incorrect method of sample selection? How can an auditor counteract the effects of dollar-unit sampling?

Source: T.W. Hall, J.E. Hunton, and B.J. Pierce, "Sampling Practices of Auditors in Public Accounting, Industry, and Government," *Accounting Horizons* vol. 16, no. 2, June 2002, pp. 125–136.

6.4.2 Factors to Consider when Selecting a Sample

There are a number of factors to consider when selecting a sample. The factors discussed in this section are common to all sampling methods. When selecting a sample, an auditor will use their judgement and knowledge of the client to determine control risk, detection risk, and planning materiality, all of which impact the sample size. The lower the control risk, the smaller the sample size when testing controls. The lower the detection risk, the larger the sample size when conducting detailed substantive procedures. The sample size must be large enough to reduce the sampling risk to an acceptable level. The sample size is determined either by using professional judgement or by applying a statistical formula based on the tolerable error, the expected error, and the required confidence level. These concepts will be discussed below.

An auditor uses their professional judgement when selecting the population from which a sample is drawn. This decision is determined by the audit procedure undertaken, which, in turn, is determined by the assertion being tested. When testing the existence of inventory, it is appropriate to select a sample from the client's inventory listing (that is, the population from which a sample is selected is the client's complete list of inventory), whereas when testing the completeness of inventory, it is appropriate to select a sample of physical inventory (that is, the population from which a sample is selected is the client's physical inventory).

An auditor may decide to stratify the population before selecting a sample from it. Stratification improves audit efficiency by dividing the population into groups and then selecting items from each group. For example, a population may be divided into months of the year. When testing controls, it is important to ensure effectiveness throughout the year. By dividing items into months of the year and selecting from each month, an auditor can efficiently ensure that the whole year is covered by their test. If stratification were not used in this example, the sample chosen would likely be much larger to ensure each month is included in the sample. In another example, a population may be divided into different characteristics so that riskier items have an appropriate chance of being selected for testing. Credit sales are riskier than cash sales, so sales may be divided into credit and cash before a sample is selected.

An auditor will also use their professional judgement when considering what would be considered an error within the population tested. When testing controls, an auditor will define what represents a deviation from a prescribed control procedure. For example, if a client has a control procedure that requires a manager to authorize purchases greater than $20,000, a deviation will be evidence of unauthorized purchases greater than $20,000.

When conducting substantive procedures, an auditor will define what represents a misstatement in transactions or account balances. For example, if an auditor conducts receivable confirmations to test the existence of accounts receivable, a non-reply would be considered a potential error and would require further audit work. If an auditor conducts a test of the accuracy of the depreciation expense by recalculating selected items, and some items are significantly different from the client's depreciation amounts, those differences would be considered potential errors that would require further audit testing.

An auditor will use their professional judgement to determine the **tolerable error** or **misstatement** and required level of confidence. The tolerable misstatement is the maximum error an auditor is willing to accept within the population tested (CAS 530). When testing controls, this is the tolerable rate of deviation that an auditor is willing to accept before concluding that a control is ineffective. When conducting substantive procedures, tolerable error relates to auditor-assessed materiality. If an error is considered material, an auditor will conclude that the account is materially misstated.

tolerable error (or **misstatement)** the maximum error an auditor is willing to accept within the population tested

The required level of confidence is a function of control risk when testing controls and of detection risk when conducting substantive procedures. When control risk is initially assessed as low, based on an auditor's understanding of the client's system of internal controls, an auditor will require a high level of confidence that the controls are effective before concluding that control risk is low. In this situation, an auditor will increase the sample size when testing controls to reduce the risk that the client's system of internal controls is believed to be effective when it is ineffective. (Refer to the top section of table 6.1.)

When detection risk is determined to be low, an auditor will require a high level of confidence that the transactions and accounts are not materially misstated. Recall that, by determining a low detection risk, the auditor believes that inherent risk and control risk are high; that is, the transactions and accounts are at risk of material misstatement and the client's internal controls are believed to be ineffective. In this situation, the auditor will increase the sample size when conducting substantive tests of transactions and balances to reduce the risk that the auditor concludes that a material misstatement does not exist when it does. (Refer to the top section of table 6.2.)

To summarize, before selecting a sample, an auditor will use their professional judgement to assess control risk and detection risk, set planning materiality, select an appropriate population for testing, define what is to be considered an error within the population to be tested, set the tolerable error rate, and set the required level of confidence. Once these parameters are set, an auditor will select the sample using a statistical or non-statistical sampling technique.

Before You Go On

6.4.1 What is the difference between random and haphazard sample selection?

6.4.2 What is the risk in using systematic sample selection?

6.4.3 What factors should be considered when selecting a sample?

6.5 Factors that Influence the Sample Size—Testing Controls

LEARNING OBJECTIVE 5

Determine the factors that influence the sample size when testing controls.

There are a number of factors that will influence the sample size when testing controls. These are summarized in **table 6.3**, which comes from CAS 530.

The first factor listed in table 6.3 is an increase in the extent to which the risk of material misstatement is reduced by the operating effectiveness of controls. If an auditor believes that a control will be effective in reducing an identified risk of material misstatement, their audit strategy will be to increase testing of that control to ensure it is effective. When concluding that a control is effective, an auditor will rely on that control to prevent and detect a material misstatement, and reduce their detailed substantive procedures.

rate of deviation when testing controls, the proportion of items tested that did not conform to the client's prescribed control procedure

The second factor listed in table 6.3 is an increase in the **rate of deviation** from the prescribed control activity that the auditor is willing to accept. As described previously, an auditor will use their professional judgement to determine the tolerable rate of deviation that is acceptable. There is an inverse relationship between the tolerable rate of deviation and sample size. If an auditor intends to rely on a control to prevent and detect a material misstatement, a lower tolerable error rate will be set, and the sample size will be increased to provide the auditor with the evidence required to demonstrate that the control is effective. If an auditor expects to place relatively more reliance on their substantive procedures and reduce their reliance on an internal control, they will increase the tolerable rate of deviation and reduce the sample size when testing the control.

The third factor listed in table 6.3 is an increase in the rate of deviation from the prescribed control activity that the auditor expects to find in the population. If an auditor believes that the rate of deviation has increased when compared with prior audits, they will increase the sample size to accurately evaluate the impact of the changed circumstances. For example, the rate of deviation could increase if the client has new staff, if the client has significantly changed a computer program, or if the client has changed its internal control procedures.

The fourth factor listed in table 6.3 is an increase in the auditor's required confidence level. When control risk is assessed as low for a risk factor, an auditor's required level of confidence in the effectiveness of their client's internal control is higher than when control risk is assessed as medium to high. If an auditor is to rely on the client's internal control procedures to prevent or detect an identified material misstatement, their required confidence level in that control increases and they will increase the sample size when testing that control.

TABLE 6.3 Factors that influence the sample size when testing controls

Factor	Effect on Sample Size
1. An increase in the extent to which the auditor's risk assessment takes into account plans to test the operating effectiveness of controls	Increase
2. An increase in the tolerable rate of deviation	Decrease
3. An increase in the expected rate of deviation of the population to be tested	Increase
4. An increase in the auditor's desired level of assurance that the tolerable rate of deviation is not exceeded by the actual rate of deviation in the population	Increase
5. An increase in the number of sampling units in the population	Negligible

Source: CPA Canada Handbook – Assurance, CAS 530 *Audit Sampling*, App. 2.

The fifth and final factor listed in table 6.3 is an increase in the number of sampling units in the population. When a population is large and fairly homogeneous, there is little benefit from continuing to increase the sample size, as the results from continued testing should confirm early findings. For example, an auditor may test control procedures surrounding the processing of sales. When all sales are processed using the same procedure, there would be little difference in the sample size if the population of sales was to vary from one year to the next.

Before You Go On

6.5.1 What are the factors that influence sample size when testing controls?

6.5.2 What is the relationship between the tolerable rate of deviation and sample size?

6.5.3 How is the auditor's required confidence level influenced by control risk?

6.6 Factors that Influence the Sample Size—Substantive Testing

LEARNING OBJECTIVE 6

Determine the factors that influence the sample size when doing substantive testing and consider techniques used to perform substantive tests.

6.6.1 Factors that Influence Sample Size when Performing Substantive Tests

There are a number of factors that will influence the sample size when testing transactions and balances. These are summarized in **table 6.4**, which comes from CAS 530.

TABLE 6.4 Factors that influence the sample size when testing transactions and balances

Factor	Effect on Sample Size
1. An increase in the auditor's assessment of the risk of material misstatement	Increase
2. An increase in the use of other substantive procedures directed at the same assertion	Decrease
3. An increase in the auditor's desired level of assurance that tolerable misstatement is not exceeded by actual misstatement in the population	Increase
4. An increase in tolerable misstatement	Decrease
5. An increase in the amount of misstatement the auditor expects to find in the population	Increase
6. Stratification of the population when appropriate	Decrease
7. The number of sampling units in the population	Negligible

Source: CPA Canada Handbook – Assurance, CAS 530 *Audit Sampling*, App. 3.

The first factor listed in table 6.4 is an increase in the auditor's assessment of the risk of material misstatement. This risk is influenced by the auditor's assessment of inherent risk and control risk. The higher the inherent risk and control risk, the greater the risk that a material misstatement exists in a client's financial statements, and the more an auditor must rely on their substantive tests of transactions and balances to identify potential material misstatements. When an auditor decides to increase their reliance on their substantive procedures, they will increase the substantive testing sample size.

The second factor listed in table 6.4 is an increase in the use of other substantive procedures directed toward the same assertion. When testing transactions and balances, an auditor will use a number of audit procedures. The more procedures that are directed to the same audit assertion, the less an auditor will need to rely on the evidence provided by one test alone and the smaller the sample size required. For example, when testing the valuation of inventory, a number of procedures can be used. They include inspecting inventory on hand for evidence of damage, recalculating cost multiplied by quantity on hand, tracing of cost to supplier invoices, and testing for the lower of cost and net realizable value.

The third factor listed in table 6.4 is an increase in the auditor's required confidence level. This factor is also related to the level of inherent risk and control risk. The greater the inherent risk and control risk, the lower the detection risk established by the auditor, and the greater the confidence level required when conducting substantive tests of transactions and balances. When an auditor requires more confidence from the results of their testing, they will increase the sample size.

The fourth factor listed in table 6.4 is an increase in the total error that the auditor is willing to accept. When an auditor increases the tolerable error, they are indicating that they are not relying on that particular test to provide all of the evidence required for a particular assertion. In that case, the auditor will reduce the sample size. The tolerable error is equal to or less than the materiality level set for the class of transactions or balances being tested.

The fifth factor listed in table 6.4 is an increase in the amount of error the auditor expects to find in the population. When an auditor believes that there is likely to be a material misstatement in the population of transactions or amounts making up an account balance, they will increase the sample size to gain a better estimate of the actual misstatement in the population. This will occur when an account is at risk of material misstatement, such as when it requires estimation (for example, the allowance for doubtful accounts); when it requires complex calculations (for example, foreign exchange translations); or when it requires difficult valuation techniques (for example, fair values). This will also occur when the auditor has assessed that control risk is high and the client's control procedures are inadequate.

The sixth factor listed in table 6.4 is stratification of the population. As described previously, stratification of the population will result in more efficient sampling and reduce the sample required. The seventh and final factor listed in table 6.4 is the number of sampling units in the population. As described previously for tests of controls, when a population is large and fairly homogeneous, there is little benefit from continuing to increase the sample size, as the results from continued testing should confirm early findings.

6.6.2 Techniques for Performing Substantive Tests

Substantive procedures are predominantly designed to verify a balance or a transaction back to supporting documentation. As indicated, auditors may in some cases audit an entire population, but more often they do not audit an entire balance or class of transactions. Auditing requires using professional judgement when determining how much testing to apply to a balance. The auditor is not required (nor may it be appropriate) to perform audit procedures on 100 percent of the balances and disclosures within the financial statements. Often, transactions, balances, and disclosures that are more likely to contain material errors are selected.

There are two types of tests of details often used when the auditor tests less than the entire population. They are (1) key item testing and (2) representative sampling.

Both of these are now discussed further.

Key Item Testing

When conducting substantive testing, the auditor uses either a statistical basis or professional judgement to identify and test key items within a balance. Their focus is on selecting the largest transactions (or other individually significant items) within a balance to obtain "coverage" over the total. That is, by selecting the largest transactions to test, the auditor is able to conclude over the entire balance based on the conclusions they reached by testing the largest transactions within a balance.

For example, say an auditor is testing accounts receivable existence using accounts receivable confirmations. The total receivables are $3 million, with two key item trade receivables due from customers totalling $2.75 million of the balance. By selecting these two accounts and sending confirmation requests to them, assuming they reply, the auditor is able to conclude that, because 91.7 percent of accounts receivable exist as at the confirmation date ($2.75 million/ $3 million), it is reasonable that total accounts receivable of $3 million exist as at the confirmation date.

Some audit firms have software that assists in determining whether key items selected will provide enough of a basis to conclude that the audit assertion being tested has been met (within the confines of materiality). These software tools use a variety of methods to assess the approach planned and ordinarily take into consideration the total population (the account balance being audited), the materiality for the audit, and the other procedures that might be planned that will provide evidence to the auditor about the assertion being tested. The more persuasive the evidence from other procedures, the less coverage these key items need to address. The less persuasive the evidence from other audit procedures, the more coverage is generally necessary from these key items.

Representative Sampling

After key items have been segregated, there may remain a large population of items that are individually unimportant but significant in total. These populations can consist of either transactions through a point in time (for example, sales) or items within an account balance at a point in time (for example, year-end finished goods inventory on hand). If risk assessments indicate that the results of key item testing do not provide sufficient evidence to conclude that the population is free from material errors, the auditor obtains additional required evidence by sampling from the remainder of the population (after excluding the key items). When sampling from the remainder of the population, the sample items are selected, either statistically or non-statistically, in such a way that the sample is expected to be representative of that remaining population. This is referred to as representative sampling. When a representative sampling approach is appropriate, the sample should be large enough to achieve the audit objective. The auditor also attempts to ensure that every item in the population has an equal chance of selection and that there is no conscious or inappropriate bias in the selection of items.

When the auditor uses representative sampling, three common sampling strategies are applied, depending on the auditor's expectations of error and their overall audit objective (that is, identifying overstatement or understatement of the amount being audited).

The following are the three sampling strategies.

1. *Representative sampling using audit risk tables*. The auditor uses this technique when they do not expect errors or they expect a low number of errors; that is, the risk of material misstatement has been assessed as low, and their primary concern is with the overstatement in an account balance. This is a common technique used to obtain "coverage" of a total balance as at year end and can be used to calculate errors that can then be extrapolated across a total balance. Many firms have software tools that assist in the calculation of representative samples; the audit risk tables are embedded within the tool and will calculate the sample size, depending on the input of other considerations, such as materiality, total key items already tested, and audit evidence obtained from other substantive procedures. The technique is generally not used for accounts where the key concern is understatement, as the technique will sample (and therefore test) items that are in the balance. It will not, however, select a sample of items that may be missing from the balance. In these cases, the auditor may supplement the testing of the balance with extensive

cut-off and completeness substantive tests (for example, testing a sample of transactions after year end to determine if any of the transactions should have been recorded in the period subject to audit).

2. *Variables estimation sampling.* The auditor uses this technique if they expect more than a few errors in an account balance. This technique differs from representative sampling in that it can be used when the concern is both understatement and overstatement. Variables estimation sampling is usually applied to detect misstatements of the book values (carrying amounts or recorded values) of populations. The sample items selected are examined to determine their audited value (that is, the true or estimated amounts at which they should be carried). The differences between the book and audited values are then projected to estimate the error in the population. This technique evaluates selected characteristics of a population on the basis of a sample of the items constituting the population. The design of a variables estimation sampling approach involves mathematical calculations that tend to be complex and difficult to apply manually. Because of this, most audit firms use a specialized tool as well as a sampling specialist to assist them in applying this technique.
3. *Attribute sampling.* The auditor uses this technique to supplement other substantive procedures to obtain audit assurance related to tests of transactions when they do not expect errors (or when they expect a low number of errors). Attribute sampling is used to obtain a level of confidence, based on a statistically valid sample of transactions, that key attributes in existence for the sample tested can be inferred to be in existence for the entire population. Attribute sampling does not ordinarily lend itself to calculating a precise error that can be extrapolated across the entire balance.

Sampling is a complex area that requires the use of mathematically relevant, statistically valid techniques as well as a high degree of professional judgement to determine the nature, timing, and extent of testing.

Before You Go On

6.6.1 What are the factors that influence sample size when conducting substantive procedures?

6.6.2 What influences an increase in the auditor's assessment of the risk of material misstatement?

6.6.3 Describe variables estimation sampling.

6.7 Evaluating Sample Test Results

LEARNING OBJECTIVE 7

Outline how to evaluate the results of tests conducted on a sample.

After an auditor has completed their audit testing, the next stage is to evaluate the results. There are numerous methods available to do this. They vary in complexity, with the most complex requiring access to high-powered computer software. In this section, we outline how sample test results are evaluated in practice, without delving into the complex programs available to aid auditors in some firms. When testing controls, an auditor will consider whether the results of the tests applied to a sample provide evidence that the control tested is effective within the entire population. When testing transactions and balances, an auditor will consider whether the results of the tests applied to a sample provide evidence that the class of transactions or the account balance tested is fairly stated (that is, does not contain a material misstatement).

If an auditor discovers departures from prescribed controls when testing controls, they will calculate a deviation rate. The deviation rate is the proportion of departures within the sample.

For example, if an auditor finds three departures from a prescribed control when testing a sample of 30 items, the deviation rate is 10 percent (3/30). If the sample is representative of the population, the auditor will compare this deviation rate with their tolerable rate of deviation. If the rate of deviation exceeds the tolerable rate, the auditor will extend their testing (particularly when the auditor is concerned that their sample may not be representative) and gather further evidence of other controls that may be aimed at reducing the identified risk of material misstatement. If, after conducting more testing, the auditor finds that the rate of deviation remains consistent with their initial findings and other controls are similarly ineffective, the auditor will conclude that the client's system of internal controls cannot be relied on to prevent or detect a potential material misstatement and the auditor will increase their reliance on their substantive tests of the account tested.

If an auditor discovers errors when testing transactions or account balances, the auditor will need to project the error to the population being tested, provided that the sample is representative of the population (CAS 530). First, an auditor will consider whether an error is considered to be an anomaly and not likely to be repeated throughout the population being tested. If an error is considered to be an anomaly, it will be removed before projecting remaining errors to the population. Second, an auditor will consider whether the population was stratified before being sampled. If so, errors are projected within each stratum and then totalled together with any unique errors identified. An auditor will consider the impact of **projected errors** on the class of transactions or account balance being tested to determine whether a material misstatement has occurred.

projected error extrapolation of the errors detected when testing a sample to the population from which the sample was drawn

For example, an auditor has conducted substantive testing on an account balance, which has been split into three strata. The results of that test are summarized in **table 6.5**. The first column contains the stratum number, the second column the error found for each stratum, the third column the dollar value of the sample tested, the fourth column the dollar value of the entire stratum available for testing, and the final column the calculation of the projected error for each stratum.

The net total error for the sample is $2,649. It would be incorrect to compare that amount with the tolerable error rate because the error in the sample underestimates the error in the entire population. The errors found are projected to the population in the final column in table 6.5, providing a total net error of $5,257. That error is compared with the tolerable error rate for that account balance. If the tolerable error rate was set conservatively at $3,500, the auditor would conclude that the errors uncovered are material and further work is required. This may involve increasing the sample size and/or conducting other tests aimed at the assertion being tested. If the tolerable error rate was set at $7,500, the auditor would conclude that the errors uncovered are not material. As the total net error is close to the tolerable error rate, some additional testing within the sample may be considered to confirm that conclusion.

While the techniques to project errors can be more sophisticated than noted here, they all have in common a need to consider the sampling technique used, the level of precision required, and the extent of evidence provided by other audit procedures. As described in Professional Environment 6.1 appearing earlier in this chapter, audit firms tend to use non-statistical sampling techniques, which require less sophisticated interpretation of the results.

TABLE 6.5 **Evaluation of results of substantive testing**

Stratum	Error	Sample	Stratum	Projected Error
(1)	(2)	(3)	(4)	(2)/(3) × (4)
1	$1,586	$20,235	$25,732	$2,017
2	$(658)	$8,398	$15,367	$(1,204)
3	$1,721	$12,568	$32,456	$4,444
Total	$2,649	$41,201	$73,555	$5,257

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Suzie concludes the discussion of sampling by assuring Ian that it will not be his task to determine sample sizes and apply judgement to consider the results of the tests—that is a job for the other senior people on the team. It will, however, be Ian's task to carry out the instructions very carefully so that he does not inadvertently introduce any bias into the tests.

Suzie returns to Ian's earlier problem. He is confused about how they can proceed with substantive tests and control tests when they seem to be interrelated. How can they determine the appropriate scheduling of control and substantive tests? She starts by asking him a question. "How likely do you think it is that Cloud 9's trial balance contains errors?" she asks Ian. "Well that depends," replies Ian. "On what?" asks Suzie. "On whether they made any mistakes, I suppose." "Well, how likely is that?" persists Suzie.

Ian is even more confused now. He wants to know about control and substantive tests, and Suzie is not telling him. Suzie tries another approach. "What can the client do to prevent mistakes getting into their accounts, or detect and correct mistakes that do enter the records?"

Before You Go On

6.7.1 What will an auditor consider when evaluating test results?

6.7.2 What is the rate of deviation and when will an auditor calculate this?

6.7.3 What will an auditor do if the rate of deviation exceeds the tolerable rate?

6.8 Tests of Controls and Substantive Procedures

LEARNING OBJECTIVE 8

Understand the difference between tests of controls and substantive tests.

A key task during the risk assessment phase of every audit involves the development of an **audit strategy**. CAS 300 *Planning an Audit of Financial Statements* requires that an auditor establish an overall audit strategy. The audit strategy provides the basis for a detailed audit plan. An audit plan includes the audit procedures to be used when testing controls and when conducting detailed substantive audit procedures.

An audit strategy is developed after gaining an understanding of a client's business and its internal control structure. Once an auditor has a thorough knowledge of their client's business, they can determine the overall level of **inherent risk** (the risk that a material misstatement could occur without considering any internal controls). Once an auditor has a thorough understanding of the client's controls, they can assess the **control risk** (the risk that a client's system of internal controls will not prevent or detect a material misstatement), which affects **audit risk** (the risk that an auditor expresses an inappropriate audit opinion when the financial statements are materially misstated). **Table 6.6** contains an overview of the link

audit strategy strategy that sets the scope, timing, and direction of the audit and provides the basis for developing a detailed audit plan

inherent risk the susceptibility of the financial statements to a material misstatement without considering internal controls

control risk the risk that a client's system of internal controls will not prevent or detect a material misstatement

audit risk the risk that an auditor expresses an inappropriate audit opinion when the financial statements are materially misstated

TABLE 6.6 Audit risk and audit strategy

Audit Risk = *f*	Inherent Risk	Control Risk	Detection Risk	Audit Strategy
High	High	High	Low	
		No tests of controls	Increased reliance on substantive tests of transactions and account balances	Substantive strategy
Low	Low	Low	High	
		Increased reliance on tests of controls	Reduced reliance on substantive tests of transactions and account balances	Combined strategy

between audit risk and audit strategy. When control risk is assessed as being high (top section of table 6.6), an auditor will adopt a substantive audit approach. This means that the audit strategy is to gain a minimum knowledge of the client's system of internal controls, conduct limited or no **tests of controls** (or **control testing**), and conduct extensive detailed substantive procedures.

tests of controls (or **control testing)** the audit procedures designed to evaluate the operating effectiveness of controls in preventing or detecting and correcting material misstatements at the assertion level

When control risk is assessed as low (bottom section of table 6.6), an auditor may adopt a combined audit strategy. This means that the audit strategy is to gain a detailed understanding of the client's system of internal controls, conduct extensive tests of controls, and, if those controls prove effective, conduct less detailed substantive procedures.

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Ian is starting to understand. Suzie has already explained the idea of inherent, control, and detection risks to him, but until now he did not realize the practical implications. He can now answer Suzie's question: he is able to explain that the client is responsible for creating a system of internal controls to stop or detect mistakes from entering the accounts. A strong system of internal controls means lower control risk. Tests of controls are designed to gather evidence about the strength of the system of internal controls and to justify the auditor's decision about how much reliance to place on the system. Greater reliance on a strong system of internal controls will allow the auditor to rely less on substantive procedures. This is the combined audit strategy. The other strategy, a substantive audit strategy, means low (or no) reliance on the system of internal controls and greater reliance on substantive procedures. But Ian is still worried—how do you actually make these assessments?

6.8.1 Tests of Controls

The purpose of this brief discussion is to introduce tests of controls and highlight how they differ from substantive tests. When testing controls, an auditor is interested in assessing the effectiveness of internal controls identified when gaining an understanding of their client's system of internal controls during the risk assessment phase of the audit. When making a preliminary assessment that control risk is medium or low (bottom section of table 6.6), an auditor is basing that assessment on their knowledge of the significant risks faced by the client and the suitability of the client's internal controls to mitigate those risks.

Before an auditor can conclude that control risk is medium or low, they test the controls to check their effectiveness. If the controls prove effective, the auditor can reduce their reliance on detailed substantive procedures. If the controls prove ineffective, the auditor reassesses control risk as higher than before and increases their reliance on detailed substantive procedures (that is, moves toward the top section of table 6.6).

Tests of controls are conducted to establish that controls:

- operate effectively, meaning that the rate of deviation from prescribed control procedures is minimized and controls effectively prevent and detect material misstatements
- operate consistently throughout the accounting period

Remember that the main evidence-gathering procedures used by an auditor include inspection, observation, inquiry, confirmation, recalculation, re-performance, and analytical procedures. When testing controls, the procedures commonly used include:

- inspection of documents for evidence of authorization
- inspection of documents for evidence that details included have been checked by appropriate client personnel
- observation of client personnel performing various tasks, such as preparing bank deposits and conducting an inventory count
- inquiry of client personnel about how they perform their tasks
- re-performing control procedures to test their effectiveness

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Suzie explains that control testing means, for example, that the auditor inspects documents, observes personnel, makes inquiries, re-performs certain controls, or conducts other tests that suit that particular client's systems. Suzie gives examples of the control tests that they intend to perform for Cloud 9: read the policies and procedures manuals, check for evidence of supervisors' reviews of cash receipts, observe staff in the shipping department handling dispatches, talk to the financial controller about the inventory management system, and re-perform a sample of bank reconciliations.

All of these control tests (plus others) have to be scheduled in the audit plan. Ian is still confused about how they can schedule substantive tests before they do the control tests. "What if the test results reveal poor controls?" he asks. Suzie explains that they have an initial assessment of control system strength and plan their substantive tests based on that assessment. "Remember," she adds, "we have already done some inquiries at a high level, plus we have the results of the analytical procedures. We have a pretty good idea of where the problems will arise. However, if our expectations are not met, we simply adjust the plan as we go along."

6.8.2 Substantive Procedures

The purpose of this brief discussion is to introduce substantive testing procedures and highlight how they differ from tests of controls. The three types of substantive procedures include substantive tests of transactions, substantive tests of balances, and analytical procedures.

When an auditor assesses inherent and control risk as low for a client and tests of controls confirm their effectiveness (bottom section of table 6.6), they will reduce the amount of planned detailed substantive procedures. This means that an auditor will rely to some extent on the client's internal control procedures to prevent and detect material misstatements. As a result, an auditor can rely more on their analytical procedures, which are more efficient than substantive testing of details, and place greater reliance on the client's accounting records.

When an auditor assesses inherent and control risk as high for a client and decides that the client's internal controls are unlikely to effectively reduce identified inherent risks (top section of table 6.6), the auditor will adopt a substantive approach to their testing. This means that an auditor will not place too much reliance on the client's system of internal controls to prevent and detect material misstatements and will instead conduct detailed substantive procedures of their own to reduce audit risk to an acceptably low level. Recall that audit risk is the risk that an auditor expresses an inappropriate audit opinion when the financial statements are materially misstated (CAS 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Canadian Auditing Standards*). When control risk is high, an auditor will not rely too heavily on their analytical procedures and will instead conduct more time-consuming and costly substantive testing of transactions and balances.

When conducting detailed **substantive procedures** (also called **substantive testing** or **tests of details**), an auditor searches for evidence that:

- recorded and disclosed transactions occurred and relate to the client (**occurrence** assertion),
- all transactions have been recorded and all related disclosures have been included (**completeness** assertion),
- all transactions have been recorded at appropriate carrying amounts and appropriately measured, and the related disclosures have been appropriately measured and described (**accuracy** assertion),
- all transactions have been recorded in the correct accounting period (**cut-off** assertion),
- all transactions have been recorded in the correct accounts (**classification** assertion), and
- all transactions and events have been appropriately aggregated or disaggregated, and the related disclosures are relevant and understandable (**presentation** assertion).

When gathering this evidence, an auditor uses a variety of audit procedures. Here are a few examples:

- receiving confirmation from the client's bank regarding interest rates charged on amounts borrowed by the client during the accounting period (accuracy assertion)
- recalculating an interest expense using the confirmed interest rates (accuracy assertion)
- inspecting documents to verify the date of transactions around year end (cut-off assertion)
- inspecting suppliers' invoices to verify amounts purchased (completeness assertion)

substantive procedures (substantive testing or **tests of details)** audit procedures designed to detect material misstatements at the assertion level

occurrence assertion that transactions, events, and disclosures that have been recorded or disclosed have occurred and pertain to the entity

completeness assertion that all transactions, events, assets, liabilities, and equity items that should have been recorded have been recorded and all related disclosures that should have been included have been included

accuracy assertion that amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described

cut-off assertion that transactions and events have been recorded in the correct accounting period

classification assertion that transactions, events, assets, liabilities, and equity interests have been recorded in the proper accounts

presentation assertion that transactions, events, assets, liabilities, and equity items have been appropriately aggregated or disaggregated, clearly described, and related disclosures are relevant and understandable

When conducting detailed substantive procedures, an auditor searches for evidence that:

- recorded accounts such as assets, liabilities, and equity accounts exist (**existence** assertion),
- all accounts that should have been recorded have been recorded and all related disclosures have been included (completeness assertion),
- recorded accounts represent items owned by the client or amounts owed by the client to third parties (**rights and obligations** assertion), and
- recorded accounts appear at appropriate carrying amounts and any resulting valuation or allocation adjustments have been appropriately recorded and the related disclosures have been appropriately measured and described (**accuracy, valuation, and allocation** assertion).

existence assertion that recorded assets, liabilities, and equity interests exist

rights and obligations assertion that the entity holds or controls the rights to assets, and that liabilities are the obligations of the entity

accuracy, valuation, and allocation assertion that assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded and related disclosures are appropriately measured and described

When gathering this evidence, an auditor uses a variety of audit procedures. Here are a few examples:

- receiving confirmation from a selection of accounts receivable of amounts owed to the client (existence assertion)
- recalculating the wages payable amount (accuracy, valuation, and allocation assertion)
- inspecting inventory and counting amounts on hand (existence and completeness assertions)
- inspecting supplier statements for amounts outstanding at year end (completeness and accuracy, valuation, and allocation assertions)
- inspecting title deeds to verify that the client owns property (rights and obligations assertion)

An auditor ensures assets, liabilities, and equity interests have been recorded in the proper accounts (classification assertion) and they have been appropriately aggregated or disaggregated, clearly described, and all related disclosures are relevant and understandable (presentation assertion).

An auditor can use analytical procedures when testing transactions and account balances. Analytical procedures can be used to:

- estimate depreciation expense by multiplying the average depreciation rate on a class of assets by the average balance for the year (accuracy assertion)
- compare the wages expense month by month for this year and last year (completeness and occurrence assertions)
- compare inventory balances for this year and last year (existence, completeness, and accuracy, valuation, and allocation assertions)
- compare accounts payable balances for last year and this year (completeness, existence, and accuracy, valuation, and allocation assertions)
- discuss unusual fluctuations with client personnel (occurrence, completeness, and accuracy, valuation, and allocation assertions)
- estimate revenue for a movie theatre, for example, by multiplying the average price of a ticket by the number of seats in the theatre, by the average proportion of seats sold per session, by the average number of sessions per week, by the number of weeks per year (occurrence and accuracy assertions)

Professional Environment 6.2 examines how audit testing might be performed in the future as technology evolves.

Cloud 9 Integrated Case

Ian confesses to Suzie that he has a problem understanding the difference between control and substantive tests. “For example, at Cloud 9, a supervisor is supposed to check and authorize cash receipts deposited to the bank account. Suppose I find that the amount of the bank deposit is correct but that the supervisor forgot to sign the authorization. Is that an error?”

Suzie replies, “Remember, tests of controls are performed to assess whether the controls are working and therefore can be relied upon. Substantive tests are performed to detect misstatements in an account balance. You performed a test of the control that the supervisor authorizes the transaction and found an error or a deviation from the correct performance of the control. However, you then performed an alternate substantive test and found that there was no error in the actual deposit. You have found evidence to substantiate the accuracy and occurrence assertions for that transaction. We would then consider all the other relevant evidence we have gathered about the controls over cash receipts. For example, how often do we find this type of control deviation for cash deposits? If we find significant problems with the controls, we could adjust our control risk assessment for cash receipts.”

6.2 Professional Environment Automated Auditing?

It is predicted that by 2025 robots will be taken for granted! Not only are self-driving cars no longer a dream of the future, it is predicted that robots will replace humans in a variety of tasks. Currently, robots excel in crunching numbers, lifting heavy objects, working in dangerous environments, moving with precision, and performing repetitive tasks. Because of this, Oxford University researchers estimate that 47 percent of jobs in the United States could be automated within the next two decades. Such automation would likely change the way organizations operate, including accountants and accounting firms. So, is it possible that one day robots will replace auditors?

With the continuous and rapid development of robots and artificial intelligence, robots may not replace humans entirely, but they could certainly change the world of auditing. Advocates of artificial intelligence not only see a future where organizations will have a chief robotics officer, they also see a future where artificial intelligence systems will be able to audit 100 percent of a business's transactions. They see auditing becoming an ongoing, real-time exercise, not something performed once a year at a busy season. Because robots excel in repetitive and time-consuming tasks, they can sort through data faster and more accurately than humans. Robots can also quickly identify patterns and therefore recognize anomalies. All of these abilities may certainly improve and change how audits are conducted.

However, humans still have a few advantages over their automated counterparts—humans are creative and curious, and they can provide fast, multidimensional feedback. Much of the work of the auditor involves face-to-face interaction, and this is hard to automate. Also, robots are unlikely to possess two primary skills needed by an auditor: professional scepticism and professional judgement. Auditors maintain an attitude of professional scepticism; they question not only the quality of the data but also the sufficiency and appropriateness of the evidence. The auditor also uses professional judgement to assess the reasonableness of the financial statements and the disclosures. Using all of their abilities, the auditor is able to provide an opinion on the reasonableness of the financial statements—skills robots are unlikely to possess.

Q: How can we use the technologies available today to increase audit efficiencies?

Sources: Bill Brennan, Michael Baccala, and Mike Flynn, "Artificial Intelligence Comes to Financial Statement Audits," *CFO*, February 2, 2017; Bob Violino, "The Future of Robotics: 10 Predictions for 2017 and Beyond," *ZDNet*, December 22, 2016; Thomas Claburn, "How Robots, Analytics Can Work Side-By-Side," *InformationWeek*, November 12, 2015; Marguerite McNeal, "Rise of the Machines: The Future Has Lots of Robots, Few Jobs for Humans," *Wired*, 2015; Kai Goerlich, "The Future of Robotics: More Ironman, Less Terminator," *Forbes*, September 4, 2015.

Before You Go On

6.8.1 What will be an auditor's strategy when control risk is assessed as high?

6.8.2 What are the two broad purposes of tests of controls?

6.8.3 What are the main objectives when conducting substantive tests of account balances?

6.9 Nature, Timing, and Extent of Audit Testing

LEARNING OBJECTIVE 9

Explain the factors that impact the nature, timing, and extent of audit testing.

The nature, timing, and extent of audit testing are crucial factors in every audit. An auditor uses their professional judgement when determining the nature, timing, and extent of audit procedures to use for each client. The audit plan details the procedures to be completed by the audit team. The nature, timing, and extent of audit procedures used on each audit vary depending on the audit strategy adopted and the type of testing relied on; that is, tests of controls or detailed substantive procedures (CAS 330 *The Auditor's Responses to Assessed Risks*).

6.9.1 Nature of Audit Testing

nature of audit testing the purpose of the test and the procedure used

The **nature of audit testing** refers to the purpose of the test (that is, to test controls, transactions, or account balances) and the procedure used (that is, inspection, observation, inquiry, confirmation, recalculation, re-performance, or analytical procedures). The nature of an audit procedure will also depend on the assertion being tested. The higher the risk of material misstatement, the greater the use of audit procedures that access the most persuasive audit evidence.

As described above, tests of controls are quite different from substantive procedures. Tests of controls are concerned with providing evidence that an internal control procedure exists and is effective. The nature of these control tests is to re-perform certain procedures, inspect documents for evidence of procedures carried out by client personnel, and observe client personnel performing control procedures. Controls can also be tested by purposefully trying to trip them up. For example, transactions can be created by an auditor to test controls embedded in the client's computer programs, also referred to as application controls. Such transactions (referred to as test data) can include valid and invalid items. Valid data are traced to ensure that appropriate accounts are updated when the transactions are processed. If a client's internal controls are effective, invalid data should be identified and rejected by the program. For example, if a sales program includes a procedure to check the customer number against an approved customer listing before processing a credit sale, an auditor could include a sale to a fictitious credit customer to test that the control is working. If the program processes the sale to a fictitious customer created by the auditor, the control procedure cannot be relied on as it has not operated effectively during this instance and there is a risk that some sales have been processed by the client that did not occur (occurrence assertion).

As described above, substantive procedures include detailed tests of transactions, balances, and analytical procedures. The lower the risk of material misstatement and the more effective the controls, the more reliance is placed on more efficient, less costly, analytical procedures. For these tests to be effective, it is important that an auditor plan to spend time testing the relevant assertions and the significant transaction classes, account balances, and disclosures. Substantive procedures should be performed to specifically address any significant risks. For assertions most at risk, an auditor endeavours to gather the most persuasive evidence.

6.9.2 Timing of Audit Testing

Timing of audit testing is the stage of the audit when procedures are performed and the date, such as within or outside the accounting period, that audit evidence relates to. Tests of controls are designed to provide evidence that a control was effective throughout the accounting period. As such, tests of controls can be conducted during the interim stage of the audit and then extended to the end of the year when conducting the year-end audit. The interim stage of the audit is the initial visit to a client, before year end, where planning takes place. It is common for audit planning to begin before year end to aid in efficiency and to free up time at year end. After gaining an understanding of the client and its internal controls, an auditor can begin tests of controls during the interim period. Substantive testing of transactions, which also occurs throughout the year, can also begin during the interim audit.

timing of audit testing the stage of the audit when procedures are performed and the date, such as within or outside the accounting period, that audit evidence relates to

For low-risk accounts, it is common to conduct more work during the interim audit, including testing controls and conducting substantive tests of transactions. If, after conducting these preliminary tests, the auditor concludes that the risk of material misstatements matches their initial low- to moderate-level assessment, detection risk will be set as high to medium and less reliance will be placed on detailed substantive testing at year end. If, after conducting preliminary tests of controls, the auditor concludes that control risk is higher than initially estimated because, for example, the rate of deviation in controls from the client's prescribed procedures is above the expected rate for a low-risk account, the auditor will increase their reliance on detailed substantive testing at year end.

For high-risk and significant accounts, the timing of most audit procedures will be at, or after, year end. When there is a high risk of material misstatement in the amounts appearing in the financial statements, an auditor will spend most of their time conducting detailed substantive tests of those account balances. Analytical procedures may be used to aid in the identification of those accounts most at risk of material misstatement, but these procedures will not be relied on as the only audit evidence obtained.

Some assertions, such as cut-off, can be conducted only on transactions around year end. For example, as inventory counts are generally conducted on, or close to, year end, audit procedures used to assess the effectiveness of the count can be conducted only around year end. Some audit procedures are conducted throughout an accounting period (tests of controls and substantive tests of transactions), while others are predominantly conducted at year end (substantive tests of account balances). The higher the risk of material misstatement, the greater the reliance on testing conducted close to year end.

6.9.3 Extent of Audit Testing

extent of audit testing the amount of audit evidence gathered when testing controls and conducting detailed substantive procedures

The **extent of audit testing** refers to the amount (quantity) of audit evidence gathered when testing controls and conducting detailed substantive procedures. When control risk is low (bottom section of table 6.6), the audit strategy is to increase reliance on tests of controls and reduce reliance on substantive testing of transactions and account balances. This means that the auditor will increase the extent of their testing of controls to gain evidence that their client's system of internal controls is effective in preventing and detecting material misstatements. If that extensive testing confirms the auditor's belief that their client's system of internal controls is indeed effective, the auditor will reduce the extent of substantive testing of transactions and balances and increase the extent of their reliance on more efficient analytical procedures.

When control risk is high (top section of table 6.6), the audit strategy is to do little or no testing of controls and to increase reliance on substantive testing of transactions and account balances. This means that the auditor will not rely on their client's system of internal controls to prevent and detect material misstatements. Instead, the auditor must rely on their own extensive substantive procedures to uncover any material misstatements.

Cloud 9 Integrated Case

Suzie emphasizes to Ian that the detailed audit program section of the audit plan must specify three things about every test—nature, timing, and extent. That is, which tests will be performed, when they will be performed and which period the data belong to, and how many times the tests will be performed. The "how many" part relates to the size of the sample. The population from which a sample is drawn could be documents, inventory items, people (to talk to or observe), and so on.

Because W&S Partners has been appointed before year end, it can test interim data and spread the testing over the available time before the audit report deadline. However, timing is not just about convenience. If controls are weak, more tests have to be scheduled near year end. Control risk has a very pervasive effect on testing because weaker controls mean that the auditor must perform tests that will produce more persuasive evidence and select larger samples.

Before You Go On

6.9.1 What are the three main categories of substantive procedures?

6.9.2 What are the two most common types of testing that can be started during the interim audit?

6.9.3 What does the extent of audit testing refer to?

Summary

1 Explain when and how audit sampling is used in an audit.

When creating an audit plan and designing audit procedures, an auditor also decides how to select appropriate items for testing. When there are numerous transactions or items within an account balance available for testing, an auditor must decide whether to conduct an audit data analytic or how best to select a sample that is representative of the entire population of items available for testing.

2 Understand the difference between sampling and non-sampling risk.

Sampling risk is the risk that the sample chosen by the auditor is not representative of the population of transactions or items within an account balance available for testing and, as a consequence, the auditor arrives at an inappropriate conclusion. Non-sampling risk is the risk that an auditor arrives at an inappropriate conclusion for a reason unrelated to sampling issues, such as using an inappropriate audit procedure.

3 Differentiate between statistical and non-statistical sampling.

Statistical sampling involves random selection and probability theory to evaluate the results. Non-statistical sampling is any sample selection method that does not have these characteristics.

4 Describe sampling methods and the factors to be considered when choosing a sample.

Sampling methods include random selection, systematic selection, haphazard selection, block selection, and judgemental selection. Before selecting a sample, an auditor will set parameters pertaining to control and detection risk, planning materiality, population, tolerable error rate, and the required level of confidence. Once these parameters are set, an auditor may select a sample using a statistical or non-statistical sampling technique.

5 Determine the factors that influence the sample size when testing controls.

When testing controls, the factors that influence the sample size include the extent to which the risk of material misstatement is reduced by the operating effectiveness of controls, the rate of deviation from the prescribed control activity that the auditor is willing to accept, the rate of deviation from the prescribed control activity that the auditor expects to find in the population, the auditor's required confidence level, and the number of sampling units in the population.

6 Determine the factors that influence the sample size when doing substantive testing and consider techniques used to perform substantive tests.

When conducting substantive testing of transactions and balances, the factors that influence the sample size include the auditor's assessment of the risk of material misstatement, the use of other substantive procedures directed at the same assertion, the auditor's required confidence level, the tolerable error, the amount of error the auditor expects to find in the population, the stratification of the population, and the number of sampling units in the population.

Two main techniques are applied when the auditor is performing substantive tests and deciding how much of a balance to test. These are (1) key item testing, and (2) representative sampling.

7 Outline how to evaluate the results of tests conducted on a sample.

When testing controls, the auditor will compare the rate of deviation with the tolerable rate of deviation and determine whether they believe that the control tested is effective in preventing and/or detecting a material misstatement. When testing transactions and balances, the error in the sample will be projected onto the population and then compared with the tolerable error rate. The auditor will then determine whether the class of transactions or account balance being tested appears to be materially misstated.

8 Understand the difference between tests of controls and substantive tests.

The purpose of tests of controls is to assess the effectiveness of a client's system of internal controls throughout the accounting period being audited. The purpose of substantive testing is to gather direct evidence that the financial statements are free from material misstatement.

9 Explain the factors that impact the nature, timing, and extent of audit testing.

The nature of audit testing refers to the purpose of the test and the procedure used. The timing of audit testing refers to the stage of the audit when procedures are performed and the date, such as within or outside the accounting period, that audit evidence relates to. The extent of audit testing refers to the amount of audit evidence gathered when testing controls and conducting detailed substantive procedures.

Key Terms

Self-Test Questions

Answers to the Self-Test Questions are available in *WileyPLUS*.

6.1 A detailed audit plan:

a. is based on the overall audit strategy.

b. contains a description of the control testing procedures.

c. lists the audit procedures to be used in substantive testing.

d. all of the above.

6.2 When testing controls, the auditor:

a. is interested in assessing the effectiveness of controls.

b. gathers evidence about the balances of the main accounts.

c. does not have to have any prior knowledge of the client's inherent risks and how the controls address those risks.

d. all of the above.

6.3 Deviations:

a. are errors that affect account balances by a material amount.

b. occur when controls do not operate as intended.

c. are relevant only when they occur consistently throughout the accounting period.

d. are caused by auditors choosing incorrect audit procedures.

6.4 Analytical procedures:

a. are less efficient than substantive testing of details.

b. place less reliance on the client's accounting records than substantive testing of details.

c. are relied on to a greater extent when a client's internal controls are effective.

d. are most useful when inherent and control risk are high.

6.5 The relationship between audit risk, reliance on substantive testing, and evidence persuasiveness is:

a. high audit risk, low reliance on substantive testing, low evidence persuasiveness required.

b. low audit risk, high reliance on substantive testing, low evidence persuasiveness required.

c. high audit risk, high reliance on substantive testing, high evidence persuasiveness required.

d. low audit risk, low reliance on substantive testing, high evidence persuasiveness required.

6.6 If preliminary testing of controls reveals that the rate of deviation in controls is above the expected rate, the auditor will:

a. reduce detection risk and increase reliance on detailed substantive testing at year end.

b. increase detection risk and increase reliance on detailed substantive testing at year end.

c. reduce detection risk and decrease reliance on detailed substantive testing at year end.

d. increase detection risk and decrease reliance on detailed substantive testing at year end.

6.7 Sampling risk:

a. is the risk that the results of the test will be misinterpreted by the auditor.

b. is the risk that the sample chosen by the auditor is not representative of the population of transactions.

c. can be eliminated by taking a random sample.

d. applies only to samples for substantive testing.

6.8 Non-sampling risk:

a. occurs only if you test every member of the population.

b. applies only to samples taken for the purposes of control testing.

c. is the risk that an auditor arrives at an inappropriate conclusion for a reason unrelated to sampling issues.

d. does not occur if an auditor relies on unreliable evidence.

6.9 Tolerable error:

a. is the maximum error an auditor is willing to accept within the population.

b. is positively related to sample size.

c. relates only to control testing.

d. is an amount prescribed by CAS 530.

6.10 The auditor has discovered errors when conducting substantive testing on a sample of invoices. If the total error discovered is $3,442, the dollar value of the sample is $25,136, and the population dollar value is $64,912, then the projected error is:

a. $3,442.

b. $8,889.

c. $1,885.

d. $1,369.

Review Questions

6.1 Why do auditors use sampling? In what circumstances would the auditor decide to not use sampling, but rather test 100 percent of the population?

6.2 Explain the difference between the two types of sampling risk for controls: overreliance on an ineffective system of internal controls, and underreliance on an effective system of internal controls. What are the errors' different implications for the audit? Which is the more serious risk? Explain.

6.3 Why does non-sampling risk exist for all types of tests in all audits? Explain.

6.4 Explain the relationship between the sample size for control testing and each of the following factors: (1) the likely effectiveness of a control; (2) the acceptable rate of deviation; (3) the expected rate of deviation; (4) the required level of confidence in the effectiveness of the client's system of internal controls; and (5) the number of units in the population.

6.5 Give an example of substantive testing where stratification would be appropriate.

6.6 Assume an auditor finds total errors of $25,300 in a sample of sales invoices. Why is it not appropriate to conclude that sales are misstated by $25,300? How would you determine the estimated misstatement of sales?

6.7 Explain the difference between tests of controls and substantive procedures. How are the results of tests of controls related to decisions about the nature, timing, and extent of substantive procedures?

6.8 Explain how analytical procedures could be used for substantive testing. Give an example.

6.9 How are test data used to gather evidence about the effectiveness of controls? Why is using test data likely to be a more effective audit test than reading client procedure manuals?

6.10 Why are audit tests more likely to be conducted at or after year end for high-risk clients than for low-risk clients?

Professional Application Questions

Basic Moderate Challenging

6.1 Sampling methods **Moderate** **LO 1, 2, 3**

Bob Downe is auditing Red Gum Home Furniture (RGHF), a manufacturer and retailer of boutique home furniture. RGHF was founded 25 years ago by a husband and wife team and has grown rapidly in the past five years as solid, environmentally friendly, wooden furniture has grown in popularity. However, although RGHF's owners have attempted to expand the administration department to keep pace with the growth in sales, some systems are not operating as effectively as they should. This is partly due to difficulty in attracting and retaining accounting staff with appropriate experience and skills.

RGHF's owners have recently realized that they need to increase pay and improve conditions for the accounting staff to avoid having periods with unqualified staff, particularly for sales invoice processing. The staff shortages have resulted in sluggish performance in processing invoices, sending out customer statements, and collecting cash from customers. In addition, there have been numerous mistakes in processing sales invoices, some of which have been discovered after customer complaints.

Bob is selecting a sample of sales invoices for substantive testing. All documents relating to sales invoices for the past five years are stored in boxes in the shed behind the office. The shed is very small and the boxes are stacked on top of each other because the shelves are full. Due to the damp conditions, some labels have peeled from the boxes, so it is not clear which boxes relate to the current year.

Required

a. Should Bob consider performing an audit data analytic? Explain.

b. Describe the population(s) that would be relevant to Bob's sample selection.

c. Which sample selection methods would be appropriate for choosing sales invoices for substantive testing at RGHF? Explain the factors that would influence your choice.

6.2 Types of audit sampling and sampling risk **Basic** **LO 2, 3**

Required

Match the numbered situations below with one of the following types of audit sampling or sampling risk:

a. Statistical sampling

b. Non-statistical sampling

c. Sampling risk

d. Non-sampling risk

1. Rather than looking only for authorized signatures, an auditor checked to see if there were any signatures in the credit approval box on a sample of sales orders.

2. An auditor concluded that, based on a statistical sample, the client's control system was working acceptably when, in fact, the population deviation rate was unacceptable.

3. Using the laws of probability, an auditor selected a sample and evaluated the results of her sample.

6.3 Benefits of statistical sampling **Basic** **LO 3**

You are an audit senior, and your manager, Monique Lauzon, feels that non-statistical sampling is the best method to use on the audit of Konway Corporation. However, you believe that statistical sampling is much superior, and you have a great deal of training in the proper use of sampling techniques.

Required

What arguments could you use to convince Monique that statistical sampling should be used?

6.4 Sample selection in practice **Basic** **LO 4**

Rahim, a first-year auditor, is asked to select a sample of invoices to audit the utility expense account. Below is the account detail.

The audit program asks to select a sample of four items.

Month	Balance	Month	Balance
January	$15,245	July	$ 2,901
February	12,973	August	2,837
March	11,359	September	3,690
April	9,326	October	5,890
May	6,380	November	9,823
June	4,558	December	14,906

Required

a. Using systematic selection, determine which four months will be selected.

b. Using haphazard selection, determine which four months will be selected.

c. Using block selection, determine which four months will be selected.

6.5 Potential impact of sampling risk **Moderate** **LO 2, 4**

Your friend, Alexei Antropov, recently began working for an auditing firm and he wants your advice regarding some tests of sales transactions that he is currently undertaking with respect to one of his clients. He has been careful not to disclose to you the name of his client so as not to breach confidentiality.

Alexei selected a haphazard sample of 30 sales with a total book value of $150,000. In his sample, he found a total of $1,000 in net overstatement errors. The total sales balance per books is $20 million. Overall materiality for the engagement is $600,000. Tolerable error for sales is $140,000. The sample results indicate that Alexei's best estimate of total misstatement in sales is $70,000.

Required

Could Alexei safely conclude that no additional audit work is needed in this area? Support your answer.

6.6 Sample size selection **Basic** **LO 5**

Patrizia Montani is considering the sample size needed for a selection of sales invoices relating to the test of internal controls of Caistor Company. She is determining the acceptable risk and deviation rates, and is considering two possible scenarios, as shown in table 6.7.

Required

In which of the two cases should Patrizia select a larger sample size?

TABLE 6.7 Risk or deviation rate for sample scenarios

Risk or Deviation Rate	Case A	Case B
Acceptable risk of underreliance	High	Low
Acceptable risk of overreliance	High	Low
Tolerable deviation rate	High	Low
Expected population deviation rate	Low	High

6.7 Sampling and non-sampling risk for control testing **Moderate** **LO 1, 2, 9**

Fred Saros is auditing cash payments for OGA, a large supermarket. OGA deals with several very large corporate suppliers, which expect payment by electronic funds transfer within three business days of delivery. Other large suppliers will accept cheques or electronic funds transfers on terms of 14 days, and small suppliers receive cheques with payment terms of 30 days. Other regular, large cash payments include wages (paid weekly by electronic funds transfer from a wages imprest account), utilities (electricity accounts are paid monthly by cheque), cleaning (paid monthly by cheque), and rent (paid monthly by electronic funds transfer). In addition, there are irregular payments for items such as maintenance, fixtures purchase and lease, and vehicle running costs.

All cash payments are processed in the central office after the required set of documents has been assembled and checked by two junior accounts staff. Payments are authorized by a senior accountant, and electronic funds transfer authorizations and cheques are countersigned by the chief accountant (except if he is on holidays, when another member of the accounting staff performs this task). Journals and ledgers are maintained by staff not involved in cash payment processing.

Fred needs to test controls over cash payments and has planned to make extensive use of sampling.

Required

a. What population(s) would be relevant to Fred's control testing?

b. Explain the potential implications of sampling risk for the audit of cash payments.

c. What possible non-sampling risks exist in this case?

6.8 Determining sample size for control testing **Moderate** **LO 5**

Alice Pang is planning the control testing of the accounts payable function in the hardware retailer Bunns and Major. Alice is attempting to determine the appropriate sample size for her tests and is writing a report to the engagement partner of the audit justifying her choices. She has had the opportunity to talk to management at Bunns and Major and tour the facilities. She has also reviewed the working papers from the previous audits and identified factors that have changed from previous years. She notes that the number of accounts payable has increased by 50 percent since last year because Bunns and Major has changed some of its suppliers from large corporate wholesalers to dealing directly with manufacturers.

Overall, Alice believes that the controls in accounts payable are likely to be operating more effectively than in previous years, and she expects a reduction in control deviations. This situation is likely because of the appointment of an additional staff member in the accounts payable department three months after the start of the fiscal year. However, she is recommending that a lower rate of deviation would be acceptable this year because of the increased importance of accounts payable to Bunns and Major's solvency situation in the current economic climate. In addition, she is recommending that substantive testing of accounts payable be less extensive than in past years.

Required

Explain how the factors mentioned above would impact the sample size for control testing of accounts payable.

6.9 Evaluating substantive testing results **Challenging** **LO 5, 6, 7**

The results of substantive testing of sales invoices at City Electronics are shown in **table 6.8**. The three strata correspond to different departments, and the overall tolerable error is set at $40,000.

Required

a. Project the errors for each stratum and calculate the total projected error. Is the projected error material? What difference would it make if the tolerable error was set at $30,000? Explain.

b. Discuss the implications for the substantive testing if it was discovered that a permanent staff member in the department corresponding to stratum 3 was on long-term leave for three months of the fiscal year.

TABLE 6.8 **Substantive testing results of City Electronics' sales invoices**

Stratum	Error Found	Sample Total Value	Stratum Total Value	Projected Error
1	$ 7,930	$101,170	$128,660	
2	$ 3,290	$ 41,990	$ 76,830	
3	$ 8,600	$ 62,840	$162,280	
Total	$19,820	$206,000	$367,770	

6.10 Interpreting sampling documentation **Challenging** **LO 2, 7**

Min Li is auditing RRR Services Inc. and has designed the following tests:

Test A

1. Select 150 cancelled cheques (8 percent of the total number of cheques) at random from the cash disbursement journal for the year.
2. Ignore any cheques with a recorded value of less than $1,000.
3. Examine the cancelled cheques to verify if they have been approved by the accounting supervisor (indicated by her initials on the cheque).
4. Compare the percentage of cheques (of the sample) that lacks the accounting supervisor's initials to a predetermined percentage of 5 percent.

Test B

1. Select 150 cancelled cheques (8 percent of the total number of cheques) at random from the purchases journal for the year.
2. Compare the amount of each cheque with the amount recorded in the purchases journal.
3. Total the net overstatement or understatement for all cheques examined and project this amount to obtain an estimate for the population.
4. Compare the population estimate from step 3 to a predetermined amount of $8,000.

Required

a. Identify the attribute being tested in each test.

b. Can the results in Test B be used to project a value for the population? Explain your answer.

c. Can the results in Test A be used to project a value for the population of cancelled cheques for the year? Explain your answer.

d. Explain sampling risk in substantive testing (in one or two sentences).

Source: © CGA-Canada, now CPA Canada. Reproduced with permission.

6.11 Results of control testing **Moderate** **LO 1, 5, 7**

The controls at a retail store were assessed by the lead auditor as being effective, and the auditor intended to rely on the operative effectiveness of controls around payroll in determining the nature, timing, and extent of substantive procedures. There is no evidence of fraud.

The control activities include controls that ensure that part-time staff are paid at the correct rate. The results of testing the relevant control are: sample size 40; tolerable deviation rate 5 percent; exceptions noted: one instance of part-time staff paid an incorrect hourly rate.

Required

a. What is a tolerable deviation rate?

b. Explain why the exception is evidence that the control did not work effectively in this case.

c. Explain in general terms what impact the control test results would have on the nature, timing, and extent of substantive testing.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's Audit and Assurance Exam, December 2010. Provided courtesy of Chartered Accountants Australia and New Zealand.

Questions 6.12 and 6.13 are based on the following case.

Fabrication Holdings Ltd. (FH) has been a client of KFP Partners for many years. You are an audit senior and have been assigned to the FH audit for the first time for the fiscal year ended December 31, 2023. You are completing the audit planning for the property, plant, and equipment (PPE) account class, which is one of FH's most material balances. You are also aware that FH has made a large investment in a new manufacturing process to place itself in a more competitive position. Your analytical procedures indicate an increase in acquisitions of PPE.

You are testing the appropriateness of the depreciation rate assigned to PPE, and whether it is consistent with the present condition and expected use of the assets over their remaining life. You have sampled 35 PPE items, with a total dollar value of $1,145,000. The results show that, for the sample items, some depreciation rates were too low and/or the remaining useful life of the equipment was overstated by management. Together, these issues produce an error in the sample of $48,500. FH has a profit before tax for the current year of $1,875,000, and a PPE account balance at the end of the year of $11,345,000.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's Audit and Assurance Exam, May 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

6.12 Sampling methods and risk **Moderate** **LO 1, 2, 3, 4, 9**

Required

Discuss the appropriate method of sampling FH's PPE for the planned tests of depreciation. Define the population. What assertions are most at risk?

6.13 Projecting errors for property, plant, and equipment **Moderate** **LO 6, 7**

Required

What conclusion would you draw about "accuracy, valuation, and allocation" of PPE from the above information? Justify your conclusion.

Questions 6.14 and 6.15 are based on the following case.

Fellowes and Associates Chartered Professional Accountants is a successful mid-tier accounting firm with a large range of clients across Canada. In April 2023, Fellowes and Associates gained a new client, Health Care Holdings Group (HCHG), which owns 100 percent of the following entities:

- Shady Oaks Centre, a private treatment centre
- Gardens Nursing Home Ltd., a private nursing home
- Total Laser Care Limited, a private clinic that specializes in the laser treatment of skin defects

The year end for all HCHG entities is June 30.

During the 2023 financial year, Shady Oaks released its own line of treatment supplies, such as orthotics, massage oils, and exercise discs and balls, which are sold by direct marketing by a sales team employed by the centre. The sales team receives a base salary and a bonus component, which is based on the dollar value of sales it generates. You recognize that the team's main motivation is to maximize its bonuses. You select a sample of payments received by the centre post year end and trace the payments back to the general ledger and customer account balance.

In addition, you are reviewing the results of a number of tests in relation to accounts payable at Gardens Nursing Home, as shown in table 6.9.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's Audit and Assurance Exam, December 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

TABLE 6.9 Testing results of Gardens Nursing Home's accounts payable

Test	Result	Conclusion
1	A number of suppliers were selected from the list of trade creditors at year end and balances traced to supplier invoices and goods received reports to ensure that goods were received prior to the year end. For 2 creditors out of 15 tested, the balance was only marginally overstated.	Accepted as no material errors were found
2	A number of suppliers' invoices were selected and checked to ensure that the pricing and discount terms were reviewed and authorized by the purchase manager. Three out of 20 invoices tested had not been authorized and incorrect discounts were recorded for these invoices. A follow-up of the three samples with deviations did not highlight a pattern or specific reason for the errors.	Accepted as the errors in discounts taken were immaterial

6.14 Substantive testing and assertions **Moderate** **LO 6, 8, 9**

Required

a. Identify the key account balance at risk because of the remuneration of the sales team at Shady Oaks. Identify and explain the key assertion at risk.

b. Identify the key account balance and key assertion being tested using the substantive procedure for Shady Oaks. Given the bonus structure in place for the sales team, justify your answer.

6.15 Substantive testing versus control testing **Challenging** **LO 6, 8**

Required

For each of the test results for Gardens Nursing Home:

a. Identify whether this is a test of controls or a substantive test of detail.

b. Determine the key assertion addressed by the test procedure.

c. Explain why the conclusion reached is appropriate or inappropriate.

d. Outline the key additional procedure that you believe needs to be performed.

6.16 Control testing in previous year **Basic** **LO 9**

BBB have been the auditor of the Wild Ride Theme Park for the past two years. They have completed both the financial audit and the audit for the Department of Sport and Leisure, stating that the business has adhered to the Theme Park Regulations. Wild Ride Theme Park has requested that BBB undertake both the financial statement audit and the compliance audit engagement for the current year. In each of the previous two years, BBB has tested all of Wild Ride Theme Park's internal controls relevant to ensuring compliance with the Regulations. There have been no exceptions detected in this testing of controls in the past two years. A combined approach is also planned for the current year.

Required

The junior auditor on the engagement has suggested that, since there were no exceptions detected in previous years, no work on internal controls is required because last year's evidence will be sufficient. Explain why the junior auditor's suggestion is not appropriate.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, March 2011. Provided courtesy of Chartered Accountants Australia and New Zealand.

6.17 Testing accounts receivable **Basic** **LO 8, 9**

Emma Maltz has been appointed as audit senior of the accounts receivable area in the audit of Fantastic Cruises, a company operating leisure cruises from ports in eastern Canada. Fantastic Cruises sells cruises to individuals (via its website) and to travel agents for resale to customers. All cruises are paid in advance, with a 10-percent deposit on booking, and the remainder collected at least four weeks prior to sailing. Travel agents collect money from their customers, deduct their commission, and forward the remainder to the cruise company before the deadline. Emma has made a preliminary assessment that the client is a low control risk and she plans to conduct extensive testing of controls in the accounts receivable area to support her assessment.

Required

a. What is Emma's objective in testing the controls over accounts receivable?

b. Assuming Emma achieves her objective, discuss the implications for the nature, timing, and extent of substantive testing of accounts receivable.

Case Study—Cloud 9

Answer the following questions based on the information for Cloud 9 presented in Appendix A of this book and in the current and earlier chapters. You should also consider your answers to the case study questions in earlier chapters.

Required

a. Consider and explain the effects that the opening of Cloud 9's first retail store would have on its accounting.

b. Describe how this business change would affect the components of audit risk.

c. What changes would you expect to see in inventory transactions and balances as Cloud 9 changes from a wholesale-only business to a retail and wholesale business? Be specific in your answer.

d. Which inventory balance and transaction assertions would be most affected? Explain.

e. Describe the population(s) and suggest a sampling approach for controls and substantive testing for inventory.

Research Question 6.1

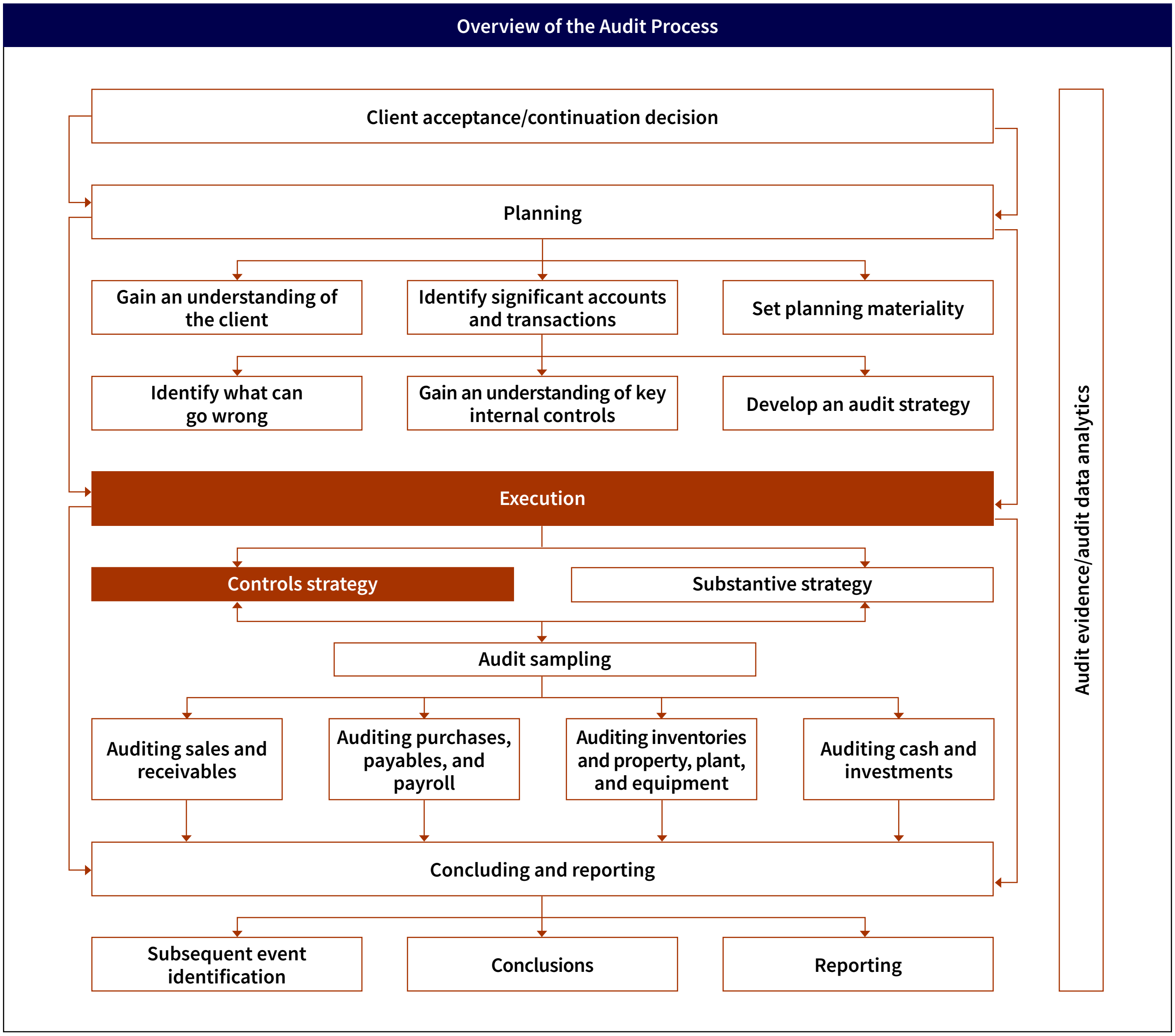
McKesson & Robbins was a company at the centre of a famous fraud in the United States in the 1930s.

Required

a. Research the facts of the McKesson & Robbins fraud and write a short description of the case.

b. Make a list of the defects in the company's system of internal controls that are relevant to the fraud and suggest audit tests that would have revealed these problems.

Understanding and Testing the Client's System of Internal Controls



LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
After studying this chapter, you should be able to:		Standards addressed in each learning objective are as follows:
1 Define the system of internal control	**7.1** The System of Internal Control Defined	CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
2 State the seven generally accepted objectives of internal control activities	**7.2** Objectives of Internal Controls	
3 Describe the elements of the system of internal control at the entity level	**7.3** System of Internal Controls **7.3.1** The control environment **7.3.2** The entity's risk assessment process **7.3.3** Information systems and communication **7.3.4** Control activities **7.3.5** Monitoring of controls **7.3.6** Internal control in small entities	CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
4 Identify the different types of controls	**7.4** Types of Controls **7.4.1** Preventive and detective controls **7.4.2** Manual and automated controls	CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
5 Explain how to select and design tests of controls	**7.5** Selecting and Designing Tests of Controls **7.5.1** Which controls should be selected for testing? **7.5.2** How much testing does the auditor need to do?	CAS 330 *The Auditor's Responses to Assessed Risks*
6 Explain the different techniques used to document and test internal controls	**7.6** Documenting and Testing Internal Controls **7.6.1** Documenting internal controls **7.6.2** Testing internal controls	CAS 500 *Audit Evidence*
7 Understand how to interpret the results of testing of controls	**7.7** Results of the Auditor's Testing	CAS 260 *Communication with Those Charged with Governance* CAS 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* CAS 330 *The Auditor's Responses to Assessed Risks*

LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
8 Explain how to document tests of controls	**7.8** Documenting Conclusions	CAS 230 *Audit Documentation* CAS 330 *The Auditor's Responses to Assessed Risks*
9 Describe the importance of identifying strengths and weaknesses in a system of internal controls	**7.9** Identifying Strengths and Weaknesses in a System of Internal Controls	CAS 260 *Communication with Those Charged with Governance* CAS 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*
10 Explain how to communicate internal control strengths and weaknesses to those charged with governance	**7.10** Management Letters	CAS 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*

Cloud 9 Integrated Case

Sharon Gallagher and Josh Thomas are working on the draft of their internal control assessment report for Cloud 9 Ltd. They met with the Cloud 9 finance director, David Collier, to gain an understanding of the internal controls at the entity level. The interview covered issues such as management integrity, policies and procedures, and monitoring of control activities. Sharon asks Josh to write up the results of the interview and make an assessment about the effectiveness of entity-level controls. Does the company demonstrate an environment where potential material misstatements are prevented or detected?

Sharon also wants Josh to document in detail an understanding of the controls at the transaction level. Sharon emphasizes to Josh that their description of Cloud 9's system of internal controls is part of the evidence for the audit, and their assessment of the system's strengths and weaknesses will influence the remainder of the planning process. They must understand when, where, and how potential material misstatements can occur.

How will Josh complete his tasks?

Chapter Preview

The purpose of this chapter is to assist in understanding the client's system of internal controls as it relates to the audit of the financial statements. This involves understanding the term "internal control," being aware of the objectives of the internal controls put in place by management and the components of these controls (particularly at the entity level), and understanding a client's system of internal controls.

This chapter will also consider the importance of evaluating how the design and implementation of controls will prevent material misstatements from occurring, or how they will detect and correct material misstatements after they have occurred.

When the auditor decides to include control testing in their audit strategy, they select those controls that will provide the most efficient and effective audit evidence. Also, the auditor will test only those controls they believe are critical to their opinion and are likely to be working effectively. Deciding which controls to test will be influenced by the type of control, the frequency with which the control is performed, and the level of assurance the auditor wants to gain from the control being designed and implemented effectively.

There are many techniques available to test and document the controls identified when planning the audit, and in this chapter we will provide an overview of several of the more typical testing techniques. This overview will include examples of the extent of control testing to perform and how this extent of testing will influence the level of assurance we obtain toward the overall audit conclusion or opinion. We will discuss what the auditor's response should be to any exceptions or errors found in their testing of controls, as well as how the auditor should document the results of their testing. In the discussion of the results, we will also include examples of how these affect the overall risk assessment and the resulting substantive audit procedures performed. Finally, we will discuss the implications of an absence of internal controls and describe how strengths and weaknesses in a system of internal controls are communicated to both management and those charged with governance.

7.1 The System of Internal Control Defined

LEARNING OBJECTIVE 1

Define the system of internal control.

Why is understanding the system of internal control of an organization important? Because when the system of internal controls is effective, the organization is more likely to achieve its strategic and operating objectives. The system of internal control is a very broad concept and encompasses all of the elements of an organization—its resources, systems, processes, culture, structure, and tasks. When these elements are taken together, they support the organization in achieving its objectives. For the purposes of this chapter, we will focus on the components of internal control that have a direct impact on the financial reporting. We will consider the safeguards put in place by management to prevent and detect errors including misappropriation of assets and human errors. The **system of internal control** is defined in the auditing standards as:

system of internal control the system designed, implemented, and maintained by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations

audit risk the risk that an auditor expresses an inappropriate audit opinion when the financial statements are materially misstated

> The system designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. (CAS 315)

Understanding the system of internal control is a key component of the overall **audit risk** assessment and provides evidence that influences the resulting strategy developed by the auditor. Also, CAS 315 *Identifying and Assessing the Risks of Material Misstatement* requires the auditor to obtain an understanding of the system of internal control on all audit engagements.

Frameworks for internal controls have been developed, such as the *Internal Control—Integrated Framework* developed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) and the *Guidance on Controls* issued by the Criteria of Control Board of CPA Canada. These frameworks provide a structure that allows the auditor to assess the system of internal controls of an organization as compared with a theoretical model. Therefore, where a system of internal controls put in place by management agree closely with the theoretical framework, the internal controls may be described as strong. However, where internal controls do not agree closely with the theoretical framework, they may be described as weak.

While we will not discuss these frameworks specifically, the general principles are consistent with the objectives and components of internal control discussed in more detail in this chapter and included in CAS 315.

Before You Go On

7.1.1 What is the system of internal control?

7.1.2 Why is it important to understand (and assess) the system of internal controls?

7.1.3 Name a generally accepted framework used to describe internal controls.

7.2 Objectives of Internal Controls

LEARNING OBJECTIVE 2

State the seven generally accepted objectives of internal control activities.

It is important for the auditor to understand the objectives of internal controls. While the auditor links controls—the policies and procedures in place to help the organization meet its control objectives—to audit assertions and account balances, the objective of controls is to connect the auditor's understanding of why the controls are important with the issues they are designed to prevent. The reason an organization puts controls in place is to ensure that errors in the processing of transactions do not occur, and if they do, that these errors are identified and rectified quickly. Without understanding the intention of management in implementing these controls, it is harder to connect them to our understanding of what can go wrong with the process and how to prevent it from happening.

There are seven generally accepted objectives of internal controls. Internal controls are designed and implemented to ensure that transactions are real, recorded, correctly valued, classified, summarized, and posted on a timely basis. When the system of internal controls meets its objectives as these relate to the recording of transactions and balances, management assertions are also likely to be valid. The internal control objectives are matched with the relevant assertions as follows:

1. Real—there are controls in place to ensure that fictitious or duplicate transactions are not included in the books and records of the organization (occurrence, rights and obligations, and existence assertions).
2. Recorded—there are controls in place that will prevent or detect the omission of transactions from the books and records of the organization (accuracy, completeness, and accuracy, valuation, and allocation assertions).
3. Valued—there are controls in place to ensure that the correct amounts are assigned to the transactions (accuracy, and accuracy, valuation, and allocation assertions).
4. Classified—there are controls in place to ensure that transactions are charged and allocated to the correct general ledger account (accuracy, classification, and accuracy, valuation, and allocation assertions).
5. Summarized—there are controls in place to ensure that the transactions in the books and records are summarized and totalled correctly (accuracy, and accuracy, valuation, and allocation assertions).
6. Posted—there are controls in place to ensure that the accumulated totals in the transaction file are correctly transferred to the general ledger and subsidiary ledgers (accuracy, classification, and accuracy, valuation, and allocation assertions).
7. Timely—there are controls in place to ensure that transactions are recorded in the correct accounting period (cut-off and completeness assertions).

Disclosures are not specifically addressed by these internal control objectives. An entity may still design controls over disclosures. The auditor performs procedures based on the controls the entity has in place. The auditor usually ensures disclosure requirements are met by substantively testing the draft financial statements. An example of how this is often done is by using a disclosure checklist. These checklists typically include all of the disclosures required by the accounting standards. They assist the auditor in ensuring that all of the required material disclosures have been made.

When the auditor gains an understanding of the client's system of internal controls and how the client uses internal controls to manage risks in the business, it is important for the auditor to remember each of these objectives. By focusing on each objective, the auditor will be able to select the appropriate controls to test to gain the greatest level of assurance possible that the client's system of internal controls is operating effectively.

The concept of testing and assessing controls is discussed in more detail later in this chapter. It is worth mentioning here that, when the objectives of internal controls are not met, it is considered to be a deficiency in internal control. The auditor then considers whether the weakness has a significant impact on their risk assessment for the relevant account balances, transactions, and disclosures. This is also discussed in further detail later in this chapter.

Internal control, no matter how effective, can only provide an entity with reasonable assurance in achieving its financial reporting objectives. There are inherent limitations of internal control. These include:

- human error that results in a breakdown in internal control
- ineffective understanding of the purpose of a control
- collusion by two or more individuals to circumvent a control
- a control within a software program being overridden or disabled

An example of a limitation is an internal control that may be designed appropriately but never implemented by management. The control, therefore, has no ability to mitigate risks. These limitations of internal controls are often mitigated by other controls (often referred to as compensating controls). If there are no other controls mitigating the weaknesses or limitations, the risks are addressed by the auditor performing extensive substantive procedures.

Cloud 9 Integrated Case

Josh knows that as he writes his report he has to think about the whole system of internal controls at Cloud 9 and how effective it is in helping the company achieve its objectives. However, as the auditor, he has to focus mostly on the controls that relate to the integrity of the company's financial statements. Which controls are keeping transactions real, recorded, correctly valued, classified, summarized, and posted on a timely basis? Also, which controls are protecting assets and ensuring that the company complies with relevant laws and regulations? The better these controls, the more likely that W&S Partners can adopt a combined audit approach strategy.

Before You Go On

7.2.1 What are the seven generally accepted objectives of internal controls as related to the recording of transactions?

7.2.2 Why are internal controls important to an organization?

7.2.3 Why are internal controls important to an auditor?

7.3 System of Internal Controls

LEARNING OBJECTIVE 3

Describe the elements of the system of internal control at the entity level.

As set out in CAS 315, the system of internal control consists of five components:

1. the control environment
2. the entity's risk assessment process
3. the information system, including the related business processes, relevant to financial reporting and communication
4. control activities
5. monitoring of controls

These internal control components, when collectively assessed, are often referred to as **entity-level controls** because each exists at an organizational or entity level rather than at a more detailed transactional level. For example, a control ensuring that sales are recorded in the sales ledger is a transaction-level control. A control such as the internal audit function of a company is an entity-level control.

entity-level controls the collective assessment of the client's control environment, risk assessment process, information system, control activities, and monitoring of controls

Gaining an understanding of the entity-level internal control components helps in establishing the appropriate level of professional scepticism, gaining an understanding of the client's business and financial statement risks, and making assessments of inherent risk and control risk, which, in turn, determines the nature, timing, and extent of audit procedures.

While the documentation and understanding of the entity-level control components are required for every audit, these controls are generally not tested, primarily because of the difficulty of doing so. For example, there is rarely audit evidence that a control such as the tone at the top of an organization is in existence and operating effectively. Also, the reason controls are put in place is to prevent or detect and rectify an error. Entity-level controls by themselves are not usually sensitive enough to prevent or detect and rectify material errors. Lower-level controls, which are discussed in this and subsequent chapters, are more capable of preventing or detecting and rectifying material errors.

7.3.1 The Control Environment

The control environment sets the tone of an entity and influences the control consciousness of its people. It is the foundation for all other components of internal control and is often thought of as a combination of the culture, structure, and discipline of an organization. It reflects the overall attitude, awareness, and actions of management, the board of directors, others charged with governance, and the owners concerning the importance of controls and the emphasis given to controls in determining the organization's policies, processes, and organizational structure. Therefore, the control environment is sometimes referred to as the "tone at the top."

The **control environment** also sets the foundation for effective internal control, providing discipline and structure, and includes the following elements.

control environment the attitudes, awareness, and actions of management and those charged with governance concerning the entity's internal control and its importance in the entity

- *How management's responsibilities are carried out, including creating and maintaining the entity's culture and demonstrating management's commitment to integrity and ethical values.* Integrity and ethical values are essential elements of the control environment, affecting the design, administration, and monitoring of key processes. Integrity and ethical behaviour are the products of the organization's ethical and behavioural standards, how they are communicated, and how they are monitored and enforced in its business activities. Control activities include management's actions to remove or reduce incentives, pressures, and opportunities that might prompt personnel to engage in dishonest, illegal, or unethical acts. Other control activities include the communication of the organization's values and behavioural standards to personnel through policy statements and codes of conduct, and the examples set by management.

  For example, management may state in its code of conduct that employees are not allowed to accept gifts from suppliers valued above a certain amount and that all offers of gifts (whether accepted or not) are to be reported. Although a code of conduct does not guarantee that employees will act ethically regarding gifts, it does indicate that management communicates standards of behaviour that it expects employees to adhere to. Coupled with other procedures, such actions may demonstrate an effective control environment. It is also important that management be seen to comply with its own policies.
- *How the entity attracts, develops, and retains competent employees.* Management is responsible for ensuring the entity has appropriate human resource policies and practices relating to the hiring, inducting, training, evaluating, counselling, promoting, and compensating employees. The competence and integrity of an entity's employees are essential elements of its control environment. The organization's ability to recruit and retain competent and responsible employees is therefore dependent to a large extent on its human

resource policies and practices. Management must ensure appropriate human resource policies are in place so that staff with the required skills are hired and matched to the right jobs. For example, standards are often set for hiring qualified individuals, focusing on educational background, prior work experience, past accomplishments, and evidence of a cultural fit with the employer organization (values and ethics). These standards show the organization's commitment to employing only competent and trustworthy people. Often job descriptions illustrate the expected levels of performance and behaviour.

When assessing the control environment, auditors use professional judgement to determine whether they believe management and employees appear to be competent to carry out their assigned roles and receive adequate supervision where required. For example, they will consider whether employees in the accounting department have the knowledge and expertise necessary to understand and execute the requirements of the generally accepted reporting framework, the International Financial Reporting Standards (IFRS), or the Canadian Accounting Standards for Private Enterprises (ASPE)?

- *How independent and active those charged with governance are*. The organization's control environment is influenced significantly by its board of directors and others charged with governance of the entity: for example, by the audit committee members or the executive members of the board of directors if they are charged with responsibility for governance and are members of management. Those charged with governance are responsible for overseeing the entity's accounting and financial reporting policies and procedures. As a result, those charged with governance have an obligation to be concerned with the entity's financial reporting to shareholders and the investing public, and to monitor the entity's accounting policies and the internal and independent (external) audit processes.

  In determining the effectiveness of the participation of those charged with governance, in particular the board of directors, auditors consider the board's independence from management, the experience of its members, the extent of its involvement and scrutiny of management's day-to-day activities, and its interactions with the internal and/or external auditors. For example, if the board has regular and open communications with its auditors, management may be more willing to inform the board of issues arising in the business on a timely basis (to avoid "surprises").

- *How the entity assigns authority and responsibility*. The client's organizational structure provides the framework within which its activities for achieving entity-wide objectives are planned, executed, controlled, and monitored. Establishing an organizational structure includes considering the key areas of authority and responsibility as well as the appropriateness of the lines of reporting.

  The size and complexity of the organization, together with management's business and operating philosophies, significantly affect the organizational structure and the need for formal organization charts, job descriptions, and policy statements. In addition to the formal organizational structure, an informal structure may also exist that affects the control environment. An auditor will gain an understanding of their client's organizational structure and the suitability of its policies and procedures in light of its size and complexity.

  Assignment of authority and responsibility includes how authority and responsibility for operating activities are assigned, and how reporting relationships and authorization hierarchies are established. It includes policies relating to appropriate business practices, knowledge, experience of key personnel, and resources provided for carrying out duties. Assignment of authority and responsibility also includes policies and communications directed toward ensuring that all employees understand the organization's objectives, know how their individual roles and actions contribute to those objectives, and recognize how they will be held accountable for their actions.

  The information technology (IT) environment is also an important aspect of the auditor's review of the assignment of authority and responsibility. The auditor looks to assess if the entity has the appropriate organizational structure, talent, and resources to support the IT infrastructure and systems. The auditor also needs to consider whether the IT deployed by the entity allows clear assignment of responsibilities. This should include the assignment of authorization to initiate and/or change transactions and

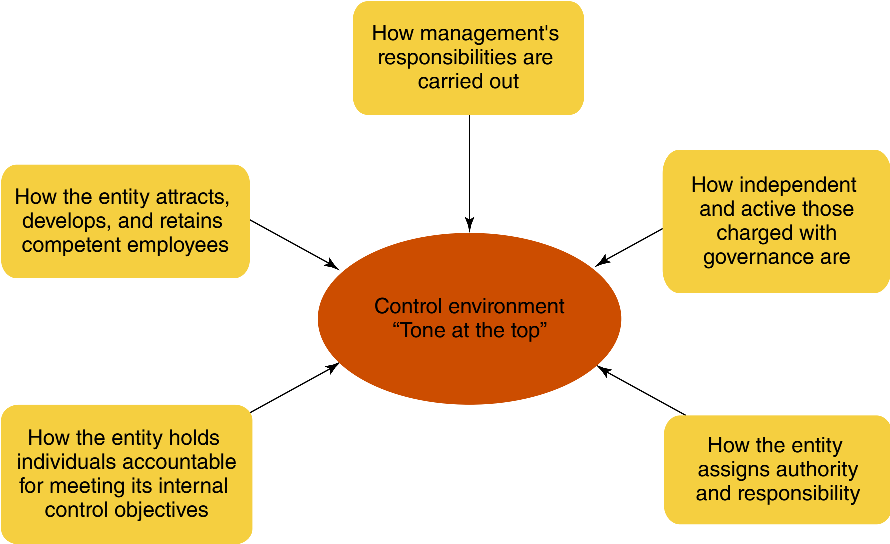


FIGURE 7.1 **Control environment**

programs as well as efforts to ensure that there is appropriate segregation of duties related to the programming, administration, operation, and use of IT. Segregation of duties is explained further in section 7.3.4.

- *How the entity holds individuals accountable for meeting its internal control objectives.* Management is responsible for not only ensuring employees understand their responsibilities with respect to internal controls, but also for keeping employees accountable for meeting the organization's control objectives. Employees need to understand what they are accountable for, how they are being measured, and the related reward systems.

When gaining an understanding of the control environment, the auditor considers each of the above elements and their interrelationships. The auditor evaluates the control environment to determine if management has created an appropriate foundation to convey the importance of honesty and ethical behaviour. In particular, the auditor needs to understand whether there are any significant deficiencies in any one element, as these deficiencies may have an impact on the effectiveness of the other elements. For example, management may establish a formal code of conduct but then act in a manner that condones breaches of that code.

The assessment of the system of internal controls, as well as the impact of weaknesses in or exceptions to internal controls, is discussed in more detail later in this chapter. **Figure 7.1** shows how the tone at the top affects the control environment, and Professional Environment 7.1 provides a concrete example.

Cloud 9 Integrated Case

During the interview Josh and Sharon held with David Collier, they learned a lot about the tone at the top at Cloud 9. Top-level management at the company is bound by a code of conduct based on a similar document adopted by the parent company, Cloud 9 Inc. The parent company has adopted a very strict approach to management integrity. Cloud 9's board members and senior managers attend training and awareness sessions on the code at least annually. In addition, there has been a rigorous process of embedding the code's main points throughout the company's policies and procedures, most of which have been rewritten in the previous two years.

A copy of the company's code of conduct and the policies and procedures are included in the audit working papers. Josh also writes a description of the company's efforts to communicate its approach to management integrity in the report. He assesses the control environment at Cloud 9 as effective.

7.1 Professional Environment Tone at the Top Trickles Down

The corporate culture at Wells Fargo, a giant U.S. bank, came into the spotlight when it was reported that 5,300 employees were fired as a consequence of a sales scandal. Over a five-year span, bank employees were encouraged and financially rewarded for opening new customer accounts. "The push to make sales quotas was so intense and relentless that some bank employees forged customers' signatures on new accounts." The result? Up to 2 million unauthorized accounts may have been created, and many customers paid fees on accounts they did not want or even know about. Some customers even faced credit issues due to overdue fees on accounts they did not know they had. This left many wondering where the oversight of the board of directors was.

A corporate board has many duties, but three of the most crucial are to assess the business risks and handle them before they develop into a crisis, to distribute compensation to encourage good behaviour, and to set a strong tone at the top. After the sales scandal, many corporate governance experts rated Wells Fargo's board with failing grades in all areas. "When testifying to the U.S. Congress about the scandal the bank's CEO indicated he first became aware of the problem in 2013, and that employees were still being fired for creating phony accounts. He also admitted that no senior management leaders had been fired over the scandal. Even if not aware of the issue until 2013, governance best practices and federal law would require Wells Fargo to disclose to its auditors any potential 'material event' that could have a negative impact on the company, and it should have been included in their regulatory filings."

The tone at the top is especially crucial as it has a trickle-down effect on all employees of the organization. A recent study conducted by the Ponemon Institute found that, if management is committed to a culture and environment that embraces honesty, integrity, and ethics, employees are more likely to uphold those same values. By not taking significant action to change the focus of the sales program when the unethical sales practices first came to light, senior management was complacent. Despite having a code of ethics claiming the importance of doing the right thing, when it came to sales growth, it seemed they were prepared to turn a blind eye and this trickled down the organization.

Q: Other than the possibility of fraud, how else can the tone at the top impact an organization?

Sources: Sheryl Nance-Nash, "How Can Wells Fargo's Board Move Forward?" *IR Magazine*, October 11, 2016; Ponemon Institute and Shared Assessments, *Tone at the Top and Third Party Risk*, May 2016; Gretchen Morgenson, "By Taking Back Money, Wells Fargo's Board Seems to Recall Its Role," *The New York Times*, September 27, 2016; www.wellsfargo.com/about/corporate/governance/; Mark W. Sheffert, "Wells Fargo Fiasco Resulted from Leadership Culture the Company Apparently Plans to Keep," *StarTribune*, October 18, 2016.

7.3.2 The Entity's Risk Assessment Process

All entities, regardless of their size, structure, nature, or industry, encounter risks at all levels within the organization. Risks will affect the entity's ability to survive, compete, grow, and improve the quality of its products, services, and people. It is not possible to reduce these risks to zero; however, management (in conjunction with those charged with governance) needs to determine how much risk is acceptable to the organization. Some organizations have a risk committee, which is responsible for ensuring that all of these risks are identified, managed, and reported to the board of directors.

The entity's risk assessment process is its method for identifying and responding to business risks. For financial reporting purposes, the entity's **risk assessment process** includes how management identifies risks relevant to the preparation of the financial statements to ensure a fair presentation in accordance with the entity's applicable financial reporting framework. For identified risks, management estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to manage them.

risk assessment process the entity's process for identifying and responding to business risks

Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. For example, new accounting pronouncements and significant changes to the financial reporting standards (such as the change from local accounting standards to IFRS) are externally created risks relevant to the entity's financial reporting. Corporate restructurings that result in reduced employee levels may weaken the segregation of duties, and the internal control structure is an internally generated risk relevant to an entity's financial reporting. An organization's risk assessment process is different from the auditor's consideration of risk. The purpose of the entity's risk assessment process is to identify, analyze, and manage the risks that affect its ability to achieve its operational effectiveness. In an audit, the purpose is to assess the combined **inherent**, **control**, and **detection risks** to evaluate the likelihood that material misstatements could occur in the financial statements.

inherent risk the susceptibility of the financial statements to a material misstatement without considering internal controls

control risk the risk that a client's system of internal controls will not prevent or detect a material misstatement

detection risk the risk that the auditor's procedures will not be effective in detecting a material misstatement should there be one

An entity's risk assessment for financial reporting purposes is its identification, analysis, and management of the risks relevant to the preparation of the financial statements that are fairly presented in compliance with the accounting framework (for example, IFRS or ASPE). Once risks are identified, management will ordinarily initiate plans, programs, or other actions to address the risks. Alternatively, management may decide to accept the risk without addressing it. Usually, this decision is made on the basis of the cost versus the benefit of managing the risk.

Risks can arise or be transformed as a result of changes to the organization and the environment it operates within. These include changes in the operating environment, new personnel, extensive or new technology, rapid growth, business restructuring, and new accounting pronouncements, as discussed above. It is important for the auditor to understand the risks identified by the entity as this will assist the auditor in considering where (and if) a material misstatement in the financial statements might exist. The overall potential for risks to have a material impact on the financial statements is increased when management appears willing to accept unusually high risks when making business decisions, when entering into major commitments without sufficient consideration of the risks, when failing to closely monitor and control the risks associated with commitments entered into, and when failing to manage the risks related to IT, such as those related to data integrity.

Cloud 9 Integrated Case

In their interview, Josh and Sharon ask David Collier about Cloud 9's risk assessment process. They want to know which risks management has identified so that they can consider whether those risks could cause a material misstatement in the financial statements. They also want to know about the company's methods of responding to the identified risks. David Collier tells them that Cloud 9's management continually monitors its competitors' activities. It also considers the risk of interruption to supplies because of shipping problems and labour disputes at production plants or transportation companies.

Another example of risks that could have a major impact on the financial statements is the possible use of forward exchange contracts to control the risks caused by purchasing in foreign currencies. Management is also very aware of risks associated with the just-in-time inventory system, which has had some problems lately, and has planned some changes to deal with those problems.

Management is monitoring the risks of using a hockey player as a spokesperson for the brand, plus the broader risks arising from sponsorship of the hockey team because there has been a lot of adverse publicity about hockey players' behaviour over the past year. Such adverse publicity could impact negatively on sales. Cloud 9's management ensures that the hockey team's management keeps them informed of players' activities, where appropriate.

Josh concludes from the interview that Cloud 9 has an effective system of risk assessment because it actively searches out and considers potential risks to the business and has developed action plans to deal with each risk, depending on its likely occurrence.

7.3.3 Information Systems and Communication

The role of information systems is to capture and exchange the information needed to conduct, manage, and control an entity's operations. The quality of information and communication affects management's ability to make appropriate decisions in controlling the organization's activities and to prepare reliable financial statements. Information and communication involve capturing and providing information to management and employees so that they can carry out their responsibilities, including providing an understanding of individual roles and responsibilities as they relate to internal controls over financial reporting.

Information is needed at all levels of the entity to run the business and to assist in the achievement of financial reporting, operating, and compliance objectives. An array of information is used. Financial information, for instance, is used not only in developing financial statements for external dissemination; it may also be used for operational decisions, such as monitoring performance and allocating resources. Similarly, operating information (for example, airborne particle emissions and personnel data) may be needed to achieve compliance and financial reporting objectives as well as operating objectives. However, certain operating information (for example, purchases and sales data) is essential for developing the financial statements. As such, information developed from internal and external sources, both financial and non-financial, is relevant to all three objectives.

Information is identified, captured, processed, and reported by information systems. Information systems may be computerized, manual, or a combination thereof. The term "information systems" is frequently used in the context of processing internally generated data relating to transactions (for example, sales) and internal operating activities (for example, production processes). However, information systems as they relate to internal controls are much broader. That is, information systems also deal with information about external events, activities, and conditions.

Auditors are most interested in the information systems that are relevant to the financial reporting objective; that is, the systems responsible for initiating and recording transactions, balances, and events that will ultimately be reflected in the financial statements. These systems consist of the procedures, whether automated or manual, and records established to initiate, authorize, record, process, and report transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. Clients use IT systems to varying degrees. Some use customized and complex automated systems, while others use simple off-the-shelf commercial software. The extent of the client's use of IT systems affects the controls needed to minimize IT-related risks, including those related to IT infrastructure. Where a client has a highly automated information system, the auditor is interested in how the systems are integrated, and how the integrity of the information is maintained. Other systems of audit interest include the client's asset-safeguarding controls and the process for authorizing transactions, including adequate segregation of incompatible duties. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial statements.

The information systems that are relevant to the financial reporting objective encompass methods that ensure transactions and disclosures are real, recorded, valued, classified, summarized, and posted on a timely basis. (Refer to section 7.2 for discussion of the seven generally accepted objectives of internal controls.)

Communication is the process by which information is provided to those who need it on a timely basis. For example, a monthly management reporting package contains information about the company's financial performance and is used by many companies as the major way of communicating this information to executives and directors.

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Josh is an expert on information systems and, based on the interview with David Collier, which covered the information systems at a high level, he can conclude that the entity-level controls in this area are effective. Josh will gather further information in an interview with Cloud 9's financial controller, Carla Johnson. Based on this second interview and a review of the company's documents, he will write a description of his understanding of the processes used in each of the major transaction cycles.

7.3.4 Control Activities

control activities policies and procedures that help ensure that management directives are carried out. Control activities are a component of internal control.

Control activities are policies and procedures that help ensure that management's directives are carried out. They help guarantee that necessary actions are taken to address risks affecting the achievement of the organization's objectives. Control activities, whether automated or manual, have various objectives and are applied at various organizational and functional levels. Generally, control activities that may be relevant to an audit may be categorized as policies and procedures pertaining to the following:

- *Performance reviews*. These control activities include reviews of actual performance versus budgets, forecasts, and prior-period performance. Performance reviews compare different sets of data (operating or financial), analyzing these relationships and investigative and corrective actions. They also include reviews of functional or activity performance, such as, at a bank, a consumer loan manager's review of reports by branch, region, and loan type for loan approvals and collections. By investigating unexpected results or unusual trends, management identifies circumstances where the underlying activity objectives are in danger of not being achieved.

- *Information processing*. A variety of controls are performed to check accuracy, completeness, and authorization of transactions within information processing environments. Information processing controls can be manual controls; automated controls (that is, application dependent); manual controls dependent on an automated process (that is, IT dependent); or IT general controls (ITGCs). These concepts are discussed further later in this chapter.
- *Authorization controls*. These control activities define who can approve the various transactions within the organization. There is typically an approval hierarchy indicating authorization levels within the organization. The approval level generally increases as management responsibility increases. Approval should be required before any expenditure is made, including the hiring of employees, the ordering of goods and services, and the ability to extend credit.
- *Account reconciliations*. Reconciliations involve the preparation and review of account reconciliations on a timely basis. Bank accounts, intercompany accounts, and any clearing and suspense accounts should be reconciled on a regular basis. Sub-ledgers should be reconciled to the general ledger accounts. Reconciling items should be investigated and corrected promptly.
- *Physical controls*. These control activities encompass the physical security of assets, including adequate safeguards over access to assets and records (such as secured facilities and authorization for access to computer programs and data files) and periodic counting and comparison with amounts shown on control records. The extent to which physical controls intended to prevent theft of assets are relevant to the success of the business and the reliability of the financial statement preparation (and therefore the audit) depends on the circumstances, such as if assets are highly susceptible to misappropriation.
- *Segregation of incompatible duties*. This control activity encompasses the concept that no one employee or group of employees should be in a position to both perpetrate and hide errors or fraud in the normal course of their duties. In general, the principal duties that are incompatible and should be segregated are:

  – custody of assets
  – authorization or approval of transactions affecting assets
  – recording or reporting of transactions

In addition, a control over the processing of a transaction should not be performed by the same person who is responsible for actually recording or reporting the transaction.

Assigning different people the responsibilities of authorizing transactions, recording transactions, and maintaining custody of assets reduces the opportunity for an individual to both make and hide errors (whether intentional or not) or commit fraud in the normal course of their duties. Adequate segregation of duties is an important consideration in determining whether a client's controls are effective, as it reduces the likelihood that errors (intentional or not) will remain undetected. When IT is used in an information system, segregation of incompatible duties is often achieved by implementing system-based controls (referred to as logical access controls).

In understanding the client's control activities at the entity level, consideration is given to factors such as:

- the extent to which performance of control activities relies on IT
- whether the necessary policies and procedures exist with respect to each of the entity's activities, including IT security and system development
- the extent to which controls included in the organization's policies are being applied
- whether management has clear objectives in terms of budget, profit, and other financial and operating goals, and whether these objectives are clearly written, communicated throughout the entity, and actively monitored
- whether planning and reporting systems are in place to identify variances from planned performance and communicate such variances to the appropriate level of management
- whether the appropriate level of management investigates variances and takes appropriate and timely corrective actions

- to what extent duties are divided or segregated among different people to reduce the risk of errors, fraud, or manipulation of results
- whether software is used to control access to data and programs and, if so, the extent to which segregation of incompatible duties is achieved by implementing these software controls
- whether periodic comparisons are made of amounts recorded in the accounting system with physical assets
- whether adequate safeguards are in place to prevent unauthorized access to or destruction of documents, records, and assets

The auditor finds these controls the easiest to test compared with other types of entity-level controls, as their operation is readily verifiable. For example, the controls surrounding the segregation of duties can be observed, while management integrity is not observable or easily verified. While we can see there are many possible control activities, CAS 315 requires the auditor to gain an understanding of the control activities that address significant risks, controls over journal entries, and controls the auditor plans to test, including those for which substantive procedures alone will not provide sufficient, appropriate evidence. The auditor should also gain an understanding of any other controls considered appropriate, such as the controls over significant classes of transactions, balances, and disclosures.

7.3.5 Monitoring of Controls

After establishing and maintaining internal controls, another important responsibility of management is to monitor the controls to assess whether they are operating as intended and are modified for changes in conditions on a timely basis. Over time, systems of internal controls change and the way controls are applied may evolve. Also, the circumstances for which the system of internal controls was originally designed may change, causing it to be less effective in warning management of risks brought about by new conditions. Accordingly, management needs to determine whether its system of internal controls continue to be relevant and able to address new risks.

Monitoring is a process of assessing the quality of internal control performance over time, considering whether controls are operating as intended, and making sure controls are modified as appropriate for changes in conditions. It involves assessing the design and implementation of controls on a regular basis and taking necessary corrective actions. This process is accomplished through ongoing activities and separate evaluations, or through a combination of the two.

Ongoing monitoring procedures are built into the normal recurring activities of the entity and include regular management and supervisory activities. For example, managers of sales, purchasing, and production at divisional and corporate levels should understand the entity's operations and question the accuracy of reports that differ significantly from their knowledge of operations. Monitoring activities may include using information obtained from communications with external parties. For example, customers ordinarily verify and corroborate a client's billing data by paying their invoices or by complaining about overcharging.

Much of the information used in monitoring is produced by the entity's information systems. If management assumes that data used for monitoring are accurate without having a basis for the assumption, errors may exist in the information, potentially leading management to incorrect conclusions from its monitoring activities.

One of the most common monitoring activities is the internal audit function. In many organizations, internal auditors (or personnel performing similar functions) contribute to the monitoring of the client's activities through separate evaluations. They regularly provide information about the functioning of internal controls, focusing considerable attention on the evaluation of the design and implementation of controls. They communicate information about strengths and weaknesses and make recommendations for improving internal control. The importance that a company places on its internal audit function also provides evidence about its overall commitment to internal control.

When evaluating the effectiveness of the internal audit function, factors to consider include independence, reporting lines, adequacy of staffing, adherence to applicable professional standards, scope of activities, adequacy of work performed, and conclusions reached.

The internal audit activities most relevant to the audit include those that provide evidence about the design and effectiveness of internal controls or that provide substantive evidence about potential material misstatements in the financial statements.

Finally, when gaining an understanding of the client's monitoring processes at the entity level, factors such as the following are ordinarily considered:

- whether periodic evaluations of internal control are made
- the extent to which personnel, in carrying out their regular duties, obtain evidence as to whether the system of internal controls continues to function
- the extent to which communications from external parties corroborate internally generated information, or indicate problems
- whether management implements internal control recommendations made by internal and external auditors
- whether management's approach to correcting known significant deficiencies is timely
- whether management's approach to dealing with reports and recommendations from regulators is effective
- whether an internal audit function exists that management uses to assist in its monitoring activities
- whether evaluations or observations are made by the external auditors

Cloud 9 Integrated Case

In the interview with David Collier, Sharon and Josh ask about both the control activities and the monitoring of those activities at Cloud 9. Sharon and Josh are particularly interested in the systems used at the company to make sure that information about management's plans and orders is transmitted throughout the organization and that there are policies and procedures to ensure that the appropriate actions are taken and reviewed.

In addition to asking David Collier about these matters, Josh reads the policy and procedures manuals and he and Sharon tour the offices and other facilities. For example, Cloud 9 has a tightly structured system of performance reviews. Managers at each level must report financial and operating performance against budget at regular intervals. Higher-level managers are able to access information about activities within their area of responsibility for monitoring purposes through the information system. Although there have been some issues with theft of goods from the retail store, the losses have been contained following the installation of additional security, including cameras. Josh and Sharon are particularly impressed with the thorough approach to segregation of incompatible duties.

Josh is able to conclude that, at an entity level, there is sufficient evidence that these controls are effective. He plans to review the specific controls that affect transaction cycles in more detail so that he can document his understanding of these processes.

7.3.6 Internal Control in Small Entities

In smaller entities, there are often limitations on the entity's ability to put effective internal controls in place. This is due to the small number of employees, which in turn impacts the ability of the organization to segregate duties. Also, it is often not practical for smaller organizations to create an appropriate paper trail of documentation that allows an assessment of internal controls to be made.

However, despite the size limitations of these entities, internal controls still exist. Ordinarily in smaller businesses, there is an owner-manager who is heavily involved in the day-to-day running of the business. This can be seen as both a strength and a weakness. It is a strength (assuming the owner-manager is competent) because the owner-manager is so closely involved in the business and day-to-day operations, including the selling of goods and services and the daily cash management of the operations, that it is unlikely that they would not detect material errors that might occur. It is also a weakness because that same owner-manager is in a position to be able to override internal controls.

The risk of management override can be reduced by establishing documented policies and procedures. However, if no such procedures or controls are in place, the risk of management override will need to be reduced from an audit perspective by the performance of additional audit procedures (through an increase in substantive procedures).

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Cloud 9 Ltd. has effective internal controls at the entity level. Sharon Gallagher, the audit manager, believes that, when considered at a high level, the company has an environment where potential misstatements are likely to be prevented or detected. Sharon has instructed the audit team to turn its attention to considering the transaction-level controls. Josh has asked Weijing Fei, a new member of his group, to identify the controls that Cloud 9 uses to either prevent or detect misstatements. Weijing needs some help with this because she does not understand the difference between preventive and detective controls.

Before You Go On

7.3.1 What are the five components of internal control?

7.3.2 Why is segregation of duties important when understanding internal control?

7.3.3 How does management's attitude and control consciousness affect the internal control environment of an organization?

7.4 Types of Controls

LEARNING OBJECTIVE 4

Identify the different types of controls.

Now that we have discussed entity-level controls, we will consider transaction-level controls. While it is important to understand (and document) the entity-level controls in an organization, they are very rarely sensitive enough to prevent or detect material misstatements. Further, they are often the types of controls that are very difficult to test or to obtain evidence of their being in place. For example, we could test the effectiveness of an internal audit function, but we would find it very difficult to test the "tone" of management. It is for these reasons that entity-level controls are rarely tested. Instead, the auditor focuses on testing controls that are operating at a much lower level and have the best chance of preventing things from going wrong with transactions, or detecting when they have gone wrong. These are referred to as transaction-level controls.

transaction-level controls controls that affect a particular transaction or group of transactions

Transaction-level controls are controls that affect a particular transaction or group of transactions. Transactions in this sense refer to transactions that are ordinarily recorded in the general ledger and span from the initiation of a transaction through to the reporting of the transaction in the financial statements. Transaction-level controls respond to things that can go wrong with transactions. They must be sensitive enough to either prevent an error from occurring or detect the error, report it, and have it rectified on a timely basis. Therefore, transaction-level controls include any procedure the client uses and relies on to prevent errors from occurring during the processing of transactions, or to detect and correct errors that may occur in these transactions.

Controls have two main objectives: to prevent or detect misstatements in the financial statements, or to support the automated parts of the business in the functioning of the controls in place. Preventive controls are those applied to each transaction that prevent fraud or errors from occurring. Detective controls are those applied after transactions have been processed to identify whether fraud or errors have occurred. These concepts will be explained in more detail in section 7.4.1.

Controls are classified as one of four types:

1. manual
2. automated (otherwise known as application controls)

3. information technology (IT) general controls (ITGCs) (the overall controls put in place to manage changes to applications and programs, as well as to limit access to appropriate users of those IT applications only)
4. a combination of control types referred to as IT-dependent manual controls

The reason controls are classified is to assist the auditor in understanding the type of risks each control addresses, how the control addresses those risks, and the potential audit evidence that a control provides. Also, the classification assists in considering the nature, timing, and extent of the tests of controls and in determining the skills needed to perform the tests. It is not important what these controls are labelled; what is important is whether the control can be tested, is effective, can be relied on to provide audit evidence.

7.4.1 Preventive and Detective Controls

Tests of controls (or **control testing**) are the audit procedures performed to test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level. The controls are tested to determine if they are properly applied throughout the entire period. Remember, this testing is required if the auditor plans to rely on the controls to reduce the amount of substantive work to be performed.

tests of controls (control testing) the audit procedures designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level

Preventive Controls

Preventive controls can be applied to each transaction during normal processing to avoid errors occurring. Preventing errors during processing is an important objective of every accounting system. To be effective, controls over transactions should ideally include both preventive and detective controls. This is because, without the underlying preventive controls, detective controls may not be sufficiently sensitive to identify and correct misstatements. This concept is discussed further in the detective controls section below.

When designing controls, consider what can go wrong with the transaction (that is, what is the risk of material misstatement) that would result in an error. These are sometimes referred to as **WCGWs** (what can go wrongs). Effective preventive controls should prevent the WCGWs from occurring. If they do occur, detective controls should ensure that the errors are detected and corrected as quickly as possible.

WCGWs areas where material misstatements due to error or fraud could occur in a flow of transactions or in the sourcing and preparation of information

Table 7.1 shows examples of preventive controls and some of the WCGWs each control is designed to prevent.

Preventive controls do not always produce physical evidence indicating whether the control was performed, who performed it, or how well it was performed. In other cases, there may be

TABLE 7.1 **Examples of preventive controls**

WCGW	Assertion	Preventive Control
Sales occur that are not collectible.	Occurrence, accuracy	The computerized accounting program will not allow a sale to be processed if a customer has exceeded its credit limit.
Fictitious employees are paid.	Occurrence	Amounts cannot be paid to employees without first matching a valid social insurance number to the employee master file.
Sales are recorded at the wrong amount.	Accuracy	Sales invoices are automatically priced using a master pricing file.
Transactions are classified and coded to incorrect accounts.	Classification	The account coding on each purchase order is checked by the computer using a table of valid account numbers, and then various logic tests are performed by the computer.

evidence that the control was performed, but evidence as to the effectiveness of the control may not be available. For example, the signature of the warehouse receiver on a receiving report or a bill of lading indicates that the receiver agreed that goods were physically received into the warehouse, but it does not guarantee that the person carefully reviewed the shipment or checked that the quantities of each item matched the quantities on the bill of lading. The documentation may have been signed based on a quick glance or without any review at all. Thus, goods may be recorded that do not exist, excess goods may have been received but not recorded, or the goods received may not match the goods ordered and recorded. Therefore, in this example, the quality of the evidence that the control will prevent one of these errors from occurring is not persuasive enough for the auditor to conclude that the control operated effectively throughout the reporting period.

A lack of effective preventive controls increases the risk that errors will occur or that fraud may occur and therefore increases the need for controls that are sensitive enough to detect these errors should they occur.

Detective Controls

The purpose of detective controls is to discover fraud or errors that may have occurred during transaction processing (in spite of any preventive controls) and to rectify those errors. As discussed earlier, companies put detective controls in place to help management ensure that WCGWs do not occur and that the business is functioning as planned through the design and implementation of its business processes.

Generally, detective controls are not applied to each transaction during the normal flow of processing. Instead, they are applied outside the normal flow of individual transactions to groups of transactions that have been fully or partially processed. For example, often when payables are paid, a cheque run is processed to print the cheques, but the transaction is not completed: the debit is not recorded to the payables account and the credit is not recorded to the cash account. Instead, the transaction is only partially processed and then "held" by the system. Once the cheques have been signed as approved for payment, the payables clerk will process the rest of the transaction by "releasing" the payments and recognizing the debit to payables and credit to cash.

Detective controls vary from client to client to a greater extent than preventive controls. Detective controls can depend on the nature of the client's business and on the competence, preferences, and imagination of the people who perform the controls. Detective controls may be formally established procedures, such as the preparation of a monthly reconciliation and the subsequent follow-up of reconciling or unusual items. Or they may be procedures that employees regularly perform and typically document, even though they are not formally required to do so by the company. For example, the financial accountant may keep a list of standard month-end journal entries to use as the basis for checking the entries each month as they are made, following up on any exceptions. Detective controls are often "unofficial" procedures similar to this example, which client personnel perform to make sure that the information they are responsible for is accurate.

It is important that detective controls:

1. completely and accurately capture all relevant data
2. identify all potentially significant errors
3. be performed consistently and regularly
4. include timely follow-up and correction for any misstatements or issues detected

There are many examples of detective controls, including the following:

- Management-level reviews are made of actual performance versus budgets, forecasts, prior periods, competitors (if available), and industry averages (if available). Management's actions in analyzing and following up on unexpected variances are a detective control. For example, the financial controller may review the monthly results and compare the number of days' sales outstanding to previous periods to ensure any allowance for doubtful accounts is reasonable.
- Reconciliations are prepared, reconciling or unusual items are then investigated, and issues are resolved or corrections made, if necessary. The performance of reconciliations without following up on reconciling or unusual items is not a control. The follow-up is

the control. Typical reconciliations are performed between the general ledger and some other form of external evidence or a subsidiary ledger. For example, the bank reconciliation reconciles the bank statement to the cash recorded in the general ledger. The accounts receivable reconciliation reconciles sales recorded in the trade receivables subsidiary ledger (via the sales ledger) to the trade receivables recorded in the general ledger.

- Exception reports are reviewed. Reports are automatically produced showing transactions/groups of transactions that fall outside a set of parameters selected by the client. These exception reports are then reviewed and followed up (if necessary). For example, a report may be produced that shows all sales made to a customer that has exceeded its credit limit. The credit manager then follows up on these sales with the salesperson to ensure no further sales are made until the balance is brought below the credit limit. Alternatively, if necessary, a re-evaluation of the customer's credit limit is performed and the limit is increased (if appropriate).

Table 7.2 shows examples of detective controls and some of the WCGWs each control is designed to prevent.

As illustrated in this section, detective controls are often accompanied by physical evidence, such as a monthly reconciliation. This is in direct contrast to preventive controls, which are often driven by the programming of the particular software used by the company, and therefore produce no physical evidence of the control.

When assessing detective controls, it is not necessary for the auditor to re-perform all of the steps in, for example, preparing a reconciliation to gain sufficient evidence that the control is operating effectively. It is normally enough to examine evidence that the reconciliation was properly completed and that the appropriate reviews and follow-ups were carried out by the client in a timely manner.

Preventive and Detective Controls Compared

Preventive controls may be dependent on IT (that is, they are IT-dependent manual controls). Specialist IT skills are required to audit IT-dependent manual controls, depending on how sophisticated the client's IT system is. It is important to note, however, that detective controls are only effective, and therefore only provide audit assurance, when the underlying data and transactions (and therefore preventive controls) can be relied on. Therefore, it is important to gain an understanding of (and possibly test) the preventive controls in addition to the detective controls to which they relate.

TABLE 7.2 Examples of detective controls

WCGW	Assertion	Detective Control
Cash is received but not recorded in the general ledger, payments are made but not recorded, or cash receipts or cash payments are not real or not recorded on a timely basis.	Completeness, occurrence, cut-off	Bank reconciliation and follow-up of unexpected outstanding items (for example, unexpected or large deposits not yet cleared by the bank, cheques presented by the bank but not recorded in the general ledger).
Shipments are not billed and recorded, or billings are not related to actual shipments of product.	Completeness, occurrence	The computer performs a daily comparison of quantities shipped to quantities billed. If differences are revealed, a report is generated for review and follow-up by the billing supervisor.
Unrecorded billings and errors in classifying sales or cash receipts.	Completeness, occurrence	Quarterly reviews of credit balances in accounts receivable to determine their causes.
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.

For example, the review and follow-up of a monthly management report that compares actual results to budget results will be ineffective if there is no evidence available to show that the budgeted amounts are the approved amounts and the actual amounts are the total of the transactions recorded in the general ledger. In addition, the auditor needs to obtain evidence that the underlying transactions are captured and recorded properly. This is ordinarily done via the identification and testing of the underlying preventive controls. Also, the monthly comparison needs to be at an information level that is detailed enough to identify material misstatements, and the review and follow-up need to be timely.

Because detective controls can be applied to groups of transactions rather than on a transaction-by-transaction basis, they are ordinarily performed less frequently than preventive controls. Therefore, if detective controls operate effectively throughout the period, a high degree of reliance can be obtained by examining a relatively small amount of evidence.

As noted earlier, this does not mean that the auditor will forgo tests of controls over individual transactions. Performing tests of transactions allows the auditor to satisfy themselves that a preventive control was in use and functioned as intended. The auditor also performs tests of transactions to confirm that their understanding of the flow of transactions from initiation to reporting is correct. In computerized environments, preventive controls can often be tested just as effectively and efficiently as detective controls. This is because preventive controls are accompanied by direct evidence (for example, review and follow-up of exception reports) as to the effectiveness of their operation. As well, the auditor is able to re-perform the control to ensure it is operating effectively. This is discussed in more detail in the section on automated controls.

Cloud 9 Integrated Case

A new auditor, Weijing Fei, has joined Josh on the Cloud 9 audit team. Josh has asked her to identify the key controls that Cloud 9 uses to either prevent or detect misstatements.

Weijing asks Josh about the types of controls that are normally used in a company like Cloud 9. Josh explains that it is useful to start by classifying controls as automated, manual, IT-dependent manual, or IT general controls. However, he says that Weijing's focus should be on considering whether each of these controls prevents an error from occurring in the first place, or whether each is designed to detect an error that has already occurred so it can be brought to someone's attention.

Josh gives Weijing an example of a preventive control at Cloud 9. Based on his conversation with Carla Johnson, the financial controller, he has discovered that the computerized credit checking system at Cloud 9 will not allow a sale to be processed if a customer has exceeded its credit limit. This control prevents a customer order from becoming a sale unless the client has been assessed as being able to pay the amount. It also helps prevent some clerical errors, such as 10 units being entered incorrectly as 1,000 units (because this would usually take a customer's order over the customer's credit limit). This control is designed to operate for every order, but there does not seem to be anything in Cloud 9's system to show if and when it is done, so it is not easy to know if the control is operating effectively.

Josh also gives Weijing an example of a detective control at Cloud 9. Carla Johnson performs a monthly bank reconciliation that is reviewed and approved by David Collier, the finance director. However, Josh explains to Weijing that he does not know yet if there is any follow-up on unusual items discovered during the reconciliation and review. If this follow-up is being done, then the control should detect errors in the bank account.

7.4.2 Manual and Automated Controls

In this section, we consider manual and automated controls, as well as ITGCs and application controls and IT-dependent manual controls (which combine the characteristics of manual and automated controls).

Manual Controls

Purely manual controls are those that do not rely on the client's IT environment for their operation. An example is a locked safe for cash to which only a few authorized staff members have access. However, manual controls may use IT-produced information from third parties. For example, a client may reconcile the amount of consignment inventory that was manually counted during its inventory count to the amounts listed in the third party's computer-generated consignment inventory listing.

There are very few, if any, companies that do not use some form of IT to assist in transaction processing, and most controls rely on IT in some way. (Refer to the section on IT-dependent manual controls.)

Automated Controls

Controls generally rely on the client's IT applications (or software) in some way. Generally, IT systems benefit a system of internal control because they result in:

- greater consistency in information processing because all transactions are processed the same way and
- better information for management analysis and decision making because reports can be generated quickly, using up-to-date information.

While an IT system can provide clear benefits, related risks include:

- inaccurate data processing because systems are not properly configured or because of unauthorized changes
- loss of data due to data breaches, system failures, and natural disasters
- lack of audit trail and
- data that may be only in machine-readable form.

Therefore, it is important to identify how much a control is automated in order to determine how IT will affect the evaluation of controls. The key consideration is to determine whether or not the client has effective ITGCs.

IT General Controls (ITGCs)

ITGCs are the client's controls over the hardware and software it uses, including acquisition and maintenance of equipment, backup and recovery procedures, and the organization of the IT department to ensure the appropriate segregation of duties.

These ITGCs support the ongoing functioning of the automated (that is, programmed) aspects of preventive and detective controls and also provide the auditor with a basis for relying on electronic audit evidence. The auditor needs to identify, understand, walk through, test, and evaluate the ITGCs that have been implemented for computer applications they plan to rely on, as they do for any other type of control.

Ordinarily, an entity has three types of ITGCs in place:

1. Program change controls—only appropriately authorized, tested, and approved changes are made to applications, interfaces, databases, and operating systems. All changes are documented so systems documentation is up to date.
2. Logical access controls—only authorized personnel have access to IT equipment, data files, programs, and applications, and these personnel can perform only authorized tasks and functions. For example, the accounts receivable clerk does not have access to or authorization to use the cash payments application; the payroll manager may have access to the electronic funds transfer application but is unable to process any pay runs without the additional approval (and use of passwords) of the financial controller.
3. Other ITGCs (including IT operations)—often difficult to identify in smaller organizations, these include controls such as ensuring regular and timely backups of data, following up and resolving program faults and errors regularly, following up any deviations from scheduled processing on a timely basis, and planning regular upgrades to programs and applications, as well as ensuring the existence of a disaster recovery plan.

Table 7.3 provides a more complete list of common IT general controls.

ITGCs are important because they impact the effectiveness of both application controls and IT-dependent manual controls, as well as potentially affecting the reliability of electronic audit evidence the auditor may wish to rely on during the audit. For example, if a client relies on an application that records a sale and then automatically updates the accounts receivable ledger for that particular customer, the client also relies on its IT program change procedures and security to verify that the program and this specific control are not changed without appropriate approval and testing.

TABLE 7.3 Common IT general controls

Controls to Ensure the Effective Management of the IT Department
• Specific job descriptions exist for the IT manager and support staff (or person(s) assigned IT responsibilities). • The data access and span of control exercised by IT staff is limited, where possible, through access cards, passwords, and segregation of duties. • Contracts are signed with qualified third-party service providers that address the expectations, risks, security controls, and procedures/controls for information processing (for example, payroll). • Job performance of IT staff is periodically evaluated and reviewed with the employee, and appropriate action is taken.
Controls to Ensure the Accurate Processing of Data
• Entity uses mainstream accounting and other software packages with no modification. • Access to applications is restricted by passwords, etc., to authorized personnel. • Staff that uses or enters data into software applications has been suitably trained. • Only authorized software is permitted for use by employees. • Custom software is subject to an appropriate level of testing before being implemented. • Program changes are subject to formal change management procedures.
Controls to Prevent Unauthorized Access to Data
(including destruction of data, improper changes, unauthorized or non-existent transactions, or inaccurate recording of transactions) • Networks, servers, firewalls, routers, and switches are properly configured to prevent unauthorized access. • Management protects data in storage and during transmission against unauthorized access or modification. • Data files and critical applications are regularly backed up and stored in offsite locations. • Access to IT facilities, equipment, and applications (including remote access) is restricted to authorized personnel. • Passwords are changed regularly. • Policies exist to ensure departing employees are denied access to software programs and databases. • Procedures exist to protect against computer viruses.

Source: "General IT controls." Based on Pervasive (entity-level) risks and controls, PEG Forms—Audits, Form 530, © 2017 CPA Canada PEG and Form 530, June 2016.

Examples of tests of controls over program changes and access to data files include:

- Program change controls—examine documentation for evidence (for example, signatures on the program change forms) that the changes were authorized, tested, documented, and approved by appropriate personnel (for example, users, programmers, the IT manager).
- Access controls—check whether the access control software options in effect are properly approved and whether the options selected are reasonable; test or observe attempts to log on to terminals and access files using unauthorized user IDs; review the related access violation or exception reports to determine whether all of the attempts are properly recorded.

Application Controls

Application controls are the fully automated controls that apply to the processing of individual transactions. They are the controls that are driven by the particular software application being used, hence the name "application" controls. These are the controls that ensure transactions are processed correctly. There are generally three categories of application controls:

1. Input controls are the controls designed to detect and prevent errors during the data input stage. Examples of input controls include:
   - verification controls to check input to previously entered data such as the master file
   - missing data checks to ensure all required data have been input and no data are missing
   - check digits to prevent input errors by applying a mathematical formula
2. Processing controls are the controls in place to ensure the data are processed as intended and no data are lost, added, duplicated, or altered during processing. Examples of processing controls include:
   - control totals ensure that input totals are balanced and reconciled
   - reasonable checks compare actual data with expected data and ensure they are reasonable
   - sequence tests review sequential data and produce exception reports for missing numbers
3. Output controls ensure that the processed results are correct and that only authorized personnel have access to the output. Examples of output controls include:
   - reconciling totals to ensure that input totals agree with output totals
   - uploading output to a secure server location in read-only format
   - printing output on a secure printer with limited access

Application controls may also be important in enforcing the segregation of incompatible duties, particularly in large organizations.

It is usually difficult for smaller organizations to implement effective application controls unless there are enough employees to make sure that the physical segregation of duties is mirrored by appropriate access restrictions for particular applications.

IT-Dependent Manual Controls

In many situations, the auditor identifies preventive or detective controls that have both manual and automated aspects. These are referred to as IT-dependent manual controls, and consideration must be given to both their manual and automated aspects. For example, suppose management reviews a monthly variance report and follows up on significant variances. Because management relies on the computer-generated report to identify the variances, the auditor also needs to check that there are controls in place to ensure that the variance report is complete and accurate.

When evaluating the completeness and accuracy of computer-produced information, before the auditor can rely on that information, they need to identify the source and the controls that ensure the information is complete and accurate. As illustrated earlier, the client often relies on both application and IT general controls to make sure that any computer-produced information is complete and accurate. If the auditor does not test both the application controls and the ITGCs to determine that the controls are effective (as they relate to particular reports or data), they run the risk of placing undue reliance on reports or data produced by the client's IT system. Auditors need to ensure that any evidence they plan to rely on (even if it is in the form of an internal system-generated report) is accurate, complete, and can be relied on. This testing can either be performed directly on the report in question or, alternatively, can be performed on the overall application that produces the report and the relevant ITGCs, which then removes the need to test the actual report.

Professional Environment 7.2 examines the future of data, as forecast by the organization COSO.

7.2 Professional Environment COSO Internal Control Framework

All companies benefit from an effective system of internal controls because it helps organizations achieve their goals. In addition, companies subject to an external financial statement audit can benefit from a more effective system of internal controls because it means financial statement audits are more efficient and effective.

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) produced an integrated framework on internal control in 1992 following the release of the Treadway Commission's recommendations. The framework provides principles-based guidance for designing and implementing effective internal controls. It is now the most widely used internal control framework in the United States and is commonly used around the world. COSO provided an updated *Internal Control—Integrated Framework* in 2017.

The COSO framework includes five interrelated components, which are:

- governance and culture
- strategy and objective setting
- performance
- review and revision
- information, communication, and reporting.

COSO expects its guidance to help organizations adapt to changing business conditions, including greater complexity, uncertainty, and volatility. For businesses to do this, they should be aware of the following trends:

- *Growth in data:* More data will become available, and businesses will need to analyze them faster to adapt. The data will be from internal and external sources, and will be structured in new ways. Analytics and other tools will be very helpful in understanding risk and its impact.
- *Growth in artificial intelligence and automation:* Automated processes and artificial intelligence will grow in importance. Businesses must be prepared to consider the impact of these future technologies, and leverage their capabilities.
- *Importance of risk management:* Many business executives express concern regarding the cost of implementing the systems of internal controls. As technologies and risk management practices evolve, activities spanning risk, compliance, control, and governance need to be coordinated to provide maximum benefit to the organization.

Q: How can a strong system of internal controls help an organization adapt to the complexity, uncertainty, and volatility of the future business environment?

Sources: Committee of Sponsoring Organizations of the Treadway Commission website, www.coso.org; "COSO Issues Updated *Internal Control—Integrated Framework* and Related Illustrative Documents," COSO news release, May 14, 2013; COSO, "Enterprise Risk Management: Integrating with Strategy and Performance, Executive Summary," June 2017.

Before You Go On

7.4.1 What are the different types of controls?

7.4.2 What is the difference between an application control and an IT general control?

7.4.3 Which type of control, preventive or detective, is usually a more efficient control type to test?

7.5 Selecting and Designing Tests of Controls

LEARNING OBJECTIVE 5

Explain how to select and design tests of controls.

The auditor must decide which controls should be selected for testing and how much audit testing must be performed. Both decisions require the auditor to apply a large degree of professional judgement, and the considerations that must be taken into account are explained in the following sections.

7.5.1 Which Controls Should Be Selected for Testing?

As explained above, controls are put in place to prevent or detect errors occurring (or a WCGW from actually going wrong). When the auditor decides to include control testing in the audit approach, they select those controls that will provide the most efficient and effective audit evidence (that is, evidence that will provide the assurance required that the controls are working). To improve efficiency, the auditor will test only those controls that they believe are critical or key to their opinion. These may also be referred to as key controls. In other words, they must decide which controls identified for each relevant assertion are likely to be most effective at preventing the WCGWs from occurring or detecting them if they do occur. The auditor also considers which controls provide reasonable assurance that the controls operated effectively throughout the period of reliance. Deciding which controls to test will be influenced by the types of controls, the frequency at which the controls are performed, and the level of assurance the auditor wants to gain from the controls being designed and implemented effectively. As a general rule, the best controls to test are those that address the WCGWs most effectively with the least amount of testing required (which is an efficient testing strategy). If one control addresses multiple WCGWs, it stands to reason that this control would be selected instead of testing several different controls that each address one of the WCGWs to obtain the same level of assurance that a WCGW had not occurred.

7.5.2 How Much Testing Does the Auditor Need to Do?

Once the controls have been selected for testing, the auditor must decide how much testing is to be performed, a decision that is driven by the frequency of the control in question. For example, is the control operating daily, weekly, monthly, or for every transaction processed?

When testing controls, either statistically based sampling techniques or professional judgement can be used to determine the extent of testing. In some cases, where large data sets are available, an audit data analytic may be conducted, allowing the auditor to test the entire population. However, if not appropriate or the auditor elects not to conduct an audit data analytic, sampling is used and there are a number of factors to consider. The more assurance the auditor wants from the performance of the controls, the more testing they need to do. That is, if they are intending to reduce control risk to the lowest level possible, they perform more testing than if they are planning to obtain only limited assurance from their testing (and to reduce control risk by only a limited amount). The factors to consider when deciding the extent of testing include the following:

- How often the control is performed—the less frequently a control is performed (for example, a control applied monthly compared with a control applied daily), the fewer instances of the control there are to test and therefore the less testing the auditor needs to perform to be satisfied the control is operating effectively.
- The degree to which the auditor intends to rely on the control as a basis for limiting their substantive tests—the greater the degree of intended reliance (that is, the more they intend to rely on the particular control and thereby limit their substantive procedures), the more they test that control to provide the required assurance.
- The persuasiveness of the evidence produced by the control.
- The need to be satisfied that the control operated as intended throughout the period of reliance—for some controls, the auditor may need evidence only at year end, whereas for most controls they need evidence that the control operated throughout the year.
- The existence of a combination of controls that may reduce the level of assurance needed from any one of the controls.
- The relative importance of the "what could go wrong" questions or statements considering the inherent risks, the audit assertions, and the volume, complexity, and materiality of the transactions or accounts.
- Other factors that relate to the likelihood that a control operated as intended—in determining the extent of tests of a control, the auditor considers several other factors that affect the auditor's perception of the likelihood that a control operated as intended throughout the period of reliance, including:
  - the competence and integrity of the employee performing the control
  - the quality of the control environment such as the potential for management override or for the control to be bypassed

– changes in the accounting system and whether a control may have been less effective during the period when the changes were being implemented, and whether the control is still applicable to the new accounting system
– unexplained changes in related account balances
– the auditor's prior-period experiences with the engagement and the past results of the control testing

Even though the factors listed above may reduce the expectation of errors, the auditor's tests of a control need to be sufficiently extensive to provide reasonable assurance that the control operated effectively throughout the period of reliance.

When the control is applied every month, the auditor may decide to test the application of the control in detail for two months and review the remaining 10 months for unusual items. If the control is applied more frequently (say, weekly or daily), the auditor might test more than one application of the control in detail and review a sample of the remaining applications for unusual items.

Tests of preventive controls that are accompanied only by inferential (rather than physical) evidence of their effective operation include, for example, reviewing documents for an initial or signature and re-performing the checking routine itself. (For example, if the signature signifies that the price, extensions, and additions have been checked, the auditor checks the price, extensions, and additions.) The extent of such tests is a matter of professional judgement, but, generally speaking, large sample sizes are not necessary. Under normal circumstances, a random sample of, say, 25 to 30 items, assuming no control exceptions (that is, deviations) are observed, when combined with the evidence obtained from other audit procedures performed on the related accounts, provides evidence that controls operated as intended (that is, the control was effective). This sample size has been calculated using audit risk tables and a technique called **attribute sampling**, a sampling technique used to reach a conclusion about a population in terms of a rate (frequency) of occurrence. For instance, a sample of cash payments can be examined for signatures that are required as evidence of proper approvals. The number of missing signatures (that is, exceptions) is then used to estimate the overall rate of exceptions for the entire file of payments. Each sample item provides one of only two possible outcomes: the attribute being tested (for example, a signature, price, or recorded balance) is either correct or incorrect, present or absent, valid or not valid.

attribute sampling a sampling technique used to reach a conclusion about a population in terms of a rate (frequency) of occurrence

Normally, attribute sampling by itself does not provide a direct estimate of dollar values, such as the dollar amounts of exceptions. That is why attribute sampling is most often used for tests of controls (rather than as a substantive test of account balances). However, by using this sampling technique, the auditor is able to determine with a certain level of confidence (90 percent or more) that the error rate for **control exceptions** is acceptably low; that is, they may not need to perform additional control testing to reduce control risk further. If the audit objective is to obtain evidence directly about a dollar amount being examined, the auditor generally uses a different sampling technique (such as systematic selection).

control exception an observed condition that provides evidence that the control being tested did not operate as intended

There may be circumstances where more or less testing is carried out. Regardless of the size of the sample, all control exceptions (deviations) (including those that are accompanied by errors) are investigated by the auditor. The auditor is careful not to dismiss an observed control exception as a random, non-systematic occurrence. Therefore, the detection of one control exception results in the auditor extending the sample size (when the auditor anticipates no further control exceptions will be found), amending the decision to rely on that control, and/or considering whether another control is available that can be substituted for the control being tested (often referred to as a compensating control).

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Talking with Josh about the factors that have to be considered when deciding how much control testing to do helps Weijing appreciate her task. She realizes that her previous understanding of a combined audit strategy was too simple. Gathering evidence about the effectiveness of controls in order to reduce the reliance on substantive testing does not mean that the auditor has to test every control in the same way.

Weijing realizes that, if the evidence that would be produced from testing a control is not very persuasive, there is little point in devoting a lot of effort to testing that control. For example, a preventive control that requires a supervisor to authorize a transaction only produces evidence of the presence or absence of a signature, not evidence of whether the supervisor was performing the task of reviewing the transaction effectively. Obtaining plenty of evidence that the supervisor's signature was on the appropriate form will not provide much assurance by itself about the effectiveness of the control.

Also, Weijing is now starting to understand what Josh means by "key or critical controls." Josh wants to know which of the controls identified for each assertion are likely to be the most effective at preventing the WCGWs from occurring or detecting them if they do occur. Josh would like to focus testing on these controls and gather sufficient, appropriate evidence to justify reduced substantive testing.

For example, there are usually several controls designed to prevent or detect errors and misstatements in inventory and sales. In the wholesale sales area at Cloud 9, these controls include signed delivery receipts, policies requiring undelivered goods to be returned to the warehouse at night, and use of a locked shipping cage. Other controls include the use of electronic scanners and matching and authorizing documents in the shipping and invoicing process. However, despite all these controls, Josh has also identified from his conversation with Carla Johnson that, unless the controls over the inventory management software system are tested thoroughly, they will not be able to justify reduced substantive testing. This is because so much of the document matching and authorization depends on the correct operation of the programs.

Application Controls

The auditor may decide to rely on application controls identified and evaluated earlier in the audit. The functioning of the application control is tested to determine whether it can be relied on as an effective control. The auditor also tests the operating effectiveness of the control over the period of reliance by one or both of the following methods.

1. Focusing on manual follow-up procedures that support the application control. For example, if the computer prices the invoices using data in the price master file, the application control is a computer-generated exception report listing all sales orders entered for which there are no prices on the master file. The auditor may choose to focus on how the client follows up on these exceptions.
2. Testing controls over program changes and/or access to data files. Here the auditor is testing the ITGCs (as discussed previously). Using the example in (1) above, the auditor may choose to test controls to ensure that all additions, deletions, and changes to the pricing master file are approved.

If these testing strategies are not feasible, the auditor can still rely on application controls by testing them throughout the period of reliance. Using the price master file example above, the auditor may choose to select a sample of invoices from throughout the period and compare the prices with the approved price list instead of just testing at a single point in time.

When the client relies on controls over program changes and/or access to data files (ITGCs), it is efficient for the auditor to test these controls, as they may support reliance on several other application controls. For example, the auditor may decide to do a system-wide test of access to data files for controls that apply to more than one control objective or application.

Regardless of which testing strategy is selected, the auditor establishes a basis for concluding that the underlying processing of data is complete and accurate. The techniques to test controls over program changes and/or access to data files are similar to those used to test manual controls. They usually involve inquiry, observation, and examination of physical evidence. The testing applies to the specific applications of interest (for example, a test of program changes is limited to changes to the sales application only) if it is possible and efficient to do so.

Recognizing that application controls operate in a systematic manner, the auditor may be able to limit their testing of those controls to the significant transaction types. For example, a computerized interest calculation may consistently use the same formula (principal multiplied by an interest rate from a rate master file). Or a computerized edit check will not allow the finalization of payments greater than $100,000 without appropriate authorization. In these examples, the auditor could limit their testing to a "test of one" per transaction type (that is, test one interest calculation or attempt to process a cheque request in excess of $100,000) rather than testing a sample using audit risk tables. This test of one may have been performed as part of the walkthrough, which took place when the auditor gained an understanding of the transaction, the WCGWs, and the controls.

Timing of Tests of Controls

Tests of controls will usually be carried out at an interim date (that is, before year end). It is preferable to test entity-level controls and ITGCs early in the audit process because the results of this testing could affect the nature and extent of other procedures the auditor plans to perform. For example, if it is found that the ITGCs are not effective and cannot, therefore, be relied on, more extensive testing of application controls will need to be performed if the auditor is planning to rely on applications and computer-generated audit evidence.

The auditor updates their evaluation of controls from the time of their interim procedures through to the year-end date. They update their evaluation by identifying changes, if any, in the control environment and in the controls themselves. If changes are identified, they consider the effect of such changes on their evaluation of the controls. This update is often done via inquiry, observation, and, in some cases, testing the control again at year end. In most cases, a client will not have made significant changes in the control environment or controls between completion of the interim work and year end. When this is the case, and the auditor has noted an effective control environment, they satisfy themselves by inquiry and observation that controls continued to function throughout the remainder of the period without the need for additional detailed tests of controls.

Summary of Extent of Testing

Table 7.4 suggests how many tests of each control might be performed depending on the frequency of use for the control in question. For example, if it is a monthly control and the auditor wants to obtain a reasonable level of assurance from the control testing, two controls (for example, a monthly bank reconciliation) would be tested from throughout the year. If, however, only a limited level of assurance from the control testing is required, only one control would be tested from throughout the year.

substantive procedures (substantive testing or **tests of details)** audit procedures designed to detect material misstatements at the assertion level

A limited level of assurance may be planned for when additional evidence from other testing is already available to the auditor (such as evidence from **substantive procedures**—also called **substantive testing** or **tests of details**—which are audit procedures performed to detect material misstatements at the assertion level), or where it may be an efficient strategy to test some controls and to perform some additional substantive procedures. Reasonable assurance may be planned for when there is no additional audit evidence available from other testing, or when it is more efficient to test and rely on controls without performing a significant amount of substantive testing. This is an area that requires a significant level of professional judgement. However, the limited approach is rarely used in practice. Many auditors feel that if you are going to perform some tests of controls, you should test as many as necessary to reduce control risk to the lowest level. If the auditor is testing controls, they will want to get as much benefit from it as possible.

TABLE 7.4 Suggested extent of testing

Frequency	Reasonable Assurance from Tests of Controls	Limited Assurance from Tests of Controls
> 1,000 instances	25–40	10–20
Daily	25–40	10–20
Weekly	5	2
Monthly	2	1
Quarterly	2	1
Annually	1	1
Other	Professional judgement	Professional judgement
Application control (effective ITGCs)	1	1

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Making sure that testing covers the critical or key controls and provides sufficient, appropriate evidence of the effectiveness of the controls allows the auditor to reduce the control risk of the related financial statement assertion. Josh and Weijing have a discussion about how they can design their control tests so that they can conclude that each control:

- operated as it was understood to operate
- was applied throughout the period of intended reliance
- was applied on a timely basis
- encompassed all applicable transactions
- was based on reliable information
- resulted in timely correction of any errors that were identified

Josh explains that, if they can satisfy the above objectives in their design, and no exceptions are found when they perform their tests, the control will be deemed to be effective. If any exceptions are found, they need to perform additional procedures to obtain sufficient assurance, or reduce their reliance on the control. This latter action might require additional testing of another compensating control or increased substantive testing.

Before You Go On

7.5.1 Name three factors to consider when deciding the extent of testing to be performed.

7.5.2 When would testing application controls warrant performing a test of more than one?

7.5.3 Why does the auditor update the interim evaluation of controls at year end?

7.6 Documenting and Testing Internal Controls

LEARNING OBJECTIVE 6

Explain the different techniques used to document and test internal controls.

7.6.1 Documenting Internal Controls

Before the auditor tests the internal controls, they need to document their understanding of them. The most common forms of documentation include the following:

- *Narratives*—this is the most common form of documentation, particularly in smaller environments where accounting and internal control activities are simple or where a particular flow of a transaction is relatively simple and straightforward. It involves the auditor describing (in words) each step of the flow of transaction from start to finish (that is, from initiation to reporting in the financial statements). Refer to **figure 7.2** for an example.
- *Flowcharts*—this form of documentation is used in larger and more complex environments. It involves the auditor summarizing (in flowcharts/boxes) each step of the flow of a transaction from start to finish (that is, from initiation to reporting in the general ledger). While a flowchart may take longer to prepare, it provides a visual representation of the

Sales order is received by fax or email. Check customer details against customer account balance to see if the customer has exceeded its credit limit. If the customer has exceeded its limit, refer the sales order to the credit manager (C. Cox) for approval. If approval is denied, refer the order back to the sales manager to notify or discuss with the customer. If customer has not exceeded its credit limit or the credit manager (C. Cox) has provided an approval to exceed the limit, process the sale in the sales ledger.

FIGURE 7.2 **Example narrative for documenting credit sales process**

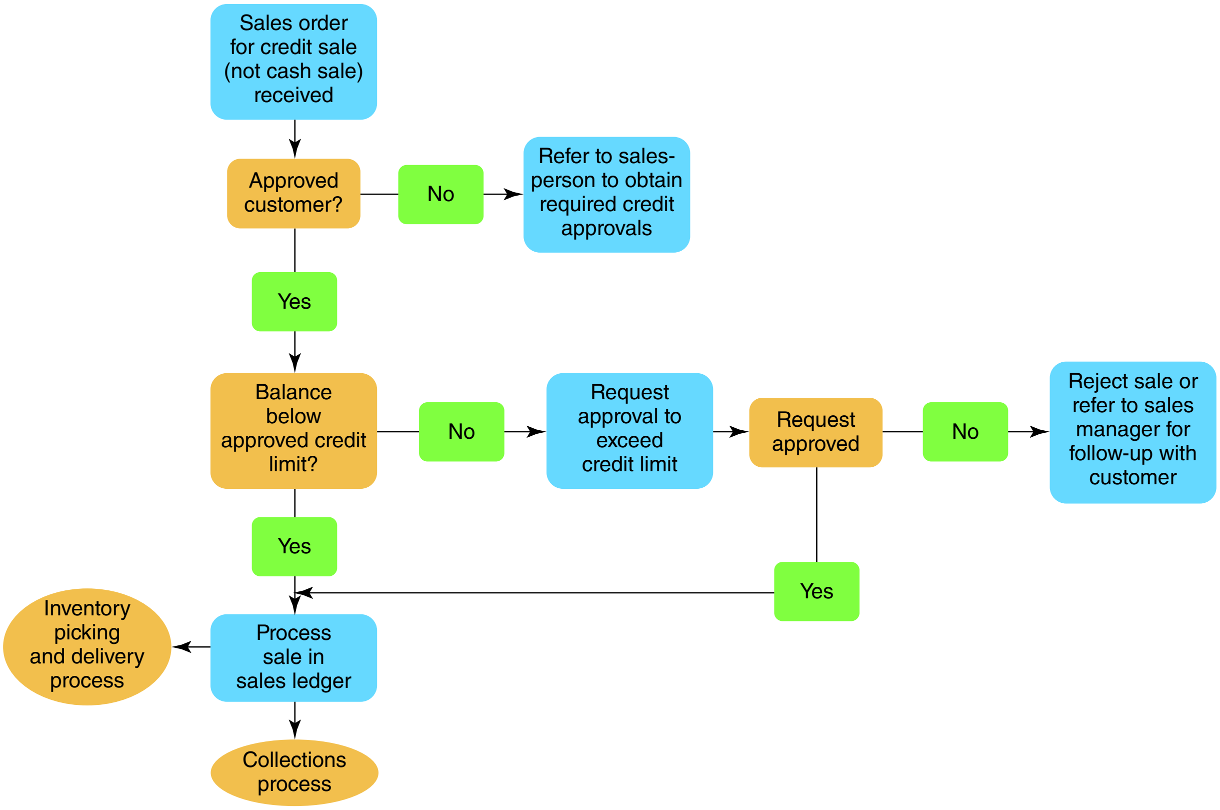


FIGURE 7.3 **Example flowchart for credit sales process**

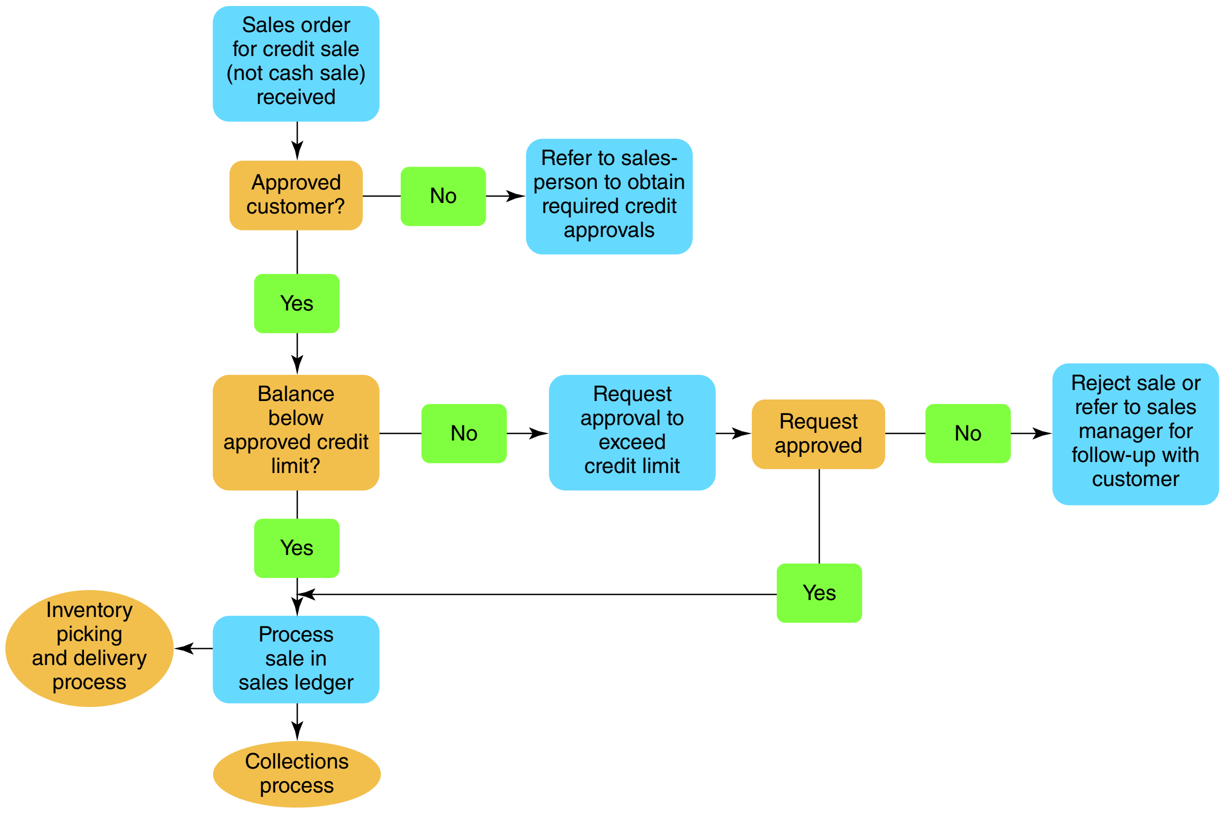
flow of the transaction and the key controls throughout the flow that is often simpler for the reader or reviewer to understand. The key to a good flowchart is to keep it as simple as possible, with as few words as possible so as not to overload the reader with information. Refer to figure 7.3 for an example.

- *Combinations of narratives and flowcharts*—this form of documenting internal controls is typically a page divided into two sections with the process flowchart on the left-hand side (or the top side) and the narrative describing each step in the flow on the right-hand side (or the bottom half of the page). The flowchart side highlights the key activities from initiation to reporting, while the narrative column contains the details about what happens in the flow of the transaction. Refer to figure 7.4 for an example.
- *Checklists and preformatted questionnaires*—an internal control checklist or questionnaire is another technique used to systematically identify the most common types of internal control procedures that should be present. This is particularly helpful in industries that the auditor may not personally be familiar with auditing, or when less-experienced auditors find it difficult to identify which are the critical controls (for example, when documenting entity-level controls). Refer to figure 7.5 for an example.

Regardless of which of the above approaches is used to document internal controls, the extent of the documentation will increase as the complexity of the client, its systems, and its internal controls increases.

7.6.2 Testing Internal Controls

Once the controls are documented, the auditor may decide to test the controls. Techniques used to test controls include inquiry, observation, inspection of physical evidence, and re-performance. Ordinarily, a combination of these testing techniques provides the evidence that the control operated as intended throughout the period in which the auditor wishes to place reliance on it.



- Sales order is received by fax or email.
- Check customer details against customer account balance to see if the customer has exceeded its credit limit.
- If customer has exceeded its limit, refer the sales order to the credit manager (C. Cox) for approval. If approval is denied, refer the order back to the sales manager to notify or discuss with the customer.
- If customer has not exceeded its credit limit or the credit manager (C. Cox) has provided an approval to exceed the limit, process the sale in the sales ledger.

FIGURE 7.4 **Example combination documentation for credit sales process**

Inquiry

This technique involves the auditor asking questions to determine how the control is performed and whether it appears to have been carried out properly and on a timely basis. For example, the auditor may ask the employees who prepare the sales invoices how they determine when to prepare the invoice and how they ensure that the revenue is recorded on a timely basis. They may also ask management how it makes sure revenue is reported correctly and completely at year end.

Observation

This technique involves the auditor observing the actual control being performed. For example, they may observe the preparation of an invoice to determine if the related shipping report has been received. The limitation with this technique is that employees may perform the procedures more diligently when they know they are being observed. Therefore, the evidence gathered applies only to the point of time of the observation.

Inspection of Physical Evidence

This technique relies on the auditor testing the physical evidence to verify that a control has been performed properly. For example, the auditor may select a sample of invoices to

Process step	Performed by	IT/reliance on electronic data Yes/No?
Customer places sales order and order is input into sales order program		
Credit and/or credit terms approved		
Order filled and prepared for shipment		
Shipping/delivery documents prepared		
Order shipped/delivered to or picked up by customer		
Sales invoice prepared		
Prices (or deviations from standard prices) approved		
Invoice reviewed for accuracy and mailed/delivered to customer		
Sales journal produced		
Sales journal summarized and posted to general ledger and trade receivables detail		
Provide any other details that are necessary to understand the initiation, processing, recording, and reporting of the transactions:		
Briefly describe the client's ***revenue recognition policy****, including* ***standard billing*** *and* ***collection terms****:*		
Briefly describe the client's ***credit terms*** *and* ***credit authorization procedures****:*		
Briefly describe the client's procedures for ***sales returns and allowances*** *and the issuance of* ***credit memos****:*		

FIGURE 7.5 **Example checklist for documenting a credit sales process**

determine if the related shipping document is attached. Also, they may review a sequential listing of invoices and shipping documents issued during the period to determine whether the control routinely detected missing invoices and whether explanations were documented to ensure the exceptions were dealt with appropriately.

Re-performance

This technique involves the auditor re-performing the control to test its effectiveness. For example, the auditor may test the application controls for accessing the billing module to ensure an unauthorized employee is unable to generate invoices (and that an unauthorized attempt to do so is recorded on an exception report).

Regardless of which of the above approaches is used to test internal controls, the extent of the documentation and testing will increase as the complexity of the client, its systems, and its internal controls increases.

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Josh will prepare a flowchart or narrative to document his understanding of the different transaction cycles. This will help him understand the stages at which the errors can occur. He will include the entire process from the initiation of the transaction through to recording in the general ledger. Where appropriate, he will link several accounting processes together into one seamless flow of transactions. For example, he has made a simple diagram of the flow of transactions from initiation of a purchase order through to the cash payment to the supplier (see **figure 7.6**). The process comprises three smaller processes: initiating a purchase order through to receipting the goods as they arrive, receiving the purchase invoice from the supplier through to entering the invoice in the general ledger, and requesting cash payment and recording the payment to the supplier. Once the transaction cycles are documented, Josh will perform walkthroughs. That is, he will walk one transaction from its inception to when it is recorded in the books to ensure his understanding of the processes is correct.

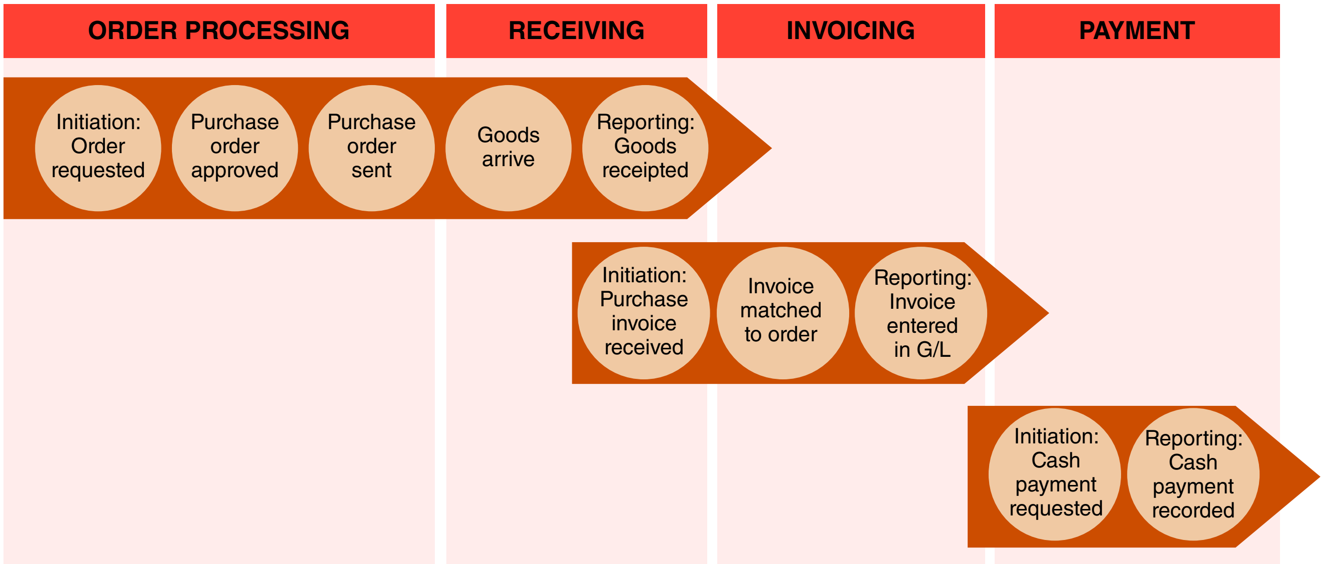

FIGURE 7.6 Cloud 9 flow of transactions—order to payment

Before You Go On

7.6.1 Explain the techniques used to document internal controls.

7.6.2 When would it be more appropriate to use a flowchart instead of a narrative to document internal controls?

7.6.3 Name the four techniques for testing controls.

7.7 Results of the Auditor's Testing

LEARNING OBJECTIVE 7

Understand how to interpret the results of testing of controls.

Before the auditor tests the controls, they should review the internal control documentation. This will ordinarily be in the form of narratives, flowcharts, checklists, a questionnaire, or a combination of these. This review should be used to validate the control testing strategy.

If the tests of controls confirm the auditor's preliminary evaluation of controls (and control risk), the planned substantive audit procedures are not modified. If the test results do not confirm their preliminary evaluation of controls (and control risk), the auditor revises the overall audit risk assessment for the related account and the planned audit strategy (that is, they increase the level of substantive procedures). For example, if the tests of controls indicate that certain controls are not as effective as originally believed or have not functioned as prescribed, and if mitigative (compensating) controls are not available or were not effective, the auditor revises their audit risk assessment (increases control risk), reduces or eliminates the intended reliance, and reduces detection risk by designing more extensive substantive audit procedures (which are intended to detect and estimate the effect of errors in the related significant account balances). As mentioned previously, when a control has not been performed as it was intended, it is referred to as a control exception (deviation).

Figure 7.7 illustrates the decision tree or thought process an auditor goes through when assessing the results of their control testing.

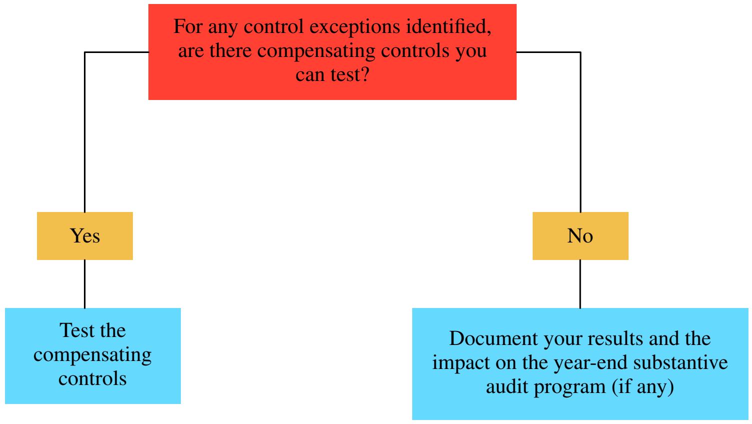

FIGURE 7.7 **Results of testing**

The auditor needs to investigate any control exceptions (deviations) they identify during their testing to find out, to the extent practical, the causes (for example, whether the exceptions may be indicative of a pattern of similar exceptions), the amounts involved, the financial statement accounts affected, and the potential effect on other audit procedures. The auditor is required to document the resolution of any control exceptions (including the impact on the remaining audit approach) and report the control exceptions in a management letter to those charged with governance, as they are considered matters of governance interest in accordance with CAS 260 *Communication with Those Charged with Governance* and CAS 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management.*

If the auditor extends their testing and another control exception is identified, they should change their decision of relying on that control. If another (compensating) control is not available to be substituted for the control being tested, or if it is not considered efficient to continue testing controls, the auditor should update (and potentially increase) the nature, timing, and extent of the planned substantive procedures. That is, the audit strategy is altered and detection risk is reduced. Therefore, if tests of controls indicate the controls are not operating effectively, then control risk must be assessed as high for that assertion. It is not possible to moderate control risk if the controls are only effective some of the time.

In trying to determine whether there is a need for additional detailed tests of controls, the following factors are considered.

- *Results of inquiries and observations.* If, during their inquiries or observations later in the audit process, the auditor identifies that significant changes to processes and controls have occurred, their previous tests of controls may no longer provide a basis for relying on those controls. Therefore, they may need to identify and test other controls, perform additional tests of controls, or increase the level of substantive testing performed at year end. Changes to processes or controls are significant only if they have implications for the continued functioning and effectiveness of controls on which the auditor is relying in the first place.
- *Evidence provided by other tests.* Tests of account balances (substantive testing) can often provide evidence about the continued functioning of controls. For example, when the auditor examines vendors' invoices in support of year-end creditors and expense account balances, they learn whether controls relating to the recording of these transactions continue to function. To the extent that their other audit procedures provide evidence of the effectiveness of controls from the date of interim work to the end of the period under audit, additional tests that otherwise might be necessary can be reduced.
- *Changes in the overall control environment.* An effective entity-level control environment may allow the auditor to limit their tests of controls to inquiry and observation during the period between when they tested the controls (interim) and year end. If they become aware of adverse changes in the overall control environment of the entity, such as a loss of employees and key management who perform key controls and who provide evidence as to the effectiveness of the overall entity control environment, additional tests of controls may be necessary.

Before You Go On

7.7.1 What does the auditor do when they identify control exceptions?

7.7.2 Why does the auditor consider the entity's overall control environment when performing control testing?

7.7.3 Why does the auditor always investigate control exceptions?

7.8 Documenting Conclusions

LEARNING OBJECTIVE 8

Explain how to document tests of controls.

Once controls have been tested, the auditor documents their work in a working paper. In this working paper, the auditor would ordinarily set out the purpose of the tests of the controls identified. This assists in carrying out the testing by reminding the auditor of their overall purpose in testing the controls. If the auditor identifies any exceptions or issues, they are able to decide if there is an impact on their testing strategy by considering whether the control exception means that the control no longer meets the objective of the test. For example, assume that the control selected for testing is a bank reconciliation, and the objective of the test is to verify that a review by the financial controller occurred on a timely basis. When performing the testing, however, it was noted that, while there was evidence of the review (a signature), there was no date, so timeliness could not be verified. Therefore, the auditor is able to conclude that the control operated, but they are not able to conclude that it operated on a timely basis. The auditor would need to determine whether a compensating control should be tested, or whether the timeliness of the review is not critical to the auditor's ability to rely on the bank reconciliation as audit evidence.

The auditor also documents the test performed, the actual controls selected for testing, and the results of the testing. There must be enough detail regarding the controls selected to allow another auditor to review the working paper, re-perform the steps (if necessary), and reach the same conclusion as the auditor who prepared the working paper. The results are often set out in a table to make it easier to review and identify quickly what (if any) exceptions were identified during the testing. Before an overall conclusion is reached for each section of work performed, the results table also assists the person reviewing the working paper to determine if enough work has been performed and if the right conclusion regarding the control testing has been reached. The working paper should also include a conclusion specific to whether the test results support the overall purpose of the test. This is the documentation standard that is required by CAS 230 *Audit Documentation.*

Regardless of how they prepare their working papers and document their results, the extent of the auditor's documentation will increase as the complexity of the client's operations, systems, and controls increases. Also, the more complex the client's operations and its internal controls, the more experienced the auditor who performs the work needs to be.

Figure 7.8 is an example of a working paper relating to control testing.

The first part of **figure 7.9** illustrates in a table format the impact of control testing on the subsequent amount of substantive testing required to be performed. For example, if inherent risk is low and a reasonable level of assurance has been gained from control testing (that is, controls are operating effectively), the auditor can rely on their original control risk assessment and continue to perform a combined audit. This means that the controls tested can be relied on, and less substantive work is required. Therefore, potentially only overall analytical

CONTROL TESTING—BANK RECONCILIATION

Client name: Aubergine Ltd.	Year end: December 31, 2023
Working paper: Cash control testing	

Purpose of test:

The purpose of this test is to verify that the bank reconciliation control was adequately designed and implemented for the 12 months ended December 31, 2023.

Work performed:

Selected two bank reconciliations from different months, tied the balance per the bank statement to the bank statement and bank confirmation, tied the balance per the general ledger to the trial balance, and vouched all reconciling items between the bank statement and the trial balance greater than $50,000 to supporting documentation to ensure valid reconciling items and that the reconciliation had been performed correctly. Ensured the reconciliation had been prepared and reviewed on a timely basis.

Findings/results of testing:

Selected bank reconciliations for the months of April and September 2023. No errors noted in the preparation of the reconciliation. Both were prepared and reviewed within four days of month end. Considered this to be on a timely basis.

Month tested	Balance agreed to bank statement and bank confirmation	Balance agreed to general ledger and trial balance	Vouched deposits >$50,000 to stamped deposit slips and cut-off bank statement	Vouched outstanding cheques >$50,000 to cheque register, cancelled cheques, and cut-off bank statement	Vouched all other outstanding items >$50,000 to supporting documentation	Verified mathematical accuracy	Date prepared and reviewed
April	Y	Y	Y	Y	NA	Y	Prepared May 2, reviewed May 4
September	Y	Y	Y	Y	NA	Y	Prepared October 3, reviewed October 4

Conclusion:

Based on testing performed, the bank reconciliation appears to have been designed, implemented, and operating effectively for the 12 months ended December 31, 2023.

	Prepared by: SEF	Reviewed by: FMC	Index: Cl:l		

FIGURE 7.8 **Example test of control working paper**

review procedures would need to be performed to reduce detection risk (and audit risk) to an acceptable level to be able to make a conclusion about the significant account assertion. If, however, the auditor has found control deviations, the cause of the deviations and the number need to be assessed. If the number of deviations exceeds a predetermined tolerable rate, the auditor may conclude that no assurance has been obtained from the control testing. In this case, control risk will be assessed as higher than originally planned and the audit strategy may be revised to a substantive approach. This means extensive substantive procedures designed to estimate the dollar value of any error in the balance would need to be performed. The second part of figure 7.9 illustrates the same information in a graph format. That is, the higher the level of confidence gained from control testing, the lower the level of assurance required to be obtained from the substantive procedures in order to form conclusions (a combined audit strategy).

Inherent risk assessment		**Reasonable level of assurance from control testing**	**Limited level of assurance from control testing**	**No assurance obtained from control testing**
	Low	Overall analytical review	Some substantive procedures	Considerable testing
	High	Some substantive procedures	Considerable testing	Extensive procedures focused on estimating errors in the balance

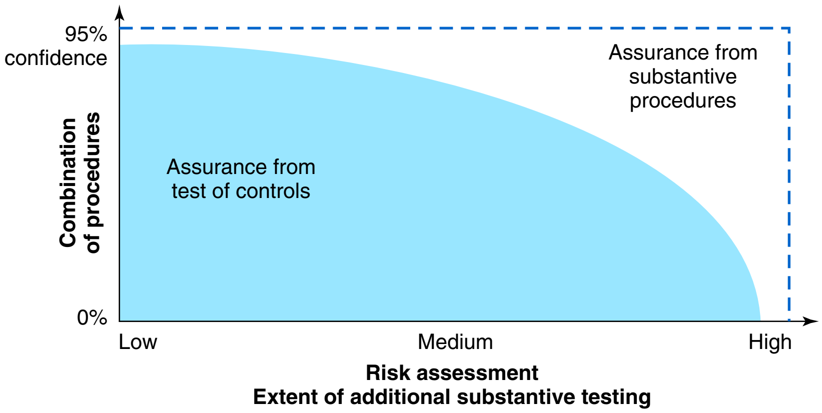

FIGURE 7.9 **Impact of control testing on level of substantive testing**

Cloud 9 Integrated Case

Josh has been busy over the past few days answering questions from Sharon and the partner about particular aspects of the control testing performed to date. He is looking forward to continuing this work as they continue the documentation of controls over the various financial statement accounts.

Before You Go On

7.8.1 What level of detail does the auditor need to include in the audit working papers when documenting the results of their control testing?

7.8.2 Which auditing standard sets the minimum level of documentation required in the working papers stored in the audit files?

7.8.3 What is the impact on the extent of required substantive testing if inherent risk is high and no assurance has been obtained from control testing?

7.9 Identifying Strengths and Weaknesses in a System of Internal Controls

LEARNING OBJECTIVE 9

Describe the importance of identifying strengths and weaknesses in a system of internal controls.

Strengths and weaknesses in internal control are usually noted by the auditor when performing tests of controls as part of the control risk assessment. An internal control strength is when a control is in place and working as intended; therefore, it is effective in preventing or detecting a material misstatement in the financial statements. Weaknesses in internal controls exist when an internal control is unable to prevent, detect, and correct material misstatements. While clients will often be interested in obtaining feedback from external auditors as to the relative strengths of their internal controls, focus is ordinarily on the areas of weakness identified. This is because it is the weaknesses that increase the risk of material misstatements being undetected by management's processes and controls, and, thus, it is on the areas of weakness that the auditor typically performs additional substantive testing to quantify the (potential) material misstatements.

Some observations made by the auditor will relate to controls that are not directly relevant to the audit. As discussed previously, some controls within the system of internal controls have a financial reporting impact, whereas other controls are implemented to assist the entity in meeting its organizational and compliance objectives. For example, a bank reconciliation is a control that has a financial reporting impact, whereas an approved supplier list is a control that ensures inventory is purchased only from reputable sources but has no direct financial reporting impact. Significant levels of professional judgement are required when deciding whether an internal control observation (individually or in combination with other observations) is, in fact, relevant to the audit and should be tested.

CAS 260 *Communication with Those Charged with Governance* and CAS 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management* require the auditor to provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process, and to promote effective two-way communication between the auditor and those charged with governance. The auditor should communicate matters of governance interest to management, such as significant (or material) weaknesses in the design or implementation of internal control, as soon as practicable, and at an appropriate level of responsibility. Examples of significant deficiencies include the following:

- evidence of an ineffective control environment, such as identification of management fraud
- absence of a risk assessment process within the entity
- evidence of an ineffective entity risk assessment process
- evidence of an ineffective response to identified significant risks
- misstatements that were not prevented or detected by the entity's internal control
- evidence of management's inability to oversee the preparation of the financial statements

It is for these key reasons that the auditor prepares what is often called a management letter, discussed in the next section.

Before You Go On

7.9.1 Why is it important to identify both the strengths and weaknesses in a system of internal controls?

7.9.2 Does the auditor provide feedback on strengths in internal controls or just weaknesses? Explain.

7.9.3 What obligations does the auditor have regarding communicating strengths or weaknesses in internal controls?

7.10 Management Letters

LEARNING OBJECTIVE 10

Explain how to communicate internal control strengths and weaknesses to those charged with governance.

management letter
a document prepared by the audit team and provided to the client that discusses internal control weaknesses and other matters discovered during the course of the audit

A **management letter** is a deliverable prepared by the audit team and provided to management and those charged with governance. The management letter discusses internal control weaknesses and other matters discovered during the course of the audit. The purpose of the management letter is to inform the client of the auditor's recommendations for improving its internal controls.

The example management letter shown in **figure 7.10** demonstrates that the combination of the auditor's experience in auditing various businesses and the thorough understanding they gain while conducting an audit places them in a unique position for communicating insights about the system of internal controls designed and monitored by those charged with governance. The management letter also enables the auditor to provide timely feedback to management on the implementation of internal controls.

Significant **professional judgement** is necessary in deciding whether a weakness identified is significant enough to warrant communicating to management and to those charged with governance. When the auditor identifies risks of material misstatement that the entity has not controlled (or has not adequately controlled), or if in the auditor's judgement there is a significant deficiency in the entity's design or implementation of internal control, the auditor is required to communicate these deficiencies as soon as practicable to those charged with governance. Deciding whether an observation should be reported to those charged with governance is often a matter of consultation and discussion among the audit team. Various cases have demonstrated that in the past some auditors have observed significant deficiencies but failed to communicate them. As a result of these cases, auditors often report all matters observed, irrespective of whether they are considered material or not. Some of the most recent and high-profile corporate collapses globally led to the creation of the U.S. Public Company Accounting Oversight Board (PCAOB) by the U.S. Securities and Exchange Commission and to the Sarbanes-Oxley Act (2002), which contains explicit provisions for internal control reporting.

professional judgement the exercise of the auditor's professional characteristics, such as their expertise, experience, knowledge, and training

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To the Management Team of Skyward Ltd.: March 15, 2024

Our audit of the financial statements as at and for the year ended December 31, 2023, has been completed. In performing our audit procedures at Skyward, we noted certain items that may be of interest to you and your team.

Our audit was designed to express an opinion on the financial statements of Skyward Ltd. and was not designed to evaluate the adequacy of individual internal controls. Accordingly, our audit would not necessarily discover all conditions requiring your attention or all opportunities to improve internal controls. Furthermore, the observations below should not be considered to be the sole matters to be addressed by management.

Our observations are as follows:

Credit Limits for Customers

Observation: We noted that there is no established policy to determine credit limits for customers.

Implication: Without proper controls over credit granting, there is an increased risk of accounts becoming uncollectible.

Recommendations: Management should design and implement a credit control system that includes a careful evaluation of the credit limits given to customers. Credit limits should be realistic and compatible with the creditworthiness of the customer and such limits should be checked before additional credit is approved. Management should review the established credit limits regularly and revise them if necessary. When special credit terms are requested, this should be approved by an appropriate level of management.

We would like to take this opportunity to thank the employees and management of Skyward for the excellent cooperation given to us throughout the audit.

This letter is intended solely for the information and use of Skyward's management and its Audit Committee and Board of Directors and is not intended to be and should not be used by anyone other than these specified parties.

Sincerely,

[Partner name], W&S Partners

FIGURE 7.10 **Example management letter**

The auditor may also identify and communicate internal control deficiencies not considered significant but still worthy of management's attention. While it is not mandatory to provide this feedback in writing, the auditor ordinarily prefers to provide their recommendations in the form of a letter or report to avoid any ambiguity or confusion as to what observations, conclusions, and recommendations they have made. Responding to a management letter also provides a simple way for management to document the actions they have taken in response to the issues raised and to share these actions (and the progress toward the resolution of the issues) with those charged with governance. Such a response also provides the auditor with valuable insights into management's attitude toward the importance of internal controls by being able to evaluate what management has done in response to the recommendations made in the previous year at the start of each audit. Depending on the size of the engagement and the timing of when control weaknesses are identified relative to the final audit visit, teams will sometimes prepare an interim management letter at the end of planning and interim procedures, with a final management letter issued at the completion of the audit.

Cloud 9 Integrated Case

Josh provides his documented understanding of Cloud 9's system of internal controls and his preliminary assessment of the system's strengths and weaknesses to Jo Wadley, the engagement partner of the audit. The audit team will gather additional evidence about the system of internal controls during the audit, and at the completion of the audit the senior members of the audit team will make a final assessment of Cloud 9's internal controls and write a management letter. Providing a management letter, including recommendations for future changes to the system of internal controls, is an important part of the auditor's role. The management letter not only discharges the audit team's responsibilities to the client, but helps the client improve its systems. In turn, this will likely increase the quality of the client's financial reporting in the future and improve the efficiency and effectiveness of future financial statement audits.

Before You Go On

7.10.1 Do auditors always communicate weaknesses in internal controls to those charged with governance? Explain your answer.

7.10.2 Can the content ordinarily included in a management letter be delivered verbally to those charged with governance? Explain your answer.

7.10.3 Why is it preferred that most communications with those charged with governance be done in writing?

Summary

1 Define the system of internal control.

Internal control is the system designed, implemented, and maintained by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term "internal controls" refers to any aspects of one or more of the components of internal control. Controls include entity-level controls and transaction-level controls.

2 State the seven generally accepted objectives of internal control activities.

Internal controls are designed and implemented to ensure that transactions are real; recorded; correctly valued, classified, summarized, and posted; and timely.

3 Describe the elements of the system of internal control at the entity level.

The system of internal control includes the control environment, the entity's risk assessment process, the entity's information system and communications, control activities, and monitoring. Internal control also includes how the controls are implemented, such as through appropriate segregation of duties.

4 Identify the different types of controls.

There are four different types of controls: manual, automated (otherwise known as application controls), IT general controls (ITGCs), or a combination of control types referred to as IT-dependent manual controls. Each of these types can be described as either a preventive control or a detective control. Preventive controls, as the name suggests, prevent errors from occurring. Detective controls detect the error after it has occurred and rectify the error on a timely basis.

5 Explain how to select and design tests of controls.

The selection of which controls to test is a matter of professional judgement. Deciding which controls to test will be influenced by the control objective, the type of control, the frequency with which the control is performed, and the level of assurance the auditor plans to gain from determining whether the control is designed and implemented effectively. As a general rule, the best controls to test are those that address the WCGWs most effectively with the least amount of testing required. The extent of testing of controls (that is, deciding how many to test) is also a matter of professional judgement, although there are sampling techniques available. The extent of testing is affected by many factors, including how often the control is performed, the degree to which reliance will be placed on the control as part of the audit, the persuasiveness of the evidence produced by the control, the need to be satisfied that the control operated as intended throughout the period of reliance, the existence of a combination of controls that may reduce the level of assurance that might be needed from any one control, the relative importance of the WCGW questions or statements being considered, and any other factors, such as the competence of the person carrying out the control, the quality of the control environment, and any changes in the accounting system.

6 Explain the different techniques used to document and test internal controls.

The most common forms of documentation are narratives, flowcharts, combinations of narratives and flowcharts, and checklists and preformatted questionnaires. There are four key techniques used for testing controls: inquiry (questions are asked regarding the operation of the control), observation (the operation of the control is observed to be occurring), inspection (physical evidence resulting from the performance of the control is examined), and re-performance (the control is re-performed to test its effectiveness).

7 Understand how to interpret the results of testing of controls.

If the controls tested are considered to be effective and can be relied on for the purposes of reducing overall audit risk for a particular significant account and assertion, the level of additional substantive testing required is reduced. If the controls tested are considered to be ineffective and are not able to provide any audit evidence that reduces overall audit risk for a particular significant account and assertion, the level of additional substantive testing that is required is increased.

8 Explain how to document tests of controls.

The purpose of the test of controls, the selection of controls to test, the results of the control testing performed, and the conclusion regarding the design and implementation of the controls are all documented in the audit working papers. The working papers are then reviewed by more experienced auditors to determine if sufficient work was performed and if the appropriate conclusion was reached.

9 Describe the importance of identifying strengths and weaknesses in a system of internal controls.

An important outcome of understanding a client's system of internal controls is the ability to make observations, draw conclusions, and offer recommendations regarding the strengths and weaknesses observed. CAS 260 and CAS 265 require auditors to provide those charged with governance with timely observations arising from the audit. This is generally done through a management letter.

10 Explain how to communicate internal control strengths and weaknesses to those charged with governance.

A management letter is a deliverable prepared by the audit team and provided to the client (including those charged with governance). It informs the client of the auditor's recommendations for improving its internal controls.

Key Terms

Attribute sampling 7-26
Audit risk 7-4
Control activities 7-12
Control environment 7-7
Control exception 7-26
Control risk 7-10
Detection risk 7-10
Entity-level controls 7-7
Inherent risk 7-10
Management letter 7-38
Professional judgement 7-39
Risk assessment process 7-10
Substantive procedures (substantive testing or tests of details) 7-28
System of internal control 7-4
Tests of controls (control testing) 7-17
Transaction-level controls 7-16
WCGWs 7-17

Self-Test Questions

Answers to the Self-Test Questions are available in *WileyPlus*.

7.1 Internal control is a system that is *not*:

a. designed to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations.

b. the responsibility of those charged with governance.

c. designed and implemented to address identified business risks that threaten the achievement of the entity's objectives.

d. designed and approved by the external auditors after consultation with management.

7.2 The objectives of internal controls include:

a. that fictitious transactions are not included in the organization's records.

b. that correct amounts are assigned to transactions.

c. that transactions are recorded in the correct accounting period.

d. all of the above.

7.3 An entity's risk assessment process:

a. is established only if the entity is subject to unusually high risk.

b. is the entity's process for identifying and responding to business risks and the results thereof.

c. is designed to help an entity think about risk in the same way that an auditor thinks about risk.

d. never allows management of an entity to decide to accept a risk without taking any action.

7.4 ITGCs are important because they:

a. promote the reliability of electronic audit evidence.

b. affect the effectiveness of both application controls and IT-dependent manual controls.

c. prevent authorized personnel from having access to data and applications.

d. allow client staff to change computer programs without needing to receive authorization for the change.

7.5 The auditor decides which controls to test by considering:

a. the type of control.

b. the frequency of the control being performed.

c. the level of assurance the auditor wishes to gain.

d. all of the above.

7.6 Inspection of physical evidence is a control test used by auditors. It:

a. relies on questioning skills.

b. is subject to a limitation because employees may be more diligent when they know they are being observed.

c. relies on testing the physical evidence.

d. requires the auditor to re-perform the control.

7.7 A major change in the accounting system has taken place during the year. The effect on control testing is that:

a. the auditor should ensure control testing is performed for periods both before and after the accounting change became effective.

b. the auditor can assume the accounting system change was necessary and has improved the client's controls, so should only test the period following the change.

c. the auditor can assume the accounting system change was necessary and has improved the client's controls, so should only test the period before the change.

d. the auditor will not conduct control testing because the client has clearly thought about making sure the accounting system works well.

7.8 Working papers:

a. document the purpose of the test of the control identified and the results of the test, including a specific conclusion about whether the test results supported the overall purpose of the test.

b. are necessary for the junior auditor to keep track of the daily work but are not important to the overall audit.

c. document the results of the tests but not the purpose of the control selected for testing.

d. document the purpose of the control selected for testing and the conclusion made by the auditor but not the results of the test.

7.9 Documenting internal controls:

a. is always handled through the use of checklists and preformatted questionnaires.

b. is not done for smaller clients because of the risk of management override.

c. can be handled with a combination of narratives and flowcharts.

d. all of the above.

7.10 A management letter:

a. contains recommendations for improving internal control and discusses other issues discovered during the course of the audit.

b. is written by management to the auditor at the start of the audit.

c. lists only the significant deficiencies discovered during the audit.

d. all of the above.

Review Questions

7.1 What is the system of internal control? Why is an auditor interested in a client's system of internal control?

7.2 Explain each of the seven objectives of internal control.

7.3 Explain the difference between entity-level controls and transaction-level controls. Is an auditor interested in both?

7.4 Explain the purpose of (a) preventive controls and (b) detective controls. Why would it be important for an entity to have both types of controls?

7.5 What does ITGCs stand for? Explain their purpose.

7.6 What are the four types of tests of controls? Explain them and comment on the reliability of the evidence obtained from each.

7.7 What factors do auditors consider when deciding how much control testing to do?

7.8 Discuss the concepts of nature, timing, and extent as they relate to control testing.

7.9 Four approaches to internal control documentation are discussed in the chapter. Assess the advantages and disadvantages of each. How would documentation assist the auditor to identify strengths and weaknesses of an entity's system of internal controls?

7.10 Why do auditors prepare management letters?

Professional Application Questions

Basic Moderate Challenging

7.1 Importance of internal control Moderate LO 1

Powersys is an electricity distribution company based in a large capital city. Its business is to manage the electricity assets, including poles, wires, and other equipment, that are used to deliver electricity to retail and business customers in the city. Pole, wire, and substation maintenance and improvements are a large part of the company's operations, and teams of highly trained technicians are used for both planned work and emergency response activities. Emergency response is required when storms or fires bring down power lines, the power must be turned off at the direction of police, or the electricity supply fails for any reason.

Each team has several vehicles (vans and trucks) and uses additional heavy equipment, such as cherry pickers, cranes, and diggers, as required. Each vehicle carries a core set of specialized parts and tools, and additional items are obtained as required from storage, which is located in a large warehouse in the northern suburbs. The warehouse is staffed on a 24-hour basis to assist night maintenance (designed to minimize disruption to business customers) and emergency response.

Required

a. Make a list of the potential problems that could occur in Powersys's maintenance and improvements program.

b. Suggest ways that good internal control over parts, equipment, and labour could help Powersys avoid these problems.

7.2 Objectives of internal control Moderate LO 2

Carmel Harrison runs Emerald Spa, a business providing women-only hairdressing, beauty, relaxation massage, and counselling services in a small tourist town. Ninety percent of the clients using the beauty and massage services at Emerald Spa are weekend visitors to the town, but 80 percent of the hairdressing and counselling clients are locals. The massage therapist and counsellor have formal qualifications and are registered with the medical authorities, allowing clients to claim the cost of the service with their private health insurer if an appropriate receipt is provided when the client pays.

Emerald Spa has just opened another branch of the business in a town 100 kilometres away, and there are plans for a third branch to be opened next year. Carmel has been very busy establishing the new branches and relies on staff in each office to run the day-to-day operations, including ordering supplies and banking receipts. In addition, the branch manager organizes the staff and authorizes their time sheets. Carmel makes the payments for rent, power, salaries, and large items of expenditure, such as furniture purchases.

Required

a. Give examples of transactions that would occur at Emerald Spa.

b. Explain what could go wrong with these transactions if the system of internal controls could not meet any of the seven generally accepted objectives of internal controls.

7.3 Control objectives **Basic** **LO 2**

The following errors due to sloppy paperwork and poor controls were found during an audit.

1. A customer's order was shipped without credit approval.
2. Some sales made in January were recorded as being made in December. The company has a December 31 fiscal year end.
3. Duplicate sales were recorded.
4. Sales to a subsidiary were recorded as sales to outsiders instead of as intercompany sales.
5. Some shipments of goods to customers were not recorded.

Required

Identify which internal control objective was violated in each case.

7.4 Control environment at a large company **Moderate** **LO 3**

International Bank is experiencing bad publicity surrounding huge fraud losses in its foreign currency department. Accusations are being made in the press that the rogue trader blamed for the losses was operating outside the official guidelines with the tacit approval of senior management in the department because of the large profits made by this trader in previous years. The press claims that it was common knowledge in the foreign currency department that strict policies and procedures surrounding the size of trades and the processes for balancing out trades at the end of each day were not to be followed if the trader had verbally informed his supervisor of the trade. The press is also suggesting that the problems are not confined to the foreign currency department, and that poor attitudes are prevalent throughout all commercial departments at International Bank.

Required

Discuss the control environment at International Bank, assuming the press reports are correct. Which parts appear to be most deficient?

7.5 Categories of controls **Basic** **LO 3**

There are several categories of control activities listed in this chapter. They include performance reviews, information processing controls, authorization controls, account reconciliations, physical controls, and segregation of duties.

Required

For each of the following, identify the type of control:

a. Petty cash is kept in a safe.
b. All invoices are stamped "paid" after processing.
c. Cheques received are pre-listed by the receptionist and recorded in the books by the accounts receivable clerk.
d. The accounts receivable sub-ledger is agreed to the general ledger at each month end.
e. Passwords are required before journal entries may be posted.
f. Monthly results are compared with budget, and unexpected results are investigated.
g. Overtime must be approved by a supervisor.
h. Pre-numbered purchase orders are required before an invoice will be paid.
i. Employee payroll records are kept in a locked filing cabinet.
j. The person responsible for shipping and receiving goods does not perform the related billing.
k. Monthly results are sent to divisional managers for review.

7.6 IT controls—suppliers **Basic** **LO 4**

Within a client's IT system, supplier information is contained in a supplier master file (SMF). Each supplier has a unique supplier code. If the purchasing clerk attempts to place an order from a supplier not in the SMF, the order cannot be processed. To avoid delays in processing orders, the purchasing clerk has access to the supervisor's password, which allows the clerk to allocate a supplier code to new suppliers.

Required

Explain what type of control the above information describes. Discuss its strengths and weaknesses.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, March 2011. Provided courtesy of Chartered Accountants Australia and New Zealand.

7.7 Preventive controls **Moderate** **LO 4**

Alabama Industries manufactures and wholesales small tools. It sells the tools to a large group of regular customers and makes most sales by telephone to this group. Additionally, it receives orders online from its sales team, who sign up new customers within the sales area. In the past, Alabama Industries has had trouble with customers who do not pay their accounts on time. Despite instructing the sales team not to make sales to customers before their creditworthiness has been assessed, sales are still being made to new customers before their limits have been set and to existing customers beyond their credit limit. Also, the economic situation has started to impact Alabama's customers, and management is concerned about the possibility of increasing bad debts.

Required

a. What sort of preventive control could be used to deal with the problems faced by Alabama Industries? Explain how the control would work.

b. Assume the preventive control is implemented, and during this year there have been no sales to customers that have taken any customer beyond its credit limit. What are two possible explanations for this that the auditor must consider?

c. If an auditor finds two sales transactions during the year that are in excess of a customer's credit limit at the time of the sale, what conclusion would the auditor draw from this evidence? What other evidence could the auditor consider before concluding that the preventive control has failed?

7.8 Controls at a small start-up company **Moderate** **LO 1, 3, 4**

Two of your friends from high school will soon realize their lifetime dream of opening an English-style pub. They recently spoke with their accountant, who indicated that they should ensure that they implement some strong controls. They have no idea what the accountant was talking about. They know you are studying accounting and they have come to you for advice about what their accountant meant.

Required

a. Explain the concept of the system of internal controls.

b. List four things your friends should do to ensure that they create a strong control environment.

c. List eight control activities they should have in place. Describe how each activity is relevant to their business.

7.9 Testing bank reconciliation controls **Moderate** **LO 4, 5, 6**

You are testing the controls over bank accounts for your audit client, Manitoba Ltd. You note that the responsibility for bank reconciliations has changed due to a corporate reorganization halfway through the current financial year. Both the staff member performing the bank reconciliations and the supervisor have changed. You are only able to talk to the current staff member and supervisor because the other staff took voluntary retirement and left the client's employment three months ago.

Required

a. What techniques are available to you to gather evidence about the bank reconciliations? Explain how you would use each technique and comment on the quality of the evidence obtained from each.

b. When you ask the employees responsible for bank reconciliations about how they perform the reconciliations, there is a possibility that they will not tell the whole truth about their performance of the reconciliations. Given this, will you bother to ask them? Explain.

c. Explain the impact of the staff changes on your control testing program.

7.10 Payroll controls **Challenging** **LO 4, 6**

The audit senior on the audit of Frankel Factors is preparing the audit plan for the year ended December 31, 2023. The following notes relate to a new payroll application system that went live on January 1, 2023.

1. The new payroll application is more complex than the old system, but its reporting function provides more detail. For example, the new application calculates withholding taxes and benefits as well as any required corresponding accruals.

2. Due to the brief time available to implement the new system, the previous application ceased operation on December 31, 2022, and the new application went live on January 1, 2023, without running parallel with the previous application. Staff training and testing of the new application were limited.
3. Access to the master files is restricted to the payroll supervisor and her assistant. Access to transaction files is restricted to payroll staff who are responsible for the processing of the biweekly and monthly payroll.

   Prior to the introduction of the new payroll application system, the payroll master and transaction files were kept in a separate database from the general ledger application. At the end of each month, the IT staff imported transaction data from the database into the general ledger. Management decided to upgrade the existing accounting system due to the frequent problems encountered by IT staff when importing data into the general ledger.

Required

a. Based on the information above, explain two relevant concerns you may have about the payroll application's integration with the general ledger application.

b. Describe one IT application control that would ensure the accuracy of the salaries and wages expenses transaction.

c. Describe one IT application control that would ensure the occurrence of the salaries and wages expenses transaction.

d. Design and describe in detail appropriate tests of control that you would use to satisfy yourself about the effectiveness of these internal controls.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, July 2010. Provided courtesy of Chartered Accountants Australia and New Zealand.

Questions 7.11 and 7.12 are based on the following case.

Featherbed Surf & Leisure Holidays Ltd. is a resort company based on Vancouver Island. Its operations include boating, surfing, fishing, and other leisure activities; a backpackers' hostel; a family hotel; and a five-star resort. Justin and Sarah Morris own the majority of the shares in the Morris Group, which controls Featherbed. Justin is the chair of the board of directors of both Featherbed and the Morris Group, and Sarah is a director of both companies as well as the CFO of Featherbed.

Justin and Sarah have a fairly laid-back management style. They trust their workers to work hard for the company and they reward them well. The accounting staff, in particular, are very loyal to the company. Justin tells you that some accounting staff enjoy their jobs so much they have never taken holidays, and they rarely take sick leave. Justin and Sarah have not bothered much in the past with formal procedures and policies, but they have requested that the accounting staff start documenting the more common procedures. Justin and Sarah do not conduct formal performance reviews; they rely on their staff to tell them when there is a problem.

There are three people currently employed as accountants, the most senior of whom is Peter Pinn. Peter heads the accounting department and reports directly to Sarah. He is in his fifties and plans to retire in two or three years. Peter prides himself on his ability to delegate most of his work to his two accounting staff, Kristen and Julie. He claims he has to do this because he is very busy developing a policy and procedures manual for the accounting department. The delegated work includes opening mail, processing payments and receipts, banking funds received, performing reconciliations, posting journals, and performing the payroll function. Julie is a recently graduated Chartered Professional Accountant. Kristen works part-time—coming into the office on Mondays, Wednesdays, and Fridays. Kristen is responsible for posting all journal entries into the accounting system and the payroll function. Julie does the balance of the work, but they often help each other out in busy periods. Kristen authorizes Julie's transactions, and Julie returns the favour by authorizing Kristen's transactions. Together, they usually make the accounts balance.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, May 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

7.11 Internal control components **Challenging** **LO 3**

Required

Assess the internal controls at Featherbed. What changes would you recommend?

7.12 Communication with management **Challenging** **LO 7**

Required

Write a management letter to Justin and Sarah Morris.

Questions 7.13 and 7.14 are based on the following case.

Securimax Limited has been an audit client of KFP Partners for the past 15 years. Securimax is based in Waterloo, Ontario, where it manufactures high-tech armour-plated personnel vehicles. Securimax often has to go through a competitive market tender process to win large government contracts. Its main product, the small but powerful Terrain Master, is highly specialized, and Securimax does only business with nations that have a recognized, democratically elected government. Securimax maintains a highly secure environment, given the sensitive and confidential nature of its vehicle designs and its clients.

In September 2023, Securimax installed an off-the-shelf costing system to support the highly sophisticated and cost-sensitive nature of its product designs. The new system replaced a system that had been developed in-house, as the old system could no longer keep up with the complex and detailed manufacturing costing process that provides tender costings. The old system also had difficulty with the company's broader reporting requirements.

Securimax's IT department, together with the consultants from the software company, implemented the new manufacturing costing system. There were no customized modifications. Key operational staff and the internal audit team from Securimax were significantly engaged in the selection, testing, training, and implementation stages.

The manufacturing costing system uses all of the manufacturing unit inputs to calculate and produce a database of all product costs and recommended sales prices. It also integrates with the general ledger each time there are product inventory movements such as purchases, sales, wastage, and damaged inventory losses.

It is now October 2023 and you are beginning the audit planning for the December 31, 2023, annual financial statement audit. You are assigned to assess Securimax's IT controls with particular emphasis on the recent implementation of the new manufacturing costing system.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, May 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

7.13 Components of internal control **Challenging** **LO 3**

Required

Select two components of internal control. Explain how the roles of the internal and external auditors would differ when assessing these components in relation to the new manufacturing costing system.

7.14 Understanding types of controls **Challenging** **LO 4**

Required

In relation to the new manufacturing costing system, describe two automated application controls that you would expect to find.

Questions 7.15 and 7.16 are based on the following case.

Fellowes and Associates Chartered Professional Accountants is a successful mid-tier accounting firm with a large range of clients across Canada. In April 2023, Fellowes and Associates gained a new client, Health Care Holdings Group (HCHG), which owns 100 percent of the following entities:

- Shady Oaks Centre, a private treatment centre
- Gardens Nursing Home Ltd., a private nursing home
- Total Laser Care Limited, a private clinic that specializes in the laser treatment of skin defects

The year end for all HCHG entities is June 30.

You are an audit senior on the Shady Oaks engagement. Your initial review of the business has highlighted the following significant risks.

1. Payroll expense—Shady Oaks employs, in addition to its full-time staff, a significant number of casual nursing, cleaning, and administrative staff. Overtime is often worked on weekends and night shifts due to a shortage of staff. Payment at overtime rates for standard weekend and night shifts has been a common occurrence.
2. Accounts payable—Shady Oaks also has a large number of suppliers for various medical supplies and drugs. Paying the supplier twice for the same purchase has been a continuing problem.

In addition, your business risk assessment procedures indicate there is a risk that payments to suppliers are made prior to goods being received. As part of your evaluation of the potential mitigating internal controls, you note that accounting staff perform the following procedures:

1. A pre-numbered cheque requisition is prepared for all payments.
2. The details on the supplier's invoice are matched to the appropriate receiving report.

3. The details on the supplier's invoice and receiving report are matched to an authorized purchase order.
4. The cheque requisition is stapled to the authorized purchase order, receiving report, and supplier's invoice and forwarded to the appropriate senior staff member for review and authorization.
5. The authorized cheque requisition, together with the supporting documents, is passed to accounts payable for payment.

7.15 Preventive and detective controls **Moderate** **LO 4**

Required

For each of the accounts for Shady Oaks (payroll expense and accounts payable in items 1 and 2 above) identified to be a significant risk:

a. Determine the relevant assertions.

b. Describe a practical preventive internal control that would directly address the risk.

c. Describe a practical detective internal control that Shady Oaks could implement in relation to the risk.

You may wish to present your answer in the form of a table, as follows:

Account at Risk	A. Relevant Assertion at Risk	B. Preventive Internal Control	C. Detective Internal Control
1. Payroll expense: overpayment of overtime			
2. Accounts payable: payments made twice to the same supplier			

7.16 Preventive controls **Moderate** **LO 4, 5, 6**

Required

a. Identify the relevant assertions at risk for payables in relation to payments made prior to receipt of goods.

b. For the control procedures (1) to (5) above for payables:

  i. Identify the key preventive internal control that directly addresses the risk of payments being made by Shady Oaks to its suppliers before the goods are received.

  ii. Outline how your choice of the internal control in (i) will prevent payment to suppliers prior to receipt of goods.

  iii. Design and describe in detail an appropriate test of control that you would use to satisfy yourself about the effectiveness of this internal control.

7.17 Segregation of duties and documentation **Moderate** **LO 6, 7, 8**

Lisa Curtis is documenting the purchasing and cash payments processes at Hardies Wholesaling. Hardies Wholesaling imports ladies clothing such as T-shirts, blouses, skirts, dresses, and pants from suppliers in Southeast Asia. All items are non-perishable and made from materials such as cotton, wool, polyester, and spandex, and are distributed to retailers throughout the country.

Purchases are denominated in U.S. dollars, which the company acquires under forward exchange contracts. The purchasing department initiates a purchase order when inventory levels reach reorder points or sales staff notify the department of large customer orders that need to be specially filled. The purchase order is approved and sent to suppliers selected from an approved supplier list. Goods are transported from Southeast Asia by ship and are delivered by truck to Hardies Wholesaling's central warehouse. A receiving report is generated by the receiving department and forwarded to the accounting department for matching with the copy of the original purchase order and the supplier's invoice. When the package of documents is completed, the purchase order and invoice are entered into the general ledger. The accounts payable department creates a voucher to request payment of the invoice according to the supplier's payment terms. The payment is approved and the cash payment is made.

Required

a. Create a flowchart or logic diagram to represent the flow of transactions from the creation of a purchase order to cash payment.

b. Which duties in the above process should be segregated?

7.18 Control testing results and documentation **Moderate** **LO 5, 7, 8**

Arne Eklund, the audit senior, is reviewing the working papers written by the audit assistant on the audit of Quebec Creepers, a nursery and retailer of garden accessories. Arne reads the following description of the results of testing of inventory controls written by the audit assistant:

> The Inventory Manager advises that no changes have been made to the inventory programs during the current financial year. There are no documents on file authorizing program changes, so I conclude the Inventory Manager's statement is true. The Inventory Manager also advises that management did not attempt to override any controls relating to inventory. There are no memoranda or emails from management on file instructing the Inventory Manager to go against procedures, so I conclude the Inventory Manager's statement is true.

The audit assistant concludes that the inventory controls have not been changed or overridden during the financial year, so the results of the interim testing of controls can be relied on.

Required

a. Examine the statements by the audit assistant. What deficiencies in the testing can you identify?

b. If the results of testing one control show that the control is not effective, does the auditor have to increase substantive testing? What other options are available to the auditor?

c. Explain why it is important for the working papers to be completed with sufficient detail for another auditor to understand what has been done. Make a list of the parties who might review the documents.

7.19 Techniques for testing computerized controls **Moderate** **LO 4, 6**

The sales transactions at Alberta Park, a new audit client, are handled by a software application that is not supported by very detailed documentation. The audit partner requests that the team re-perform some controls to ensure that the software application controls are working as described by Alberta Park's management. The audit software used by the audit team can access the data on the client's files, allowing the use of standard audit procedures.

Required

Provide a list of possible audit procedures that could be used by the audit team to test the controls in the client's sales software application.

7.20 Integrative Case Study—Armstrong, Aldrin & Collins Professional Corporation

Armstrong, Aldrin & Collins Professional Corporation (AAC) operates a public accounting practice that is located in Woodstock, Ontario. AAC's common shares are owned equally by its three shareholders, who are Chartered Professional Accountants (CPAs). A plan to open an office in Stratford, Ontario, on November 1, 2023, has been developed. Financing has been arranged with the bank subject to AAC providing the bank with its audited financial statements prepared in accordance with Accounting Standards for Private Enterprises for the fiscal year ending September 30, 2023, and for subsequent fiscal years.

AAC has engaged Smithee & Co., CPAs, to perform the audit of AAC's financial statements for the year ending September 30, 2023. You, a CPA, have been assigned the role of audit senior on this engagement. It is July 25, 2023, and Roberta Payette, the engagement partner, calls you into her office and says: "I want you to prepare the audit engagement planning memo for the AAC audit. Please consider the risk and appropriate audit strategy. You should note that AAC's financial statements have not been previously independently audited or reviewed." The partner continues: "AAC has implemented a new working paper preparation and maintenance system and the shareholders have asked us to identify any weaknesses in the system and to provide recommendations for improving the system. The shareholders want the new system to provide proper quality control for AAC. I want you to prepare a draft report that addresses this client request."

Background information

AAC was formed seven years ago and has experienced rapid growth. AAC has hired three university graduates who will start work in September 2023. Roberta says that Wally Cunningham, AAC's controller, is responsible for setting accounting policies because the shareholders are "too busy growing the business to spend time on internal accounting matters, and Wally has a university accounting degree and knows what he is doing." However, Wally has recently found it difficult to keep up to date with auditing and accounting standards.

NOTES PREPARED BY THE PARTNER ABOUT THE NEW WORKING PAPER PREPARATION AND MAINTENANCE SYSTEM

Background information

A new working paper preparation and maintenance system was developed during the three months from November 2022 to January 2023. The new system, which became effective on February 1, 2023, allows for the storage of all working paper files on a secure website from which a client's information can be accessed, worked on, and reviewed from any place having an Internet connection (e.g., the AAC office, client offices, residences of staff members, and hotel rooms).

Passwords

The website is a secure site that uses 128-bit encryption for any interaction with remote computers. Each authorized AAC staff member is assigned a personal password that allows access to the system and records who uses the system and the names of the files opened. These specific passwords are stored on each staff member's computer, which allows for quick and automatic login once the site is connected by the Internet browser. After login has been achieved, the staff member starts the working paper preparation software, ClientPrep, and can use any element of this program.

Software

The ClientPrep software includes audit and review engagement assurance planning templates, standard audit program forms and working paper templates, and standard correspondence forms. When the ClientPrep working papers are completed, the software produces financial statements using standard templates, with standard note disclosures. An AAC partner can access and review any portion of a working paper file on which a staff member is still working.

Updates

ClientPrep is updated annually; however, revisions are made immediately for any income tax changes or programming errors that are identified. The annual update (or any other revision) of ClientPrep is sent directly to the website host, which makes the necessary changes to the ClientPrep program stored on the server and sends notification of the change to AAC.

When AAC wants to change the graphics or the links on the website, Michelle Collins (an AAC partner and the designated information technology officer) sends an email to the website host requesting that the desired changes be made.

Backup and security

Each week the entire population of working paper files is copied from the server to the cloud for storage. The website host prepares a report indicating those AAC staff members who have accessed files during the week and the time of each access. The AAC shareholders are concerned about the possibility of the website being infected with a virus, which could not only destroy client documentation but also prevent staff from viewing and working on client files. To address this concern, the website host scans the client data and other files used by AAC consistently using a well-respected anti-virus program.

Required

a. Prepare an audit planning memo considering the audit risk and audit approach.

b. Prepare a draft report that addresses the control weaknesses of the new system. For each item, address the implication and make a recommendation.

Case Study—Cloud 9

Answer the following questions based on the information presented for Cloud 9 in Appendix A to this book and in the current and earlier chapters. You should also consider your answers to the case study questions in earlier chapters.

Sharon Gallagher and Josh Thomas have assessed the internal controls at Cloud 9 as being effective at an entity level. This means that, at a high level, the company demonstrates an environment where potential material misstatements are prevented or detected.

PART A

Required

You have been assigned the task of documenting the understanding of the process for recording sales, trade receivables, and cash receipt transactions for wholesale customers. In your absence, Josh met with the Cloud 9 financial controller, Carla Johnson, and received permission to tape the interview, which is provided as a transcript (see Appendix A). Using this interview transcript and other information presented in the case, you are asked to:

a. Prepare a flowchart or narrative documenting your understanding of the sales to cash receipts process for wholesale sales.

b. Identify any follow-up questions you would like to ask the client if aspects of the process are not adequately explained. You could address such questions to Carla Johnson or any other employee you deem appropriate.

c. Draw up a worksheet using the following format. Use the column "Potential Material Misstatement" and identify the potential material misstatements that could occur in the sales to cash receipts process. Use as many rows as you need. Identify the potential material misstatements that could occur in the sales to cash receipts process for wholesale sales. Using the material misstatements identified, complete the third column "Assertions" to identify the financial statement assertion that is affected for each potential material misstatement. Lastly, in column four, include the transaction-level internal controls Cloud 9 has implemented to prevent and/or detect potential errors.

Significant Process	Potential Material Misstatement	Assertions	Transaction-Level Controls

PART B

In designing the audit strategy, auditors should consider the effectiveness of the client's internal control structure, thereby determining the control risk. An auditor should perform a preliminary assessment of control risk in order to be confident that they can use a controls-based approach to the audit strategy. A controls-based strategy is one in which the internal controls of a significant process are tested and proven to be effective, which means they can be relied on to reduce the level of substantive testing needed. If internal controls are tested and proven to be operating effectively, the auditor can reduce the control risk of the related financial statement assertion. This method of testing controls can reduce the number of substantive procedures to be performed or can allow substantive testing to be performed prior to year end.

When designing control tests, consider whether there will be sufficient evidence that the control:

- operated as it was understood to operate
- was applied throughout the period of intended reliance
- was applied on a timely basis
- encompassed all applicable transactions
- was based on reliable information
- resulted in timely correction of any errors that were identified

Based on the preliminary assessment of Cloud 9's control environment obtained in earlier procedures, the audit team has decided to test controls over the sales to cash receipts process. It is expected that there will be no deficiencies in the transaction-level internal controls.

Required

a. Josh has partially completed the testing for selected controls over the sales/receivables and cash receipts processes. He has asked you to complete the testing for him. All information has been provided by the client (refer to Appendix A). Document your findings on the working papers Josh has started (see tables 7.5 and 7.6), and then conclude with your assessment on the overall effectiveness of the controls tested.

b. Using the results of your control testing, assess the control risk for the assertions in table 7.7 and write your conclusions in the working paper. Use the information you provided in the worksheet completed for part (a) to focus your control testing on the significant assertions.

TABLE 7.5 Cloud 9 control testing—sales/receivables process as at December 31, 2023

	Sales Invoice #	Date	Customer Name	Sale Amount (Excl. HST)	Invoice Matches Shipping Note (A)	Shipping Note #	Shipping Supervisor Authorization (B)
1	124874	1/14/2023	David Jones—Moose Jaw	645.87	✓	D00124874	✓
2	125048	1/23/2023	Foot Locker—Ottawa	745.21	✓	D00125048	✓
3	125324	2/7/2023	Rebel Sports—Vancouver Island	905.46	✓	D00125324	✓
4	125542	2/16/2023	Rebel Sports—Sunshine Coast	517.32	✓	D00125542	✓
5	125987	3/2/2023	Meyer—Moncton	675.28	✓	D00125987	✓
6	126067	3/10/2023	Dick's Sports—St. John's	367.96	✓	D00126067	✓
7	126845	4/8/2023	Foot Locker—Regina	781.62	✓	D00126845	✓
8	127111	4/27/2023	Running Shop—Calgary	457.24	✓	D00127111	✓
20							
21							
22							
23							
24							
25							

Note: For the purposes of this case study, sample tests 9 to 19 have been removed. There were no exceptions noted in the results.

Aim: To test selected controls over the sales and receivables process.

Sample: We randomly selected 25 sales invoices from the entire year.

a. To complete this test, we matched the sales invoice to the shipping note, ensuring it was signed by the customer.

b. We used the shipping note reference number in order to recall the online authorization screen. We noted the passcode entered by the shipping supervisors, which agreed with the passcode listings obtained by the IT manager.

TABLE 7.6 **Cloud 9 control testing—cash receipts process as at December 31, 2023**

	Date	Total Posted to Trade Receivables	Total Bank Deposit	Evidence of Review
1	1/8/2023	10,548.45	10,548.45	✓
2	1/18/2023	9,587.37	9,587.37	✓
3	2/15/2023	11,486.82	11,486.82	✓
4	2/27/2023	7,456.24	7,456.24	✓
5	3/11/2023	5,836.08	5,836.08	✓
6	3/19/2023	8,012.74	8,012.74	✓
7	4/4/2023	8,753.91	8,753.91	✓
8	4/22/2023	9,687.45	9,687.45	✓
20				
21				
22				
23				
24				
25				

Note: For the purposes of this case study, sample tests 9 to 19 have been removed. There were no exceptions noted in the results.

Aim: To test selected controls over the cash receipts process.

Sample: We randomly selected 25 working days from the entire year in order to test the reconciliation of daily bank receipts to trade receivables.

Conclusion:

TABLE 7.7 Cloud 9 control testing conclusions

Account Assertion	Control Risk	Explanation
Sales—occurrence		
Sales—completeness		
Sales—measurement		
Trade receivables—existence		
Trade receivables—completeness		
Trade receivables—accuracy, valuation, and allocation		
Cash—existence		
Cash—completeness		

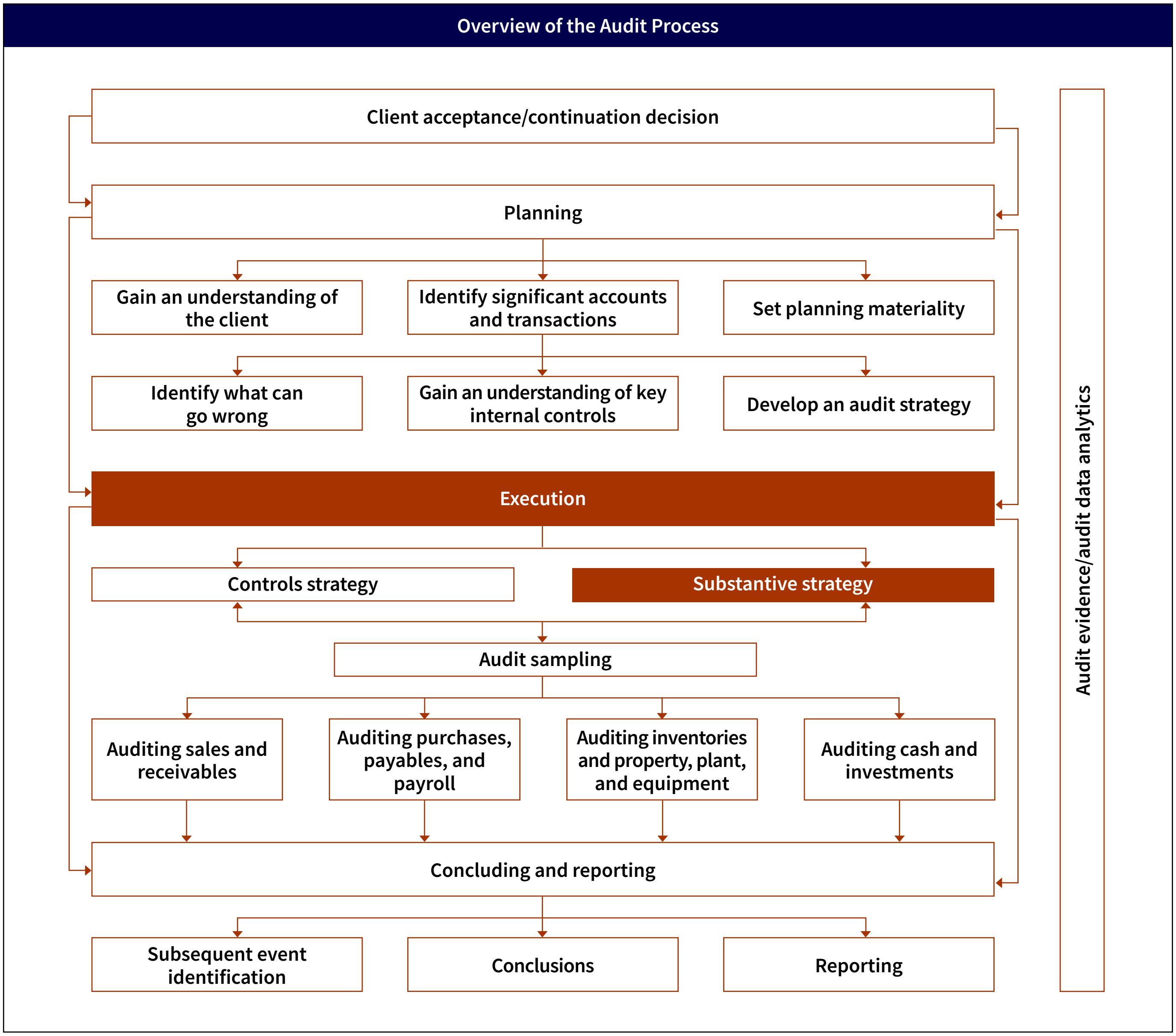
Research Question 7.1

Concerns have been raised over building an Alberta pipeline. Amid the international environmental movement, the pipeline has emerged as a significant environmental concern. Assume you are a member of senior management at a large company that wants to develop the Alberta pipeline.

Required

Write a report identifying the main risks to your company that you believe should be considered at the next meeting of the risk assessment committee. Include risks to the company's operations and assets, finances, and personnel.

Execution of the Audit—Performing Substantive Procedures



LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
After studying this chapter you should be able to:		Standards addressed in each learning objective are as follows:
1 Define substantive audit procedures	**8.1** Overview of Substantive Procedures **8.1.1** Substantive procedures and assertions **8.1.2** Definition of substantive procedures	CAS 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Canadian Auditing Standards* CAS 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* CAS 315 *Identifying and Assessing the Risks of Material Misstatement* CAS 330 *The Auditor's Responses to Assessed Risks* CAS 501 *Audit Evidence—Specific Considerations for Selected Items* CAS 505 *External Confirmations*
2 Understand the link between the audit risk model and the nature, timing, and extent of substantive procedures	**8.2** Relationship between Risk Assessment and the Nature, Timing, and Extent of Substantive Procedures	CAS 330 *The Auditor's Responses to Assessed Risks*
3 Provide examples of different substantive audit procedures	**8.3** Substantive Audit Procedures **8.3.1** Tests of details **8.3.2** Analytical procedures **8.3.3** Performing substantive testing using technology	CAS 330 *The Auditor's Responses to Assessed Risks* CAS 500 *Audit Evidence* CAS 520 *Analytical Procedures* CAS 530 *Audit Sampling*
4 Explain the different levels of audit evidence obtained when performing substantive procedures	**8.4** Levels of Evidence **8.4.1** Persuasive **8.4.2** Corroborative **8.4.3** Minimal **8.4.4** General	CAS 500 *Audit Evidence* CAS 520 *Analytical Procedures*
5 Design an audit plan to audit accounting estimates	**8.5** Auditing Accounting Estimates	CAS 540 *Auditing Accounting Estimates and Related Disclosures*
6 Describe the documentation of the conclusions reached as a result of performing substantive procedures	**8.6** Evaluating and Documenting Substantive Analytical Procedures' Results **8.6.1** Evaluating errors identified in testing **8.6.2** Concluding and documenting the results of substantive procedures	CAS 330 *The Auditor's Responses to Assessed Risks*

Cloud 9 Integrated Case

Suzie Pickering is the clothing and retail industry specialist on the Cloud 9 Ltd. audit. Suzie is mentoring Ian Harper, a junior member of the audit team, and they are working together on the detailed substantive audit program.

Ian remembers that Suzie used analytical procedures in the early risk assessment phase and that she explained to him how useful they could also be in the testing phase. Ian suggests that they plan to rely extensively on analytical procedures for Cloud 9's substantive tests. He is very enthusiastic and wants to put analytical procedures in the plan for all transaction cycles and major balances because he believes that analytical procedures will help keep the cost down and help the team bring the audit in on budget. Suzie is more cautious. Although she definitely plans to use some analytical procedures, she knows they will also need other types of tests.

"Why?" asks Ian. "How will I know when to use only analytical procedures? What other tests do we need?"

Chapter Preview

Finding an appropriate combination of audit procedures to minimize an engagement's audit risk at an acceptable cost to the auditor is a constant challenge. The purpose of this chapter is to describe the audit execution process, often referred to as "performing substantive procedures." The overall objective of substantive procedures is to supplement controls testing the auditor may have performed in order to determine that the underlying accounting records are materially correct and reconcile them to the financial statements on which the auditor will ultimately form an opinion.

The types of substantive procedures discussed in this chapter include analytical procedures, tests of underlying transactions and data, and the use of technology to assist in performing substantive procedures.

We will explain the link between the audit risk model and the nature, timing, and extent of substantive procedures. This link helps in the preparation of the audit program. We will also describe the levels of audit evidence the auditor can obtain from the various substantive procedures they have available to select from, and we will explain how to conclude that the overall account balance or disclosure being audited is not materially misstated.

8.1 Overview of Substantive Procedures

LEARNING OBJECTIVE 1

Define substantive audit procedures.

In this section, we discuss the link between audit risk, assertions, and substantive procedures, and we define substantive procedures in detail.

8.1.1 Substantive Procedures and Assertions

As discussed in previous chapters, the nature, timing, and extent of audit procedures are determined in response to the risk assessment for each **significant account** and relevant assertion using the formula for **audit risk** (that is, the risk that an auditor expresses an inappropriate audit opinion when the financial statements are materially misstated). This determination requires the use of **professional judgement**. **Figure 8.1** contains the audit risk model.

significant account any account with a relevant assertion

audit risk the risk that an auditor expresses an inappropriate audit opinion when the financial statements are materially misstated

professional judgement the auditor's exercise of professional characteristics such as expertise, experience, knowledge, and training

$$AR = IR \times CR \times DR$$

where:

AR = Audit risk

IR = Inherent risk

CR = Control risk

DR = Detection risk

FIGURE 8.1 Audit risk model

Inherent risk is the risk of a misstatement occurring irrespective of any controls management may put in place. These risks tend to be driven by the nature of the significant account or the business that the client is in. When an inherent risk is identified at the assertion level, it is assessed as to where it falls on the spectrum of inherent risk considering inherent risk factors such as complexity, subjectivity, change, and uncertainty. There is no way for the auditor to influence the inherent risk of an account or assertion.

Control risk is the risk that a client's system of internal controls will not prevent or detect a material misstatement. Control risk is assessed as high when there are no internal controls that the auditor can test or rely on (or when there are internal controls but they cannot be tested and relied on). Because the controls are deemed ineffective and will not be tested, essentially the risk of misstatement is the same as the inherent risk assessment. Control risk is assessed as low when there are good internal controls in place that have been designed and implemented effectively to reduce an identified risk, and when the auditor has been able to test the controls and verify their operating effectiveness throughout the period subject to audit.

inherent risk the susceptibility of the financial statements to a material misstatement without considering the internal controls

control risk the risk that a client's system of internal controls will not prevent or detect a material misstatement

detection risk the risk that the auditor's testing procedures will not be effective in detecting a material misstatement

The combination of inherent risk and control risk is the risk of material misstatement as described in CAS 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Canadian Auditing Standards.* This combination determines the level of **detection risk** (that is, the risk that the auditor's testing procedures will not detect a material misstatement) that the auditor is willing to accept to be able to conclude that the financial statements are not materially misstated. There is an inverse relation between the auditor's assessed risk of material misstatement and detection risk. Detection risk is reduced or increased in direct proportion to the amount of substantive testing performed. For example, let's assume that the combined inherent risk and control risk is high, meaning that the client is in a high-risk industry and a particular assertion of a significant account has a higher chance of being materially misstated because there are no controls in place and no controls have been tested. In that case, the amount of detection risk the auditor is likely to accept will be low, so significant substantive procedures will be necessary to reduce the detection risk. Now let's assume that the combined inherent risk and control risk are low, meaning that the client is in a low-risk industry and a particular assertion of a significant account has a lower chance of being materially misstated because there are controls in place. In that case, the auditor will likely accept a higher amount of detection risk, and only a small number of substantive procedures will be necessary to reduce the detection risk.

Figure 8.2 shows how the assessment of inherent risk and control risk affects the amount of substantive testing required to reduce detection risk to an acceptable level.

Control Risk Assessment

Inherent Risk Assessment		Low	Medium	High
		Controls tested extensively and able to be relied on	Limited controls testing, and they are not to be relied on	No controls tested and no assurance from controls
Low	Lower risk of material errors if no controls in place	Few substantive procedures required	Some substantive procedures required	Considerable substantive procedures required
High	Higher risk of material errors if no controls in place	Some substantive procedures required	Considerable substantive procedures required	Extensive substantive procedures required

FIGURE 8.2 Linkage between inherent risk, control risk, and substantive testing required to reduce detection risk

As discussed in previous chapters, the risk assessments discussed in this section must be performed at the assertion level as well as at the financial statement level. **Figure 8.3** gives an example of this risk assessment by assertion using accounts receivable. The audit assertions,

Account Assertion	Inherent Risk	Control Risk	Overall Risk Assessment	Detection Risk	Audit Approach
Accounts receivable—accuracy, valuation, and allocation	High	High	High	Low	Substantive approach
Accounts receivable—rights and obligations	Low	Low	Low	High	Combined audit approach
Accounts receivable—completeness	Low	Low	Low	High	Combined audit approach

FIGURE 8.3 **Example of accounts receivable risk assessment**

as outlined in CAS 315 *Identifying and Assessing the Risks of Material Misstatement* are reproduced in table 8.1 and grouped to show the assertions that have common objectives.

Table 8.1 illustrates how the objective of each assertion relates to the particular type of account or disclosure. For example, the auditor needs to verify that sales transactions recorded in the income statement occurred and relate to the entity (the occurrence assertion). Those same sales transactions flow through to the trade receivables balance in the balance sheet, and the auditor needs to verify that the balance of trade receivables as at year end exists and that the client holds the rights to those receivables (the existence assertion, and the rights and obligations assertion). The auditor then needs to verify that the balances disclosed in the financial statements as sales revenue and trade receivables occurred and relate to the entity (the occurrence assertion, and the rights and obligations assertion).

It is clear from table 8.1 that testing performed on sales revenue transactions will also provide evidence on trade receivables in the balance sheet and in the financial statement disclosures; however, additional testing will still be needed on the trade receivables balance regarding the other assertions not addressed by this example (such as testing the valuation assertion).

The classification assertion requires verification that transactions and events and account balances have been recorded in the proper accounts (that is, within the general ledger). Presentation requires verification that financial information included in the financial statements is appropriately presented and described, and that disclosures are clearly expressed. This means information is presented, described in the notes, and disclosed correctly and clearly. To ensure that this audit assertion is met, the auditor must ensure that the disclosures are in accordance with an applicable accounting framework (such as IFRS or ASPE).

TABLE 8.1 **Audit assertions**

Assertions About Classes of Transactions, Events, and Related Disclosures	Assertions About Account Balances and Related Disclosures at Year End
Typically *income statement* accounts	**Typically *balance sheet* accounts**
Occurrence	Existence
Occurrence	Rights and obligations
Completeness	Completeness
Cut-off	
Accuracy	Accuracy, valuation, and allocation
Classification	Classification
Presentation	Presentation

It is also important to note that when determining the substantive procedures to be performed, the auditor will consider the nature of the account, and the relevant assertions. For example, usually the auditor is concerned with an overstatement of the asset accounts; therefore, the procedures performed will generally focus on whether the assets exist and if they are appropriately valued. Conversely, for liability accounts, the auditor is most concerned with an understatement, so the auditor focuses on the completeness assertion, to ensure that all liabilities have been recorded.

Cloud 9 Integrated Case

Suzie emphasizes to Ian that their testing must respond to the risk of material misstatement at the assertion level. For each assertion, the audit team determines the level of detection risk, which is based on the inherent risk assessment, and the results of the control testing, which is used to establish the level of control risk. The auditors also have to consider a range of practical factors, such as constraints on timing and the complexity of the client's systems.

"Analytical procedures are always useful, but the decision to use analytical procedures and/or other substantive procedures must consider risk and practical factors," she says. "We have to decide what an acceptable level of detection risk is, and how to achieve it, for every assertion about transactions, account balances, and disclosures."

8.1.2 Definition of Substantive Procedures

substantive procedures (substantive testing or **tests of details)** audit procedures designed to detect material misstatements at the assertion level

Substantive procedures are designed to obtain direct evidence of the completeness, accuracy, and validity of data, and the reasonableness of the estimates and other information contained in the financial statements. Substantive procedures include inspection, observation, inquiry, confirmation, recalculation, re-performance, and analytical reviews. They are also referred to as **substantive testing** or **tests of details**.

The number of substantive tests performed and their timing are influenced by several factors. The most important factor, described in section 8.1.1, is the overall risk assessment for the item being tested. Before making this assessment, the auditor will have performed planning procedures and controls testing (including testing of any controls that the auditor has identified and intends to rely on). The results of these planning and interim procedures allow the auditor to make an overall assessment as to how much detection risk still exists before any substantive testing is performed. The auditor then designs what they believe are appropriate substantive audit procedures that will allow material errors and exceptions to be identified and rectified before an overall conclusion is made. These procedures are documented in what is usually referred to as the **audit program**. The audit program typically includes a detailed listing of the audit procedures to be performed during the risk assessment interim and year-end phases. The program should include enough detail to enable the auditor to understand the nature, timing, and extent (or scope) of testing required. It describes the controls testing as well as the resulting substantive procedures (as detailed in this chapter). Examples of typical substantive procedures for common significant accounts are included in later chapters.

audit program a detailed listing of the audit procedures to be performed, with enough detail to enable the auditor to understand the nature, timing, and extent of testing required

There are several other factors (over and above the audit risk assessment) that influence how much (extent) and when (timing) substantive procedures are performed. These include the following.

- The nature of the test. Some tests lend themselves more easily to testing during the year-end visit as opposed to during the interim audit visit(s). For example, it is easy to verify prepayment amounts with their supporting documentation (that is, the invoices that were paid during the year) before year end. In contrast, verifying the calculation of the split between the amount to be recognized as a prepayment and the amount to be expensed in the income statement is easier to do at or after year end.
- The level of assurance necessary. If you want reasonable assurance, rather than just limited assurance, you will have to obtain more evidence from substantive procedures in order to reach a conclusion.

- The type of evidence required. For example, are the procedures designed to provide persuasive, corroborative, or minimal audit evidence? (These concepts are discussed further in section 8.4.)
- The complexity of the client's data-capturing systems. The more complex the systems, the more complex and sophisticated the substantive audit procedures need to be.

It is ordinarily more efficient to test and rely on controls than to carry out substantive procedures; however, there are situations when this may not be possible or practicable. In these situations, the auditor will need to perform extensive substantive procedures to provide sufficient audit evidence to reach a conclusion. This is often the case when auditing smaller businesses that do not have appropriate segregation of duties or that may not have internal controls in place for the entire period of reliance.

The types of procedures used to reduce detection risk to an acceptable level consist of tests of details and analytical procedures. These are described in more detail in section 8.3.1. When controls are tested and determined to be effective, the auditor may address any residual detection risk by using substantive analytical procedures. These are described in more detail in section 8.3.2.

The auditor must use professional judgement to decide whether the substantive audit procedures start with analytical procedures and are then supplemented with additional procedures as necessary, or whether to begin with tests of details, including key item testing, and to use analytical procedures after enough other substantive procedures have been performed.

By using a combination of techniques, the auditor is able to perform substantive procedures that, when coupled with any other audit evidence obtained during the risk assessment and interim phases of the audit, will provide sufficient and appropriate audit evidence to enable the auditor to conclude both at the significant account level and overall at the financial statement level.

It is worth noting that there are certain substantive procedures that are normally performed. These include sending bank confirmations, observing inventory counts (CAS 501 *Audit Evidence—Specific Consideration for Selected Items*), confirming receivables balances (CAS 505 *External Confirmations*), and examining material journal entries and other adjustments of audit importance during the course of preparing the financial statements (CAS 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*).

Cloud 9 Integrated Case

Ian is starting to realize that the standards of professional practice would not allow him to rely exclusively on analytical procedures. Cloud 9 has significant inventory balances (about 30 percent of total assets) and receivables (more than 50 percent of total assets), so the auditors will need to gather persuasive evidence about the existence, valuation, and rights and obligations assertions for these accounts. Procedures such as confirming receivables balances and observing inventory counts are definitely going to be included in the detailed audit program.

Suzie warns Ian that it is not always the size of the account that determines the use of analytical procedures or other procedures. For example, if a client has related party liabilities, even if the dollar amount is not material, the accounting standard covering related party transactions (IAS 24 *Related Party Disclosures*) creates additional disclosure requirements for these accounts, increasing the significance of the account and the amount of testing required.

"Auditors also have to be particularly careful in assessing the materiality of any liability balance," Suzie explains. "This is because we are usually more worried about understatement than overstatement of liabilities, so the assertion most at risk is completeness, not existence."

Before You Go On

8.1.1 Describe why audit assertions are important in the determination of audit risk.

8.1.2 Define substantive procedures.

8.1.3 Are there any audits where the auditor would perform no substantive audit procedures? Explain your answer.

8.2 Relationship Between Risk Assessment and the Nature, Timing, and Extent of Substantive Procedures

LEARNING OBJECTIVE 2

Understand the link between the audit risk model and the nature, timing, and extent of substantive procedures.

The nature of substantive procedures varies from account to account and ordinarily consists of one or a combination of the following techniques:

- tests of transactions/underlying data
- analytical procedures

These techniques are described in more detail in section 8.3.

The appropriate mix of substantive procedures depends on factors such as the nature of the account balance (that is, balance sheet versus income statement account) and the risk assessment for both the specific account and the client overall (that is, at the account level and at the financial statement level).

The nature, timing, and extent of substantive procedures are responsively related to the risk assessments for each of the relevant sources of information affecting a significant account. In the case of an accounting estimate, the auditor may conclude, for example, that the likelihood of material misstatement is lower in measuring the provision for warranty claims, but there is a risk that not all such claims are identified, as there may be a management bias to minimize warranty expense. In this case, extensive tests are directed at determining whether all claims have been identified (completeness assertion), while less extensive tests are directed at determining whether the amounts already recognized as claims are appropriate (existence assertion, and accuracy, valuation, and allocation assertion). Risk assessments not only affect the extent of the tests but can also affect the nature and timing. For example, in the situation described above, the auditor would likely test the completeness of claims at or near year end; however, the tests of the valuation for individual claims by product type could be carried out before year end.

Similarly, the auditor may have agreed with the client that, based on the risk assessment, it is appropriate for the client to carry out a physical inventory count prior to year end (existence assertion). However, it is not appropriate for the auditor to test the client's valuation (pricing) of its inventory at that date. Rather, the auditor would perform tests of inventory pricing at a date nearer to or at year end.

Significant professional judgement is therefore required in relating the risk assessment to the nature, timing, and extent of the tests in order to hold overall audit risk to an acceptable level.

As can be seen from **figure 8.4**, the timing of substantive procedures is directly influenced by the level of control risk (that is, how much assurance has already been gained from the controls testing performed). Typically, substantive testing tends to be performed at or near year end, with controls testing performed during visits before year end (interim).

For accounts that accumulate transactions that, for the most part, will remain in the account balance at year end, the auditor can normally perform effective procedures before year end. For example, they could test additions and disposals to the capital asset sub-ledger or vouch individually material expense items, such as severance expenses. Since these transactions accumulate during the year and, for the most part, remain in the account balance at the end of the year, the auditor's decision to perform procedures prior to year end does not generally depend on the effectiveness of controls or the likelihood of material misstatement. Rather, the timing of such procedures is a matter of convenience and whether it is expected to contribute to audit efficiencies. It is normal for an auditor to perform as much audit testing as possible before the client's year end due to the large number of clients needing their audits completed

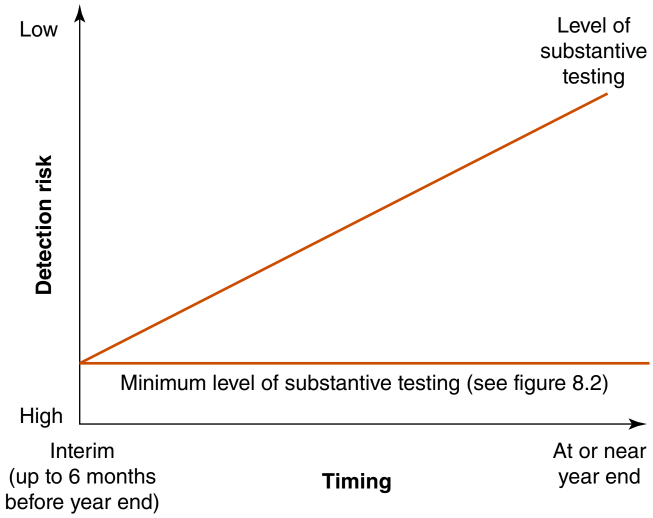


FIGURE 8.4 **Timing of substantive procedures**

by the same date. The more work the auditor performs prior to the year-end visit, the less year-end work they will need to perform during the audit firm's "busy season," which will allow more flexibility when performing audits.

For other accounts, the auditor's ability to perform substantive audit procedures at an interim date generally depends on the existence of an effective control environment and the effectiveness of the system of controls. When the control environment is ineffective or there are specific ineffective controls, the auditor considers whether or not it is appropriate to perform substantive procedures at an interim date.

The timing of the substantive procedures is most flexible when controls have been assessed as effective and tested to confirm this assessment. In these circumstances, the substantive procedures may be performed earlier in the year (for example, six months before year end). When controls are assessed as effective but not tested, the substantive procedures may still be performed at an interim date (for example, two or three months before year end).

Whenever substantive procedures are performed prior to year end, the auditor performs **roll-forward procedures** to update their audit findings from the time of the interim procedures through to year end. The nature and extent of these roll-forward procedures are matters of judgement and are responsive to the risk assessment. For example, when the entity's control environment has been assessed as effective, controls have been tested, and no significant changes in the control environment and controls have occurred, limited roll-forward procedures such as analytical procedures or limited testing of intervening transactions may be all that is necessary.

roll-forward procedures procedures performed during the period between an interim date and year end (the roll-forward period) to provide sufficient and appropriate audit evidence to base conclusions on as at year end when substantive procedures are performed at an interim date

The auditor might also perform substantive procedures prior to year end because of a client reporting requirement. For example, the auditor may be requested to confirm receivables and observe the counting of inventory before year end so the client is able to close its books promptly.

In the absence of specific effective controls, it may be acceptable for the auditor to perform substantive procedures prior to year end when they are able to conclude overall that the client's control environment is effective and the likelihood of errors is not high, or when they can perform sufficient procedures both at an interim date and during the intervening period (often referred to as the "roll-forward period"). The nature of the roll-forward procedures performed is responsive to the risk associated with the absence of controls and the timing of substantive procedures.

Cloud 9 Integrated Case

Suzie asks Ian to consider Cloud 9's warranty provision. Cloud 9 has a provision at September 30 of $91,456, which is slightly higher than the provision for the previous financial year of $85,597. What is the likelihood that the provision is understated? Are there any reasons to believe there are unidentified claims, and how would the auditors detect such claims?

Ian does not know of any change in manufacturing conditions that would affect the quality of Cloud 9's product and, by extension, the obligation under the warranty program. However, there was a new product introduced at the start of the previous year. "Because sales of the new 'Heavenly 456' walking shoe are now 20 percent of total sales," he notes, "we should consider any possible effects on the warranty provision. I recommend specific work be done to assess the claims from this product.

"However, if we remove this product from the analysis, the relationship between the warranty provision and sales is likely to be similar to past years. Because warranties apply to products, the amount of the warranty liability is determined by sales volume and product quality. Therefore, if conditions affecting product quality have not changed, and there is no change to the warranty program, analytical procedures are a useful way of testing the reasonableness of the provision.

"Finally," Ian concludes, "relying on analytical procedures to test the warranty provision is more justified if control testing suggests that Cloud 9 has effective controls over warranty claim identification and processing."

Before You Go On

8.2.1 Name the different types of substantive procedures discussed.

8.2.2 Describe the relationship between the amount of substantive testing to be performed and the timing of the testing.

8.2.3 When is the timing of substantive procedures most flexible? When are substantive procedures performed in these circumstances?

8.3 Substantive Audit Procedures

LEARNING OBJECTIVE 3

Provide examples of different substantive audit procedures.

In this section, we explore the types of substantive procedures, including tests of details and analytical procedures. We also consider how technology can be used in performing substantive testing.

8.3.1 Tests of Details

tests of details of transactions tests predominantly designed to verify a balance or a transaction back to supporting documentation; therefore, they usually include vouching and tracing

vouching taking a balance or transaction from the underlying accounting records and verifying it by agreeing the details to supporting evidence outside the company's accounting records

tracing tracking a source document back to the underlying accounting records

dual purpose tests procedures that provide evidence for both tests of controls and substantive procedures

Substantive procedures that are not analytical procedures are referred to as "tests of details"; they may include tests of details of transactions or tests of details of account balances. **Tests of details of transactions** are predominantly designed to verify a balance or a transaction back to supporting documentation (called "vouching" or "tracing").

Vouching is when a balance or transaction is taken from the underlying accounting records and verified by agreeing the details to supporting evidence outside the accounting records of the company. (Typically, the details are agreed to external third-party information such as a supplier invoice or delivery documentation.) Because vouching involves testing and verifying information already recorded in the accounting records, the primary purpose of the testing is to ensure that the balances or transactions are not overstated (for example, existence and occurrence assertions). **Tracing** is when a source document is traced back to the underlying accounting records. Because tracing involves testing and verifying information outside the accounting records that is not necessarily recorded (for instance, it does not appear on a source document such as an invoice), the primary purpose of the testing is to ensure that the balances are not understated (for example, completeness assertion). The direction of testing for vouching and tracing is illustrated in **figure 8.5**.

Sometimes, tests of details of transactions are **dual purpose tests** in that the procedures performed provide evidence of a control's effectiveness (test of controls) and also indicate if an item is being recorded properly (substantive test). An example of a dual purpose test is when

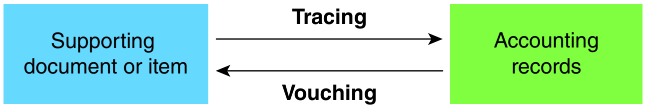


FIGURE 8.5 **Direction of testing: vouching and tracing**

the auditor tests the postings of the totals in the sales ledger to the general ledger and the sub-ledger. This is a test of control in that it provides evidence that there are controls in place to ensure that totals are transferred correctly from the general ledger to the subsidiary ledger. It is also a substantive procedure that provides evidence for the completeness audit assertion because, if the balances do not agree, it indicates something is missing.

Tests of details of balances are tests that support the ending general ledger balance of an account. An example of this type of test is when the auditor sends out accounts receivable confirmations, as this provides evidence that the accounts receivable ending balance exists.

tests of details of balances tests that support the correctness of an account ending balance

When agreeing a balance or transaction to supporting documentation, the auditor must consider the type of evidence that is available. As noted in CAS 500 *Audit Evidence*, evidence that is external to the client is ordinarily considered more relevant and reliable audit evidence than evidence generated internally by the client. For this reason, appropriate external evidence (or "third-party" evidence), when it is available, is preferred when performing these types of tests.

Auditors do not ordinarily audit an entire balance or class of transactions. Auditing often requires that professional judgement be applied when determining how much testing to apply to a balance. For this reason, an auditor may use audit sampling (CAS 530 *Audit Sampling*). Audit sampling is a valid way of performing audit procedures. The auditor is not required (nor are they always able) to perform audit procedures on 100 percent of the balances and disclosures within the financial statements. Often, they select transactions, balances, and disclosures that are more likely to contain material errors. The nature, timing, and extent of testing are based on the application of professional judgement in assessing the risks of material misstatement in the financial statements.

Another key factor impacting the nature, timing, and extent of testing is the auditor's ability (or inability) to rely on computer-generated data or reports. When the auditor is unable to rely on the IT general controls or application controls of a client, control risk is assessed as high; in this case, the sample size when conducting substantive testing is likely to be larger and will be subject to a higher level of precision or confidence in the test results. When the client has strong controls and these have been tested to provide a basis for reliance, control risk is assessed as low, the sample size when conducting substantive testing is likely to be smaller, and the auditor would ordinarily accept a lower level of precision or confidence in the test results.

The auditor often performs other tests of transactions or underlying data. Some common examples of these other tests are:

- tests of client-prepared schedules for mathematical accuracy
- tests using confirmations for such things as bank balances, accounts receivable, accounts payable, and various types of debt and share capital
- tests that inspect the physical existence of items such as inventory and capital assets
- tests to agree sub-ledger balances to general ledger balances for completeness
- tests to agree individual customer account balances to control account balances for completeness
- tests to confirm that items are recorded in the correct period to ensure cut-off
- tests performed at an interim date and then roll-forward procedures performed on the intervening period between the interim date and year end
- tests of underlying data to be used as part of the analytical procedures (refer to section 8.3.2)
- tests of income statement accounts for account classification
- tests of individual transactions by vouching/agreeing to supporting documentation

While auditors tend to use sampling, there has been a recent movement toward using audit data analytics and technology to test entire populations. Emerging software programs now make it possible and efficient to test entire populations. This will be further explored in the next chapter. Regardless, the decision on the amount of testing to perform (the extent of testing) is a matter of professional judgement. Testing needs to be sufficient to allow the auditor to conclude that the underlying data are free from material misstatement (material error).

If the auditor identifies errors when performing these tests, they request the client to investigate the reason for the errors. The reason the client provides will help the auditor determine the impact these errors may have on their risk assessment and the resultant change to the auditor's planned audit approach. (This change is ordinarily to perform additional audit work.) The auditor also performs procedures at year end to evaluate the overall presentation, classification, structure, and content of the financial statements. The auditor considers whether information is adequately aggregated or disaggregated and the appropriateness of the level of detail provided, including whether the disclosures are accurate, understandable, and complete.

Cloud 9 Integrated Case

During their conversation about Cloud 9's warranty provision, Suzie asks Ian how they would use other substantive procedures to obtain evidence about the completeness assertion for the liability balance. "For example," Suzie asks, "would vouching and tracing be useful and, if so, how would you use them?" Ian is still interested in using analytical procedures, but he considers the question carefully. "I think we would use vouching to get evidence about transactions or balances that are recorded as warranty claims by Cloud 9. However, it might be more useful to consider tracing, because this would allow us to start with the documents and get evidence about how and whether the transactions are recorded in the accounts. If we find a warranty claim has been incorrectly recorded as another type of expense, we would be concerned that the liability is understated or not complete. Additionally, we would like to examine transactions around the balance sheet date and make sure they are recorded in the correct accounting period. This evidence relates to the cut-off assertion, and is part of considering completeness."

8.3.2 Analytical Procedures

analytical procedures evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts

Substantive procedures include **analytical procedures**, which may be used:

- as primary (persuasive) tests of a balance
- as corroborative tests in combination with other procedures
- to provide at least some minimal level of support for the conclusion

As outlined in CAS 520 *Analytical Procedures*, properly designed and executed analytical procedures provide an efficient alternative to tests of details of account balances and, in some cases, may provide the most effective test of the appropriateness of account balances (for example, management's estimate of the allowance for doubtful accounts or accrual for warranty costs). In other cases, analytical procedures may provide the only method of testing. For example, if the client does not maintain an effective costing system, overheads in the closing inventory might be estimated by relating actual overheads for the year to actual direct labour (assuming reliable direct labour reporting and reliable overhead expense records). It is expected that overall analytical procedures at the financial statement level will be performed on every audit engagement, irrespective of the audit approach planned for a client.

Therefore, when planning the audit approach, the auditor should consider what analytical procedures are available. The extent to which analytical procedures can reduce the extent of, or eliminate, other substantive procedures will depend on the risk assessment and the level of assurance provided by the analytical procedures.

Types of Analytical Procedures

There are a number of techniques that can be used to perform analytical procedures as a substantive test. The objective is to select the most appropriate technique (or combination of techniques) to provide the necessary levels of assurance and precision. The techniques or types of analytical procedures include:

- absolute data comparisons (comparing current year to previous year, budgets, and forecasts)
- ratio analysis (profitability, liquidity, and solvency ratios)

- trend analysis (comparing certain data for several accounting periods)
- preparation of common-size financial statements
- break-even analysis
- pattern analysis and regression analysis (sophisticated techniques that may be used when an auditor applies audit data analytics)

Testing the Reliability of Underlying Data

The biggest risk when performing analytical procedures is that the results will lead the auditor to accept an account balance as materially correct when, in fact, it contains material misstatements. The key way to minimize this risk is to evaluate the relevance of the information used in the analytical procedure and to ensure that the financial and non-financial data used in the analytical procedure are reliable.

The following are examples of points the auditor should consider when evaluating the relevance of the information used in the analytical procedure:

- Analytical procedures may not be useful when they are used on a company with significantly diverse operations and geographical segments. In order to be useful, consolidated balances need to be broken down by geography, nature, etc. to facilitate a meaningful analysis.
- The analytical procedure is adversely affected if the industry data are unreliable or are not comparable to the client's data. Industry ratios that are no longer meaningful because of rapidly changing economic conditions may be misleading.
- For entities with operations in inflationary economies, the extent to which increases in, say, costs or prices have been affected by inflation should be considered before performing analytical procedures and relying on the results.
- The comparison of budget to actual results is meaningful only if the client's budget process is well controlled. In some cases, it may be necessary to expand the understanding of the process beyond that obtained during the risk assessment phase of the audit (as described earlier).

The auditor also needs to be satisfied, when using an analytical procedure, that the financial and non-financial data used are reliable, especially when the analytical procedure is used as a persuasive substantive procedure. When using analytical procedures as part of an overall financial statement analysis, it is not necessary to test the underlying data, because an overall financial statement analysis is performed to increase the understanding of the client's business, provide a basis for developing the scope of the audit, and identify areas requiring further investigation. However, when the analytical procedures are to be persuasive and the primary (and potentially the only) substantive test of a balance, it is necessary to test the reliability of the data being used. For example, if the auditor uses an aging report to support the reasonableness of the allowance for doubtful accounts, they ordinarily first test the accuracy of the aging.

The extent to which the auditor needs to test the underlying data is driven by the extent to which they have been able to test and form a basis for reliance on the controls surrounding the data. Primarily, this means assessing the overall control environment at the company (is it effective?), the IT general controls (are they effective?), and the application controls (have they been tested and can they be relied on?). The more effective the controls over the data that the auditor intends to use in an analytical procedure, the more the analytical procedure can be relied on as a substantive procedure. Conversely, the less effective the client's controls over the data, the less reliable the analytical procedure is likely to be, although it still may be useful in identifying areas for further investigation.

Another factor to consider is that often client-produced non-financial data used in analytical procedures (such as the tonnage of product produced in a particular location) are not subject to the same type of controls as the client's financial data. As a result, the auditor may not be able to draw a conclusion about the reliability of the non-financial data without performing tests of that data. On the other hand, if such data are used as a key indicator of performance in running the business, the auditor may take comfort in the fact (in the absence of evidence to the contrary) that the client finds the data reliable for such purposes.

In summary, the auditor tests the reliability of underlying data when the analytical procedure is to provide persuasive assurance; they use judgement to determine the need for, and extent of, tests of underlying data when the analytical procedure provides corroborative assurance; and they need not test underlying data when the analytical procedure provides minimal assurance. (Refer to section 8.4 for a discussion of each of these levels of assurance or evidence.)

Substantive Analytical Procedures—The Process

Once the auditor decides to use substantive analytical procedures, the steps they should take are as follows:

1. Identify the computation, comparison, or relationship to be made or to be investigated.
2. Assess the reliability of any data to be used.
3. Estimate the probable balance in the account or the probable outcome of the computation.
4. Make whatever computations are needed using data in the client's records or data from reliable outside sources.
5. Compare the estimated amount with the computed or recorded amount and evaluate whether the difference, if any, is significant.
6. Determine appropriate procedures for investigating the reasons for the difference if it is significant.
7. Perform the procedures.
8. Draw conclusions.

Let us look at an example of how and when a substantive analytical procedure can be used.

Step 1: Identify the computation, comparison, or relationship to be made or to be investigated.

Ian Harper of W&S Partners is currently auditing the payroll expense of a cycling shop. The audit program indicates he should apply substantive analytical procedures to determine the reasonableness of the payroll expense. The audit program specifically requires Ian to determine the average salary per employee and then extrapolate this over the year to determine the reasonableness of the total payroll expense.

Step 2: Assess the reliability of any data to be used.

Before proceeding any further, Ian assesses the reliability of the payroll data to be used in this test. He reviews the file documentation regarding the payroll processes and any significant control weaknesses. He is glad to see that other members of the W&S audit team have tested the controls over adding and removing personnel on the payroll and that the testing indicates the controls are effective. Ian concludes the information he is using for this test is reliable, and proceeds to perform the calculations.

Steps 3 and 4: Estimate the probable outcome of the computation and make necessary computations using data in the client's records.

Ian documents the work performed as follows:

Randomly selecting two pay periods ("PP"), Ian calculates the average gross salary per employee. These averages are then used to assess the reasonableness of the total payroll expense.

		Number of Staff	Total Payroll	Average Pay per Employee
PP 2	Jan. 15, 2023	20	$42,000.00	$2,100.00
PP 17	Aug. 15, 2023	30	62,000.00	2,066.67
Average		25	$52,000.00	$2,080.00

Given that Ian has determined the average number of staff during the year is 25 and the average gross pay per employee is $2,080.00, he then calculates an expected total payroll annualized of $2,704,000.00 (Step 5).

Step 5: Compare the estimated amount with the computed or recorded amount and evaluate whether the difference, if any, is significant.

He then compares this with the actual payroll expense recorded in the general ledger, which is $2,700,500.88. This results in a difference of $3,499.12, which Ian concludes is below performance materiality.

Annualize:

Average Number of Employees	×	Average Pay per Employee	×	No. of Pay Periods
25	×	$2,080.00	×	52

= Total average annualized salary per W&S	$2,704,000.00
– Total salaries per general ledger	2,700,500.88
Difference	$ (3,499.12)

As this difference is not material, Ian will skip steps 6 and 7 (determine and perform procedures to investigate the reasons for the difference if significant) and will go directly to step 8.

Step 8: Draw conclusions.

Ian concludes that, based on the work performed, the payroll expense appears reasonable as at December 31, 2023. If a significant difference was identified, further work would have to be done to audit this difference.

8.3.3 Performing Substantive Testing Using Technology

As clients have become more sophisticated and complex over time, the auditor's audit procedures and techniques have needed to respond to these complexities and have also become more sophisticated. Two ways computers may be used to assist the auditor with their testing are computer-assisted audit techniques (CAATs) and audit data analytics (ADAs).

CAATs and ADAs may be used to interrogate and examine client data files. Whenever computers are used to maintain or process accounting data, CAAT software can be used to perform procedures such as calculations (for example, the re-adding of a report) and logic tests (for example, sorting or comparing current year amounts with those from the previous year), and to select and print key items and representative samples for testing. ADAs can also be used to conduct substantive tests on large datasets, often to perform tests of details or as substantive analytical tests. For example, they can be used to conduct substantive analytic procedures such as regression analysis to predict account balances. Where amounts fall outside of the prediction, they require further examination. ADAs will be explored further in Chapter 9.

Using software when performing CAATs or audit data analytics makes the audit (1) more comprehensive, because often each item in a file can be examined and subjected to a variety of tests; and (2) more efficient, because the computer can handle large volumes of data, thereby reducing time-consuming clerical tasks. Using software will also allow the auditor to concentrate on designing the test criteria and on evaluating and interpreting the results, rather than on performing the detailed audit procedures. Available software ranges from large, highly sophisticated products through to basic electronic spreadsheets and financial statement packages. Software does not necessarily have to be designed specifically for audit purposes.

The main considerations in deciding whether to use CAATs or ADAs are the completeness of the records and the reliability of the data. As with any audit procedure, the nature and extent of the procedures performed with a CAAT or ADA will largely depend on the evaluation of the effectiveness of the client's control environment, IT general controls, and application controls.

Cloud 9 Integrated Case

Ian and Suzie continue their discussion about using analytical procedures. Ian is starting to feel more confident and suggests that there are some factors to consider about the Cloud 9 audit that would affect the use of the various procedures. "We could use all of the usual techniques in the Cloud 9 audit, although we have to be careful in making comparisons across years for a couple of reasons. We have only just taken over the audit, so although prior-year data was audited, we are still building up our level of familiarity with the data and don't really understand all the conditions that applied to the previous years. Also, the changes at Cloud 9, in particular the opening of the retail store and the additional borrowing to finance the purchase of the delivery trucks that we discovered during our preliminary work, will impact the data. We'll have to think through these impacts before using the data in our tests."

Before You Go On

8.3.1 Explain vouching and tracing.

8.3.2 How do the control environment and results of control testing influence the timing of the substantive audit procedures?

8.3.3 Why is it important to test the reliability of the underlying data used in analytical procedures?

8.4 Levels of Evidence

LEARNING OBJECTIVE 4

Explain the different levels of audit evidence obtained when performing substantive procedures.

Several different levels of evidence can be obtained when performing substantive procedures, depending on the type of substantive procedure performed. Evidence can be persuasive, corroborative, minimal, or general. Each of these levels is described below, illustrated by an example of substantive analytical procedures. Examples of the different types of evidence show that analytical procedures performed for planning purposes are quite different from those used for substantive testing purposes.

8.4.1 Persuasive

Analytical procedures can be the primary test of a balance (that is, the primary basis for the conclusion) if they provide persuasive evidence. This would be the case when the procedures generate an amount that the auditor believes is a reasonable estimate of what the balance should be, thus enabling them to conclude that the account balance is free from material errors. If an analytical review procedure is classified as persuasive, it means that no further substantive procedures need to be performed on the related account balance, even in moderate risk situations. Accordingly, the auditor must give careful consideration to the quality of evidence provided by the particular analytical procedure before they conclude that the analytical procedure is persuasive. Table 8.2 includes examples of analytical procedures that may provide persuasive evidence.

TABLE 8.2 Examples of analytical procedures that provide persuasive evidence

Evidence	Analytical Procedure
Material content of work in progress and finished goods	Relate raw materials put into production and quantities sold to normal yield factors
Overheads in closing inventory	Relate actual overheads for the period to actual direct labour, production volumes, or another appropriate measure
Finished goods pricing	Refer to selling prices less selling costs and "normal" gross margin
Charges for depreciation	Refer to asset balance, effect of additions and disposals, and average depreciation rate
Accrued payroll	Refer to days accrued and average daily payroll or subsequent period's gross payroll
Commission expense	Refer to commission rates and related sales
Accruals for commissions or royalties	Refer to terms of agreements and payment dates
Scrap income	Relate standard cost scrap factor to weight of material processed and apply the result to published scrap prices
Interest expense and related accrual	Refer to the average debt outstanding, weighted average interest rate, and payment dates
Investment income	Relate average amounts invested to an average interest rate or yield
Total revenue for a private school	Relate school fee per grade by number of students in the respective grade

8.4.2 Corroborative

An analytical procedure provides corroborative evidence if it (1) confirms audit findings from other procedures and (2) supports management representations or otherwise decreases the level of audit scepticism. For example, year-to-year detailed comparisons by product line of inventory levels and other key relationships such as turnover, gross margin, percentage composition of materials, labour, and overheads provide some evidence of the reasonableness of the inventory balance but do not provide sufficient evidence by themselves to allow us to conclude that the account is free from material misstatement.

A corroborative analytical procedure involves comparing account balances to expectations developed and documented earlier in the audit. These comparisons generally provide corroborative evidence about an account balance and enable the auditor to limit the extent of other procedures in that area. In these cases, the auditor's understanding of the client's business should help confirm the reasonableness of a balance. For example, an auditor expects general administrative expense for the year to be approximately $10 million based on their review of the client's budget and the trend in the relationship of those expenses to sales. If actual general and administrative expenses fall within a reasonable range of the expected balance, comparing the recorded balance with the expected balance would provide corroborative evidence about the balance's reasonableness. In addition, this supports the auditor's plan to reduce the extent of or eliminate other substantive testing of general administrative expenses. However, if an unexpected fluctuation is noted (for example, if general administrative expenses are less than, or exceed, expectations by a significant amount), the auditor would expand other substantive audit procedures to explain the fluctuation and to provide enough evidence to conclude that the balance was free from material misstatement. For example, they may review a listing of accounts comprising general and administrative expenses for individual account balance fluctuations, and investigate those with significant or unexpected fluctuations. Table 8.3 has examples of analytical procedures that may provide corroborative evidence.

TABLE 8.3 Examples of analytical procedures that provide corroborative evidence

Evidence	Analytical Procedure
Trade receivables, sales, going concern	Review the volatility of the customer base (for example, new customers as a percentage of existing customers) and compare with expectations
Trade receivables	Compare the current period's receivables as a percentage of net sales with prior periods' percentages, and consider the reasonableness of the current period's percentage in relation to current economic conditions, credit policies, and collectibility
Prepayments	Compare the prepayment account balances with those of prior periods and investigate any unexpected changes (or the absence of expected changes)
Property, plant, and equipment	Review the reasonableness of the depreciation expense by referring to the previous year's balance and the effects of acquisitions and disposals
Sales, commissions expense	Compare sales commissions or bonuses with related sales
Payroll expense	Compare payroll tax expenses with the annual payroll times the statutory tax rates

8.4.3 Minimal

Analytical procedures that do not provide persuasive or corroborative evidence contribute minimal support for the conclusion. In deciding whether a particular analytical procedure or combination of procedures provides corroborative evidence or only minimal support for the conclusion, the auditor evaluates both the extent of their analytical procedures and the quality of the evidence they expect to obtain. For example, they may simply compare a current-year overall balance (for example, inventory) with the prior-year balance to help identify potential problems or trends, and not to reduce the extent of other substantive procedures. If they do not supplement that comparison with any other analytical procedures (for example, product-line comparisons of turnover, gross margin, or percentage composition of materials, labour, and overhead), they obtain only minimal support for the conclusion. Table 8.4 includes examples of analytical procedures that may provide minimal evidence.

TABLE 8.4 Examples of analytical procedures that provide minimal evidence

Evidence	Analytical Procedure
Trade receivables	Understand the reason for any large credit transactions/balances in the ledger
Trade receivables	Compare the number and amounts of credit notes issued with those of prior periods
Property, plant, and equipment	Review the property, plant, and equipment and related accounts in the general ledger for unusual items
Trade payables	Compare the number of days' purchases in trade payables with those of prior years
Equity	Compare the equity account balance with that of prior years and investigate any unexpected changes (or the absence of expected changes)
Payroll expense, cost of sales	Compare the relationship between direct labour costs and number of employees with those of prior periods

8.4.4 General

Analytical procedures might provide persuasive evidence in one circumstance but not in another. To illustrate, the risk assessment related to investments might indicate a low likelihood of material misstatement related to recording investment income. If a client has a relatively stable investment portfolio, a comparison of the average amount invested with an average market rate of interest or yield may provide the auditor with persuasive evidence to conclude that the amount of investment income recorded for the year is free from material misstatement. On the other hand, another client's portfolio might be more diversified, with rapid turnover. In that case, the auditor may need to expand the analytical review by segmenting the client's portfolio and applying the average yield test to the various segments. If that is not feasible, they may find it necessary to perform a test of details of investment income.

Cloud 9 Integrated Case

Suzie agrees with Ian's assessment of the usefulness of analytical procedures and the possibility of using other techniques for testing the warranty provision at Cloud 9. "Using analytical procedures as the only substantive procedure is appropriate if we can find a close relationship between the underlying activity data and the account balance," she says. "The weaker or less consistent the relationship between the account balance and the other data, the more likely it is that we will have to perform other substantive procedures in order to obtain sufficient and appropriate evidence."

Ian suddenly has a thought. "I have just realized that, when we are using prior-year data, we know it is audited, but the trial balance is unaudited. This means that we need to recognize that there could be errors in those figures. Also, as we do the audit and we find and correct misstatements, we should have another look at our analytical procedures—the change in the underlying data might change our conclusions."

"That's right," says Suzie. "We might also discover a change in conditions, such as operational changes, that could affect our interpretation of the data. We have to be aware of how everything is connected and review our conclusions and decisions as we go through the audit.

"If we can get persuasive evidence from using analytical procedures," Suzie concludes, "we can reduce the reliance on the other substantive tests."

Before You Go On

8.4.1 What is persuasive audit evidence? Give an example.

8.4.2 When does an analytical procedure provide corroborative audit evidence?

8.4.3 When does an analytical procedure provide minimal audit evidence?

8.5 Auditing Accounting Estimates

LEARNING OBJECTIVE 5

Design an audit plan to audit accounting estimates.

One area the auditor should pay special attention to is accounting estimates. When gathering the knowledge of a client's business, an auditor assesses the inherent and control risk with respect to the client's accounting estimates. This allows the auditor to then plan an appropriate risk response. Estimates include estimation uncertainty in varying degrees, which impacts the risk of material misstatement and the audit effort required. Generally, the greater the estimation uncertainty, the greater the audit effort required. Often the audit of estimates includes reviewing the processes and controls over estimates, as well as substantive testing.

When planning the risk response, CAS 540 *Auditing Accounting Estimates and Related Disclosures* requires the auditor to include one or more of the following approaches:

1. Obtain evidence from year end to the date of the audit report. Often an audit takes place a month or later after year end. It is possible that information becomes available after year end that greatly reduces estimation uncertainty. For example, consider accounts receivable and the allowance for doubtful accounts. If an entity offers 30-day credit terms, and the audit is in process after this period, then most of the accounts receivable outstanding at year end should be collected. Where this is so, it reduces the estimation uncertainty.
2. Develop a point estimate. The auditor should develop his or her own estimated value or range. This amount or range can be compared with management's estimate for reasonability. Where significant differences are found, more work is required. In developing his or her own estimate, the auditor considers whether the client's methods, assumptions, and data are appropriate.
3. Test how management made the estimate and the related disclosures. This may include the testing of controls over the estimate process. CAS 540 requires the auditor to:
   - Determine if the model is appropriate given the requirements of the financial reporting framework.
   - Assess judgements made by management for signs of management bias, especially when complex models are used.
   - Assess if assumptions are consistent with those made in prior years and other assumptions made by management.
   - Assess the data used by considering if they are correctly interpreted and if they are reliable. For example, if the client uses an interest rate in its model, the auditor should look for external evidence to support that rate.
   - Test the estimate's mathematical accuracy.

If an estimate is assessed as a significant risk, the auditor should evaluate whether management considered alternative amounts and assumptions throughout the estimation process and how the final estimate was selected. When a significant risk exists and the auditor plans to perform only substantive procedures, testing should include tests of details. While the specific tests of details may vary depending on the client, CAS 540 suggests testing may include examining documents to corroborate terms, verifying the mathematical accuracy of the model, and agreeing assumptions to supporting documents, such as third-party published information.

As with all tests, the audit work performed should be documented, particularly the work regarding significant judgements. When the documentation is complete, the auditor should "stand back" to assess whether the estimates and disclosures are reasonable given the confirming and contradictory evidence gathered. This way, the auditor considers all of the evidence, exercises professional scepticism, and remains unbiased. See Professional Environment 8.1 to see why the "stand back" requirement and professional scepticism are so important when auditing estimates. Lastly, the auditor should review the client's disclosures to ensure they are complete to meet the requirements of the financial reporting framework.

8.1 Professional Environment Management Estimates Lead to Errors

Toshiba, a worldwide conglomerate, operates in a variety of businesses including electrical products, energy and infrastructure systems, and storage devices.

Despite achieving $63 billion in worldwide sales in 2015, it was not a good year for Toshiba. During 2015, the company announced it had overstated its profits by nearly $2 billion over the past seven years. The company first identified financial misstatements associated with various long-term contracts in which it reported revenue using the percentage of completion method. This accounting irregularity led the company to further expand its accounting investigation into its other business areas. One area further investigated was its U.S. unit, Westinghouse. Just before the close of the company's third quarter, Toshiba's auditor proposed a $332-million loss related to a Westinghouse project. Toshiba's CFO argued a $225-million loss was more appropriate, although the CFO could not support why. When the financial statements were released, a $225-million loss was reported, and the remaining $107 million was classified as an unadjusted misstatement.

It is important to note that both the percentage of completion method of revenue recognition and asset impairments rely on management estimates. The audit of estimates is known to be a challenging area for auditors as it reduces reliability. Auditors generally examine past events, yet estimates tend to incorporate future predictions and assumptions. When auditors examine estimates, they generally must look at the reasonableness of management's assumptions. However, research suggests that auditors focus on the details of the estimate rather than critically evaluate the overall reasonableness of the estimate. This tends to result in too little evidence overall and too much of it from management. It appears Toshiba's auditor may have fallen victim to this common auditor issue.

Q: What role does professional scepticism play in interpreting the results of analytical procedures?

Sources: "Toshiba Accounting Irregularities Fall into 2 Cases," *Nikkei Asian Review*, June 13, 2015, www.toshiba.com; Nathan Layne and Emi Emoto, "Toshiba Delayed a $100 Million Loss during an Accounting Scandal with These Two Words," *Business Insider*, August 5, 2015; E. Griffith, J. Hammersly, and K. Kadous, "Audits of Complex Estimates as Verification of Management Numbers: How Institutional Pressures Shape Practice," *Contemporary Accounting Research* 32(3) (September 2015), pp. 833–863.

Cloud 9 Integrated Case

Suzie and Ian have identified the warranty provision as an estimate, but they know there are others. Because of the timing of the engagement, Suzie suggests they can use information subsequent to year end, such as the accounts receivable collected, to assess the uncertainty related to the allowance for doubtful accounts. She asks Ian to determine how they might audit the reasonableness of the other estimates in the financial statements. She warns Ian to pay particular attention to areas that involve complex models and subjectivity. When Ian asks why, Suzie tells him they will need to spend more time in these areas considering management judgements because this is where management bias would most likely come into play. She asks Ian to also plan to develop a point estimate for the warranty provision. Lastly, she suggests they plan to "stand back" to ensure the audit evidence that supports the estimates is unbiased.

Before You Go On

8.5.1 Why would an auditor obtain evidence from events occurring after year end up to the date of the audit report?

8.5.2 What are three things the auditor must consider when testing management's estimates?

8.5.3 What is the requirement to "stand back"?

8.6 Evaluating and Documenting Substantive Analytical Procedures' Results

LEARNING OBJECTIVE 6

Describe the documentation of the conclusions reached as a result of performing substantive procedures.

The auditor's understanding of the client's business and industry alerts the auditor to likely fluctuations in the financial data when they are planning the audit. These fluctuations may be caused by trends, seasonal patterns, cyclical patterns, dependent relationships, specific business decisions taken, or external decisions directly impacting the business. For example, if management and the union representing the workforce have negotiated a 3-percent pay raise over the next two years, the auditor would expect the analytical procedures performed on average wages and salaries per employee to confirm this increase. Also, if the federal government enacted a law to collect an additional 1 percent in payroll tax, the auditor would expect the analytical procedure to confirm this increase in payroll tax expense.

The lack of a significant change from one year to the next does not necessarily mean that the auditor can assume that the balance is reasonable. Whether and to what extent they investigate the lack of change in a balance depends on the auditor's understanding of the client's business, the relevant controls, and the industry in which the client operates.

Cloud 9 Integrated Case

Ian and Suzie have decided that analytical procedures will not be sufficient for all accounts. For each major transaction cycle and account balance, they will also conduct tests of details. For the vouching tests, the auditors will sample transactions and balances in the accounting records and go to the underlying documentation (or physical assets) to confirm the recorded details. For example, for sales recorded as being made prior to the financial year end, they will examine the invoices and shipping documents to gather evidence on the date, amount, and other details of the transactions. If they find that a sales invoice with a January date has been included in the sales for the year ended December 31, they will have evidence of a misstatement in the occurrence and cut-off assertions for sales.

They will also trace the details in a sample of documents through to Cloud 9's accounting records. This means that they will start with the documents and then test how that transaction (or asset or liability) is recorded in the client's accounts. For example, if they find a sales invoice with a December date that is *not* included in the sales for the year, they will have evidence of a misstatement in the completeness and cut-off assertions for sales. Suzie advises Ian that the sample sizes and approach to sampling are determined by the results of the controls testing and the resulting expectations for errors.

Suzie also asks Ian to include tests of schedules, such as trade receivables and property, plant, and equipment (PPE), in the detailed audit plan. Where the risk is low, such as for PPE, they will perform these tests at an interim date.

Finally, Suzie informs Ian that the IT audit manager, Mark Batten, is writing a CAAT program and they should consider if an ADA would be effective.

8.6.1 Evaluating Errors Identified in Testing

misstatement a difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

As the auditor executes their substantive procedures, they may identify misstatements or errors. When they identify differences they did not expect, they reconsider their evaluation of the effectiveness of controls and overall risk assessments made in planning to determine whether additional procedures need to be performed. When they identify a **misstatement** (either an error—including fraud—or a difference between the auditor's professional judgement and the client's as to whether a balance is correct), it is captured centrally in the audit working papers. This will allow the auditor to assess the overall impact of all misstatements at the financial statements level during the completion phase of the audit.

As mentioned, there are two key types of misstatements ordinarily identified during the audit procedures: errors (including fraud) and judgemental misstatements. Errors may arise from a one-off event or may systematically arise as the result of a breakdown in controls. The auditor may have identified these errors as part of controls testing or as part of their substantive testing. They may have been specifically identified as a result of the testing performed, or they may have been extrapolated from a statistically valid sample. Errors do not ordinarily have any element of judgement to them and are often considered by those charged with governance as just wrong; they may therefore be corrected by management irrespective of their size or potential effect on the financial statements.

Judgemental misstatements, however, often arise due to a difference between the auditor's and management's interpretation or application of an accounting policy or standard. These differences tend to be the focus of discussions held with those charged with governance and are often round numbers or a possible error "range" rather than an exact number.

The identification and resolution of misstatements is one of the auditor's most important responsibilities in an audit and is a critical step in the formulation of their opinion on the fairness of the client's financial statements.

8.6.2 Concluding and Documenting the Results of Substantive Procedures

As discussed earlier, the nature, timing, and extent of the audit procedures are influenced by a range of factors, including the type of balance or disclosure being tested, the level of detection risk remaining after the planning procedures and controls testing is complete, and the audit assertion addressed by the test. Once the auditor has determined the nature, timing, and extent of the substantive procedures, these are documented in the audit program. This program then serves as the instructions for the audit team members to complete the required testing.

When reaching their conclusion on the results of substantive procedures, the auditor considers the results of all of their testing related to the account balance or disclosure being audited, the responses to inquiries made during the performance of the procedures, and the resolution of any misstatements identified during the audit testing. With respect to all substantive procedures, the auditor documents the conclusion statement for each significant account (including the execution of the relevant audit program steps), the results, and any significant findings, including any misstatements. They also document that the financial statements reconcile to the underlying accounting records and as noted, examine material journal entries recorded during the annual closing process.

Overall conclusion statements are usually prepared for each audit program step completed, as well as for each significant account and relevant assertion. These overall significant account conclusion statements are captured on what are often referred to as "lead sheets."

Cloud 9 Integrated Case

Suzie asks Ian to set up the working papers for the tests they will perform. The priorities for Ian are to ensure that each test is described in sufficient detail in the audit program so the audit staff can perform the test correctly and identify any misstatements. The working papers also have to provide for comments to be included as the work is completed by senior staff when they review the test results and form their conclusions on each account's assertions.

Before You Go On

8.6.1 What is a misstatement?

8.6.2 What is the difference between an error and a judgemental misstatement?

8.6.3 What is an audit program?

Summary

1 Define substantive audit procedures.

Substantive audit procedures are procedures designed to obtain direct evidence of the completeness, accuracy, and validity of data, and the reasonableness of the estimates and other information contained in the financial statements. Substantive procedures include inspection, observation, inquiry, confirmation, recalculation, re-performance, analyses of many types, and analytical reviews.

2 Understand the link between the audit risk model and the nature, timing, and extent of substantive procedures.

The combination of inherent risk and control risk determines the level of detection risk the auditor is willing to accept that will still allow them to conclude that the financial statements are not materially misstated. Detection risk is reduced or increased in direct proportion to the amount of substantive testing performed. There are several factors that influence how much substantive testing must be performed, including the nature of the test, the level of assurance necessary, the type of evidence required, and the complexity of the client's data-capturing systems. The timing of substantive procedures is most flexible when controls have been tested and assessed as effective. In that case, the procedures can be performed up to six months before year end. When controls are not tested or are not assessed as effective, the timing of substantive procedures is at or near year end.

3 Provide examples of different substantive audit procedures.

The different types of substantive procedures are tests of transactions/underlying data, and analytical procedures. Different analytical procedures include absolute data comparisons, ratio analysis, trend analysis, common-size financial statements, break-even analysis, and pattern and regression analysis. Substantive analytical procedures are different from those analytical procedures used during the risk assessment phase of the audit.

4 Explain the different levels of audit evidence obtained when performing substantive procedures.

The different levels of audit evidence obtained when performing substantive procedures include persuasive, corroborative, minimal, and general audit evidence.

5 Design an audit plan to audit accounting estimates.

After an auditor identifies and assesses the risk of misstatement relating to accounting estimates, the auditor plans the audit response. Procedures may include obtaining evidence after year end but before the audit report date, developing an estimate to compare with management's, and testing the estimate of management. Additional work is required if a risk is assessed as a significant risk. The auditor should also "stand back" to assess the audit evidence gathered in an unbiased fashion.

6 Describe the documentation of the conclusions reached as a result of performing substantive procedures.

Conclusion statements are documented for each significant account (including the execution of the relevant audit program steps), the results, and any significant findings, including any misstatements. The auditor also documents that the financial statements reconcile to the underlying accounting records. Overall conclusions are usually prepared for each audit program step completed, as well as for each significant account and significant assertion.

Key Terms

Self-Test Questions

Answers can be found in *WileyPLUS*.

8.1 Substantive procedures:

a. are done only if control testing is not done.

b. are designed to detect material misstatements at the assertion level.

c. eliminate all risk of material misstatement in the financial statements.

d. are only performed if tests of controls indicate controls are not working.

8.2 The following factor(s) influence(s) how much and when substantive procedures are performed:

a. the nature of the test.

b. the level of assurance necessary.

c. the type of evidence required.

d. all of the above.

8.3 Roll-forward procedures:

a. need to be responsive to the control risk assessment.

b. are procedures done during the month after year end.

c. have no effect on audit efficiency.

d. none of the above.

8.4 Tracing is:

a. not a useful audit procedure.

b. tracking source documents back to the underlying accounting records.

c. the main audit procedure used to gather evidence on the existence assertion.

d. not designed to be used as a substantive audit procedure.

8.5 Analytical procedures:

a. are only done during the risk assessment phase of the audit.

b. are substantive procedures and cannot be used at any other stage of the audit.

c. are used at the risk assessment and substantive testing phases of the audit.

d. can be used as substantive tests but cannot be used as primary tests of a balance.

8.6 We can conclude that analytical procedures provide persuasive evidence:

a. always.

b. never.

c. if they do not provide sufficient evidence by themselves to allow us to conclude that the account is free of material errors.

d. if we are able to conclude that no further substantive tests need to be performed on the related account balance.

8.7 The reliability of data used for analytical procedures:

a. affects the persuasiveness of the evidence from analytical procedures.

b. is more useful on a consolidated basis than on an individual business segment basis.

c. is unaffected by inflation.

d. is never affected by the strength of controls over the client's budgetary processes.

8.8 An auditor performs an analytical procedure and calculates an expected interest expense for the client using the average debt outstanding, the weighted average interest rate, and the payment dates. This test would provide what level of assurance?

a. general.

b. minimal.

c. corroborative.

d. persuasive.

8.9 In the risk response stage, when an auditor tests management's estimates, the auditor should assess all of the following, except:

a. the controls.

b. the model selected.

c. the data used.

d. the assumptions included.

8.10 Misstatements:

a. are documented in the audit working papers.

b. can be categorized as errors or judgemental misstatements.

c. must be considered for their effect on the financial statements both individually and in aggregate.

d. all of the above.

Review Questions

8.1 Define substantive testing.

8.2 What is an audit program? What should be included in the audit plan?

8.3 What factors influence how much and when substantive tests may be performed?

8.4 Differentiate between tests of details of balances and tests of details of transactions.

8.5 Vouching transactions and balances back to supporting documentation would ordinarily provide evidence about which assertions? Which assertions would vouching be *least* likely to provide evidence about?

8.6 What are analytical procedures? Describe how they can be used as substantive tests in an audit.

8.7 What conditions must be satisfied before we can regard evidence from analytical procedures as persuasive rather than corroborative or minimal? Why are these conditions important?

8.8 Why is it important to consider the quality of the data used in analytical procedures? How important to this question are client controls over financial data?

8.9 List three procedures an auditor should perform in the risk response stage with respect to estimates.

8.10 Provide an example of (1) an error and (2) a judgemental misstatement that could affect the balance of property, plant, and equipment.

Professional Application Questions

Basic Moderate Challenging

8.1 Accounts payable risk assessment **Basic** **LO 1**

Hilltop Partners is planning the audit for one of its clients. Jake Hilltop is performing the risk assessment at the assertion level for the accounts payable account to determine the nature and timing of the substantive work to be performed. Jake has assessed the inherent risk for the accounts payable account for each assertion as follows:

Existence	Medium
Completeness	High
Accuracy and valuation	Low
Rights and obligations	Low

Jake has assessed the audit risk and control risk as low.

Required

a. What assertion is at greatest risk?

b. Complete the table below and determine the appropriate audit approach for accounts payable at the assertion level.

Account Assertion	Inherent Risk	Control Risk	Overall Risk Assessment	Detection Risk	Audit Approach
Accounts payable—completeness					
Accounts payable—accuracy, valuation, and allocation					
Accounts payable—existence					
Accounts payable—rights and obligations					

8.2 Timing of substantive procedures **Basic** **LO 2**

James Wu has been assigned the audit planning for the property, plant, and equipment section for a large manufacturing audit client. The client built a new factory during the first six months of the year; therefore, significant additions were made to its property, plant, and equipment accounts.

Required

a. When should James plan for the audit work to be performed, given that the client's year end is December 31 and the audit falls during the firm's busy season? Why?

b. If James plans for the substantive testing on the asset additions to be done before year end, should James plan to perform additional audit work on asset additions at year end?

8.3 Designing substantive procedures **Basic** **LO 1, 2**

Carla DaCosta has been asked to join the team responsible for designing the audit program for a new client, Gaskin Industries Ltd., a manufacturing and wholesaling firm. Gaskin recently went public and is now listed on the Toronto Stock Exchange. Carla has worked for the audit firm for a year and received a very high performance rating from her supervisors on the previous year's audit of Bryson Ltd., a firm that provides marketing and other consulting services. Gaskin and Bryson have total revenue of approximately the same amount, so Carla feels confident that she can apply her knowledge to the new audit. She takes a copy of the audit program for Bryson to the first meeting, intending to suggest they use it as the basis for the audit program for Gaskin. Carla thinks that the Gaskin audit program could use the same substantive procedures they used on the Bryson audit.

Required

List some of the problems with Carla's idea of using Bryson's audit program as a basis for designing substantive procedures for Gaskin.

8.4 Sales cut-off **Basic** **LO 3**

Boris Shonkoff suggests the following audit procedure should be included in the audit program to gather evidence on the cut-off assertion for the revenue account:

> *Select a sample of sales from the sales journal and agree the dates on the invoices to the dates on the delivery documents signed by the customer.*

Required

Explain how the procedure addresses the assertion. What does it mean if (a) the dates agree, or (b) the dates do not agree?

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, July 2010. Provided courtesy of Chartered Accountants Australia and New Zealand.

8.5 Sales journal and invoices **Basic** **LO 3**

Boris Shonkoff has another suggestion for the audit program for the revenue account. This time he suggests:

Select a sample of sales from the sales journal and agree the details in the journal to the sales invoices, delivery slips, and customer orders.

Required

Explain which assertion for the revenue account would be addressed by this test.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, July 2010. Provided courtesy of Chartered Accountants Australia and New Zealand.

8.6 Sales invoices and journal **Basic** **LO 3**

Seb Lee and Boris Shonkoff are discussing the audit program for the revenue account. Seb and Boris disagree about whether they should use procedure A or B below to test the occurrence assertion for the revenue account:

A. *Select a sample of sales from the sales journal and agree the details in the journal to the sales invoices, delivery slips, and customer orders.*

B. *Select a sample of sales invoices, delivery slips, and customer orders and agree the details to the details recorded in the sales journal.*

Required

Which test provides evidence about the occurrence assertion? Why? Which assertion does the other test provide evidence about?

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, July 2010. Provided courtesy of Chartered Accountants Australia and New Zealand.

8.7 Substantive analytical procedure of interest expense **Challenging** **LO 3, 4**

Ann Marcus, CPA, is performing an audit for one of her clients, Artistcraft Ltd., a glass factory, for its December 31, 2023, year end. The audit program requires a substantive analytical procedure to be performed on the reasonableness of Artistcraft's interest expense on its long-term debt.

Ann has identified the following information:

Long-term debt balance confirmed by the bank in prior-year file	$1,545,861
Long-term debt balance confirmed by the bank in the current year	$1,427,529
Interest rate per the bank confirmation	6.25%
Balance per the general ledger	$89,525
Performance materiality	$7,000

Required

a. Assess the reliability of the data provided by Ann.

b. Using the average loan balance and the stated interest rate, prepare a working paper calculating the expected interest expense. Compare this to the amount recorded by the client in the general ledger and make a conclusion.

c. What level of evidence does this test provide?

8.8 Payroll testing **Basic** **LO 3, 4**

Anna Mourani has the task of designing the audit program for the payroll area. There have been no recent changes to the payroll system or its interface with the general ledger. Among other tests, Anna is considering using the following analytical procedures to gather evidence:

1. Compare payroll tax expenses with the annual payroll times the statutory tax rates.
2. Compare the relationship between direct labour costs and number of employees with prior periods.

Required

Discuss the type of evidence that would be obtained from each of the procedures.

8.9 Data for analytical procedures **Moderate** **LO 3, 4**

North West Paper Ltd. provides cardboard, paper, and plastic packaging materials to a large number of manufacturers and distributors in all provinces. The cardboard and paper division is a well-established business, but North West has been providing plastic products only since it took over Plastic Products Ltd. 18 months ago. The takeover doubled North West's revenue and caused changes in its management structure, adding another two divisional managers. These new divisional managers are in charge of plastic product sales to different areas of the country—Plastic (Eastern) and Plastic (Western)—and they join the Paper (Eastern) and Paper (Western) division managers in reporting directly to the CEO.

All internal operating reports are now structured along the four divisional reporting lines, although external financial statements continue to be produced for the whole business. All purchasing and billing systems are fully integrated, although it is possible to extract data along divisional lines and by province (as before). North West purchases bulk supplies of raw plastic and paper and makes boxes, rolls, and sheets of these materials to fill customer orders. Production processes in the paper divisions have not changed, and North West has made minimal changes to the production processes used by Plastic Products Ltd.

Required

List and discuss the factors that would increase or decrease the reliability of data used in analytical procedures at North West.

8.10 Persuasiveness of evidence from analytical procedures **Moderate** **LO 3, 4**

Mathieu Lapointe has the task of reviewing the evidence from analytical procedures conducted by the audit juniors on the audit of Soleil Services Ltd. The audit juniors have reported the results of these analytical procedures:

1. Comparison of depreciation expense with the closing balance of each depreciable asset class in property, plant, and equipment.
2. Recalculation of sales commission expenses using the standard sales commission rate and total sales.
3. Comparison of payroll expense with previous year payroll.

Required

a. What questions would Mathieu ask about each analytical procedure?

b. If all questions could be answered satisfactorily, explain whether the evidence from each analytical procedure would be persuasive, corroborative, minimal, or general. What are the implications of this judgement for further substantive testing?

8.11 Timing of substantive tests **Challenging** **LO 1, 2, 3, 4**

Connie Cyr is the recently appointed engagement partner of the audit of Camel Ltd. She has just taken over the audit from Kar-Ming Leo, who rotated off the audit after a seven-year period as the engagement partner. Kar-Ming had a small portfolio of clients and was able to complete most substantive testing for Camel at year end. Connie is unable to do this because she is facing difficulties with two of her other large clients. These clients have just been advised that their financing arrangements with U.S.-based banks may not be renewed, raising doubts about their ability to continue as going concerns. The U.S. banks will make their financing decisions very close to the clients' year ends, forcing Connie to spend considerable time in this period with these clients.

The financing problems of Connie's existing clients have created demands on her audit team that she must resolve. The audit firm cannot provide her with the additional staff she has requested for the year-end period because the clients of several other partners are also facing financing difficulties due to an economic slowdown.

The audit firm's ethical rules do not allow Kar-Ming to remain as the auditor of Camel, and it is too late to find new partners for any of her other clients, so Connie must find a way to continue with the audit and still meet all professional and legal standards. So far, the audit team has conducted the preliminary risk assessment for Camel, and the results of early control testing confirm that Camel has excellent controls.

Connie calls a meeting with her senior audit team members to discuss the issue.

Required

Explain how Connie could vary the timing of the substantive testing at Camel to help her meet her audit obligations. Specifically:

a. Give examples of substantive procedures that could be performed prior to year end.

b. Explain how Connie will use roll-forward procedures to complete the audit.

c. Explain any other considerations that would affect the timing of substantive procedures for Camel.

8.12 Tests of details **Moderate** **LO 3, 4**

Marty Novakowski has to audit the sales transactions of Okawa Ltd., which supplies tools to the mining industry. Okawa carries a large number of different makes and models of standard mining tools. It also designs and manufactures tools for special purposes and for miners operating in difficult conditions. The custom-designed tools are made only after a contract has been signed and a deposit received, while standard tools are supplied to regular customers on receipt of a telephone order. Okawa's sales transactions vary from a few dollars to millions of dollars depending on the number of items sold, whether the individual items are large or small tools, and whether the tools are standard items or custom designed.

Marty is instructed to gather evidence about the sales transactions using sampling and vouching. This is explained in detail in the audit program.

Required

a. What would you expect to see in the audit program given to Marty about the (1) sample selection and (2) vouching procedures? Explain.

b. How could Marty use CAATs to help gather the evidence?

Questions 8.13, 8.14, 8.15, and 8.16 are based on the following case.

Fellowes and Associates Chartered Professional Accountants is a successful mid-tier accounting firm with a large range of clients across Canada. In April 2023, Fellowes and Associates gained a new client, Health Care Holdings Group (HCHG), which owns 100 percent of the following entities:

- Shady Oaks Centre, a private treatment centre
- Gardens Nursing Home Ltd., a private nursing home
- Total Laser Care Ltd., a private clinic that specializes in the laser treatment of skin defects

The year end for all HCHG entities is June 30.

You are a senior auditor working on the Shady Oaks Centre engagement for 2023 and are currently in the risk assessment phase of the audit. In discussions with management, you discover that Shady Oaks has recently acquired two new full-body scanning machines. These machines use the latest technology and cost the company more than $10 million each. Although they are more than 50 percent more likely to detect abnormalities, new academic studies suggest there may be potential long-term side effects for patients scanned by these machines. However, because the machines are new, the evidence about long-term effects will not be known for many more years. Despite this, there has been some bad press for Shady Oaks, highlighting the potential risks to patients.

Shady Oaks charges a premium price for patients using the scanning machines, and there is extremely high demand. To manage the demand, Shady Oaks requires that all patients pay for their scans in full at the time of booking, and the payments are immediately recognized as revenue by the centre. Shady Oaks has taken bookings for four months in advance—although it is only April 2023, the centre has bookings for July and August 2023.

The Canadian Medical Association is currently reviewing the use of the scanning machines and is considering banning their use within Canada until the issue is resolved. A decision is expected on August 1, 2023, and managers tell you that they believe there is an 80-percent chance the scanners will be approved.

8.13 Substantive testing for specific assertions at risk **Challenging** **LO 1, 3**

Required

a. Identify two key account balances likely to be affected by the above information.

b. For each account balance identified in part (a), identify and explain the key assertions most at risk.

c. For each assertion identified in part (b), identify specific substantive tests of details that would be responsive to the identified risk.

8.14 Using analytical procedures **Moderate** **LO 3, 4**

Your audit manager has requested that you use substantive analytical procedures to calculate Shady Oaks' estimated revenue for patients staying in the centre, excluding medical procedures and ancillary costs such as medication.

Required

Based on the background provided, describe all the key information required to estimate Shady Oaks' revenue for patients staying in the centre.

8.15 Persuasiveness of evidence Moderate LO 4

Required

Review your answers to the previous two questions. Comment on the persuasiveness of evidence from each test. Explain any factors that would affect your assessment.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam,* December 2008 and March 2009. Provided courtesy of Chartered Accountants Australia and New Zealand.

8.16 Auditing estimates Moderate LO 5

To record depreciation relating to the new machines purchased by Shady Oaks Centre, management has estimated residual values and the expected life.

Required

Discuss the procedures that may be performed with respect to these estimates.

8.17 Evaluating substantive testing results Moderate LO 5, 6

The following items are documented in the audit working papers:

1. A sales transaction included in the year ended December 31, 2023, but evidence from the cut-off procedure suggests that the sale should be dated January 2, 2024 ($1,250,000).
2. Warranty expenses in the trial balance for the year to December 31, 2023, total $150,000; the liability for warranty claims as at December 31, 2022, was $100,000. Evaluation of correspondence suggests that an additional $300,000 in warranty claims could result from ongoing disputes with customers. No provision for these claims has been made. Management has made a warranty provision for 2023 of $120,000.
3. Severance expenses related to reorganization of head office administration were incorrectly charged to rental expenses ($578,920).
4. Management has not recorded an impairment for assets. A drought-induced recession has hurt property values in regional cities where seven branch offices are located. (Head office and two branch offices are located in the capital city.) Total land and buildings in the trial balance is $5.5 million.

Required

a. Evaluate each item above and explain whether it is an error or a judgemental misstatement. What action do you recommend for each?

b. Which accounts would be affected, and how, if an adjustment is made for each item?

c. Which of the above items involve estimates? What procedures should be performed? Consider management bias in your response.

Case Study 8.1—Cloud 9

Answer the following questions based on the information presented for Cloud 9 in Appendix A and in the current and earlier chapters. You should also consider your answers to the case study questions in earlier chapters.

Required

a. Based on your conclusions from the case study questions in previous chapters, complete the following worksheet to determine the overall risk assessment (ORA) and the acceptable detection risk (DR).

Account Assertion	Inherent Risk	Control Risk	Overall Risk Assessment	Detection Risk
Sales—occurrence				
Sales—completeness				
Trade receivables—existence				
Trade receivables—completeness				
Cash—existence				

b. For the items identified in part (a), discuss each with respect to risk of misstatement and develop an audit plan to address those risks.

c. Review the Cloud 9 financial statements and identify the areas involving estimates. Develop an audit plan to audit these estimates.

Research Question 8.1

Economic conditions and financial markets were significantly affected by the coronavirus that swept around the world in 2020. A decade earlier, a similar phenomenon was caused by the global financial crisis that began in 2008. Love and Lawson identified a series of specific issues flowing from the crisis that must be considered by financial statement auditors and that may affect the procedures used in conducting an audit.

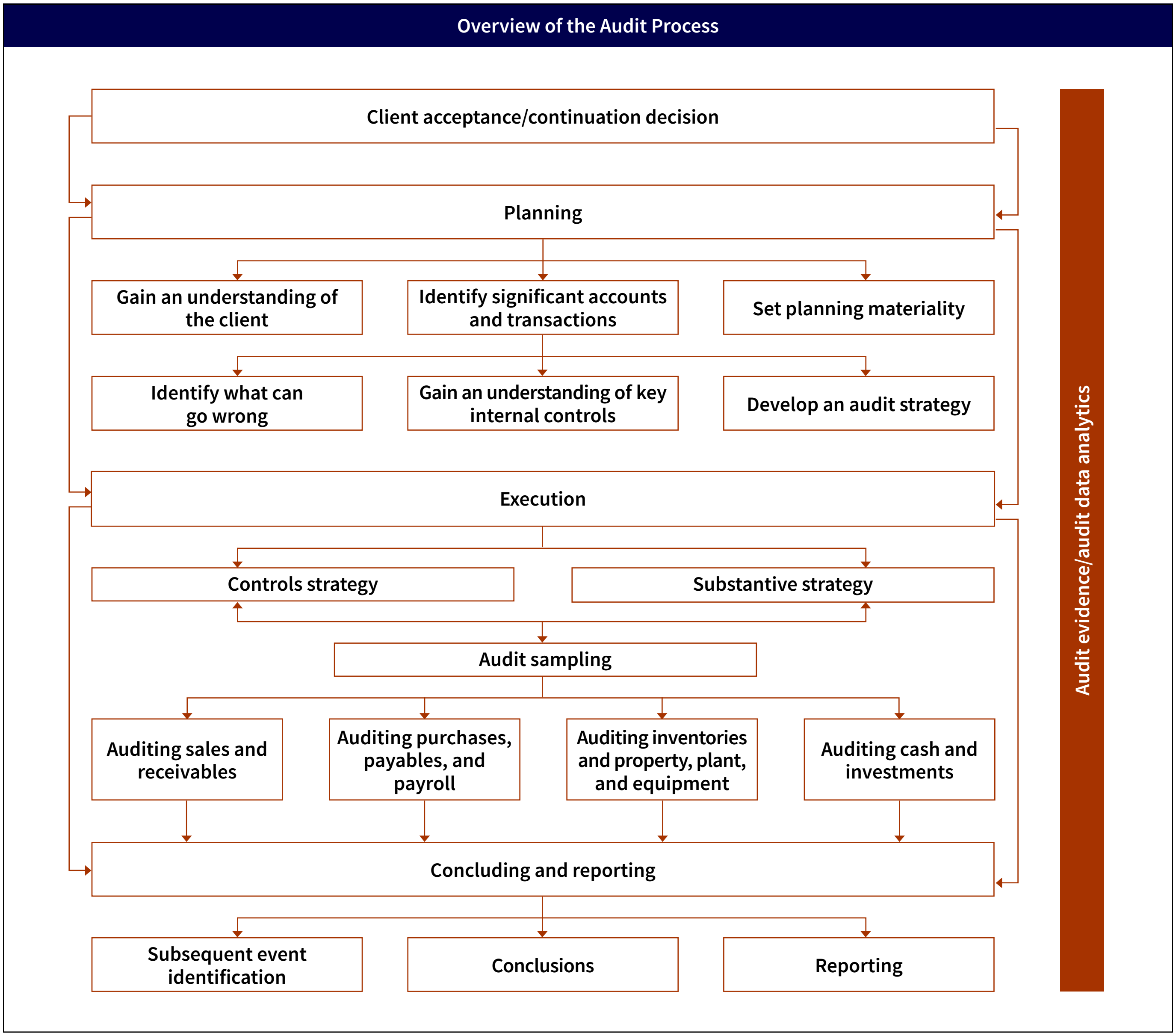
Required

Explain the impact of the 2008 global financial crisis on decisions about the nature, timing, and extent of substantive testing. Give some specific examples of the impact on analytical procedures. Explain how auditors would adjust their audit programs to ensure that overall audit risk remains acceptable.

Source: V. J. Love and C. Lawson, "Auditing in Turbulent Economic Times," *The CPA Journal* (May 2009), pp. 30–34.

CHAPTER 9

Audit Data Analytics



LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
After studying this chapter you should be able to:		Standards addressed in each learning objective are as follows:
1 Describe audit data analytics, when they can be used during an audit, and some of the approaches available to perform these procedures	**9.1** What Are Data Analytics? **9.1.1** How audit data analytics are used **9.1.2** When audit data analytics are used **9.1.3** Techniques used for audit data analytics	CAS 315 *Identifying and Assessing the Risks of Material Misstatement* CAS 330 *The Auditor's Responses to Assessed Risks* CAS 520 *Analytical Procedures*
2 Explain the key considerations related to data when performing audit data analytics	**9.2** Data Considerations **9.2.1** Types of data **9.2.2** Data access **9.2.3** Data quality **9.2.4** Data relevance and reliability **9.2.5** Documentation **9.2.6** The data life cycle	CAS 230 *Audit Documentation* CAS 500 *Audit Evidence*
3 Describe the five-step process for performing an audit data analytic and apply this process when using audit data analytics as a risk assessment procedure	**9.3** The Audit Data Analytic (ADA) Five-Step Process **9.3.1** Plan the ADA **9.3.2** Access and prepare the data **9.3.3** Consider the data's relevance and reliability **9.3.4** Perform the ADA **9.3.5** Evaluate the results **9.3.6** Additional issues to consider when performing an ADA as a risk assessment procedure	CAS 230 *Audit Documentation* CAS 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
4 Illustrate how audit data analytics can be used as a substantive analytical procedure	**9.4** Audit Data Analytics as a Substantive Analytical Procedure **9.4.1** Regression analysis	CAS 320 *Materiality in Planning and Performing an Audit* CAS 500 *Audit Evidence* CAS 520 *Analytical Procedures*
5 Illustrate how audit data analytics can be used as a substantive test	**9.5** Audit Data Analytics as a Substantive Test **9.5.1** Substantive testing **9.5.2** ADA example of accounts receivable and revenue **9.5.3** ADA example of payroll	CAS 315 *Identifying and Assessing the Risks of Material Misstatement* CAS 450 *Evaluation of Misstatements Identified during the Audit*
6 Describe the features of a good data visualization	**9.6** Features of a Good Visualization	

Cloud 9 Integrated Case

Sharon Gallagher and Josh Thomas continue to work on the Cloud 9 audit plan. Recently, they have been hearing a lot about audit data analytics. They understand that more and more of their clients, like Cloud 9, are capturing big data. They hear that audit firms are looking for ways to incorporate these data into current-day audits.

Both Sharon and Josh are scheduled to take the firm's training course offered about audit data analytics over the next few days. For now, they are confused and apprehensive as to how these new tools and techniques might be incorporated into the Cloud 9 audit. They have heard from other audit teams that these new procedures can sometimes help with audit efficiency, but there are often challenges with the client's data. They wonder if Cloud 9 might be a place to start using audit data analytics.

Chapter Preview

The purpose of this chapter is to explore how audit data analytics can be used during an audit. The chapter begins by defining audit data analytics (ADAs) and discussing how and when they can be used during an audit. Given that ADAs include the use of a client's data, the chapter considers the types of data used and key considerations surrounding the data-gathering process, including data quality from an audit perspective.

As with all audit procedures, it is important that audit data analytics are well planned. This chapter presents a five-step process as described in the CPA Canada Guide to Audit Data Analytics to assist with the planning and performing of ADAs. This process is applied to a variety of example ADAs. Lastly, the chapter will discuss key considerations when designing visualizations.

9.1 What Are Data Analytics?

LEARNING OBJECTIVE 1

Describe audit data analytics, when they can be used during an audit, and some of the approaches available to perform these procedures.

Almost everybody today has some kind of personal electronic device, whether a smart phone, a tablet, or a computer. These devices have become a way of connecting people regardless of geography. While personal use has exploded, businesses have realized that customer online behaviours can be captured and used in a variety of ways. These businesses use **data analytics**: the science of analyzing data to draw conclusions about them. Through data analytics, businesses hope to better predict customer interests, behaviours, and processes, thereby improving revenues, profits, and market share. For example, social media companies analyze user data to predict user interests for more effective target marketing, retailers analyze customer data to recommend future purchases, and transportation companies use data to predict more efficient delivery routes.

Entities may perform a variety of data analytics. A business can perform descriptive, diagnostic, predictive, and prescriptive data analytics for a variety of purposes. A business may perform **descriptive analytics** to understand past data, such as performing ratio analysis using historical financial information to understand past financial results. In performing **diagnostic analytics**, businesses look to understand why something happened, such as why there might be variances between actual expenses and budgeted expenses. **Predictive analytics** allow a business to make predictions into the future considering a variety of scenarios, such as when to restart or increase production during a global pandemic as governments lift stay-at-home restrictions. Lastly, **prescriptive analytics** support the examination of a

data analytics the analysis of data to draw conclusions about them

descriptive analytic a data analytic performed to understand past data

diagnostic analytic a data analytic performed to understand why something happened

predictive analytic a data analytic performed to make predictions into the future considering a variety of scenarios

prescriptive analytic a data analytic performed to examine a variety of solutions to determine the best outcome variety of solutions to determine the best outcome. Prescriptive analytics are commonly used by medical personnel to examine possible treatments and outcomes to decide the best course of treatment for patients. As organizations gather and use vast amounts of data to make better decisions, auditors are also looking to leverage these sorts of data analytics during financial statement audits.

9.1.1 How Audit Data Analytics Are Used

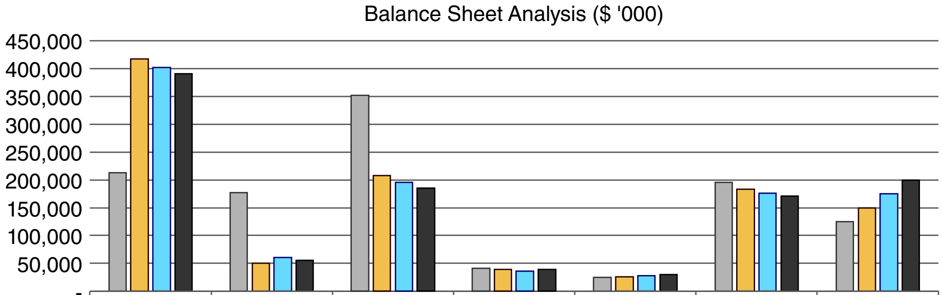
audit data analytics (ADAs) the examination of large datasets, usually using computer software, to identify exceptions, outliers, trends, and other useful information

While organizations are electronically collecting, analyzing, and maintaining large data sets, auditors are looking at ways they might use this electronic data to improve the audit process. New tools and techniques called audit data analytics are being developed. **Audit data analytics (ADAs)** are the examination of large datasets, usually using computer software, to identify patterns, trends, and outliers as a means of gathering sufficient and appropriate audit evidence. In some cases, these analytics can improve the efficiency and effectiveness of traditional audit procedures. For example, when performing trend analysis, auditors often compare current-year and prior-year financial statement account balances. Data analytic software programs allow an auditor to perform trend analysis over multiple years in greater detail in much less time than if attempted manually. The examination of more accounting information in more detail may lead to improved risk identification without adding audit time. The same software also makes it possible for the auditor to easily drill down into account details. This allows the auditor to further examine and identify specific areas that may be causing significant fluctuations. The auditor can then plan to focus the audit work in these areas, therefore improving both the efficiency and effectiveness of the audit.

ADAs are also helping to expand audit testing beyond the traditional audit procedures. Examples include using data visualizations to identify outliers, trends, and exceptions that require further investigation and using regression analysis to develop expectations when performing substantive analytical procedures. This introduces a key concept associated with ADAs: data visualization. **Data visualization** means presenting the results of an ADA as an image, chart, or table. By using visuals, the auditor can increase the effectiveness of communicating audit findings and identify items needing further investigation.

data visualization the results of an ADA presented as an image, chart, or table

This concept is demonstrated in **figure 9.1**, which presents select balance sheet accounts at year end over a four-year period. In this exhibit, the same data are presented in table and visual format. Which of them allows you to quickly and easily see the key trends? At a glance, it is the visualization. The bar chart allows you to easily identify the significant trends and fluctuations, while if you try to interpret the data in the table, it will require further calcu-



	Cash	Accounts receivable	Inventory	Prepaid expenses	Capital assets	Accounts payable	Long-term debt
2023	213,059	177,446	351,535	40,828	24,575	195,513	125,000
2022	417,126	50,791	207,899	39,633	26,100	183,248	150,000
2021	402,366	60,355	195,880	36,555	28,300	175,666	175,000
2020	390,445	55,775	185,800	38,955	29,600	170,655	200,000

FIGURE 9.1 Year-over-year visualization

lations and additional time. The ease of interpretation of visualizations can help the auditor when communicating with management and those responsible for governance. Visuals may also take the form of a dashboard. A **dashboard** consists of multiple visuals. Many businesses use dashboards to monitor business performance. Visualizations will be further discussed later in this chapter.

dashboard the display of multiple visuals to monitor business performance

Because ADAs involve performing audit procedures using technology, you may wonder how ADAs differ from computer-assisted audit techniques (CAATs). Because there are similarities between the two, "ADA may be viewed as an evolution of CAATs that allow the auditor to make effective use of data visualization techniques to achieve a broader range of audit objectives. Whether an auditor classifies a technique as an ADA or a CAAT, it more often than not comes down to a matter of professional judgement."[1]

9.1.2 When Audit Data Analytics Are Used

Audit data analytics are procedures that can be performed during the risk assessment, risk response, and reporting phases of the audit. **Figure 9.2** shows that ADAs can be used at any stage of the audit.

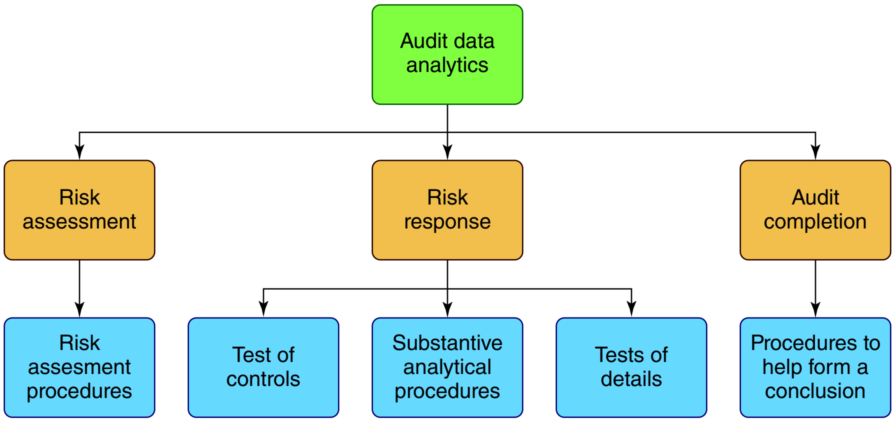


FIGURE 9.2 **When ADA can be used in an audit**

Risk Assessment

ADAs can be used during the audit's risk assessment phase to help the auditor gain a better understanding of the business and to identify where the risk of material misstatement may exist. CAS 315 requires the auditor to perform analytical procedures to help identify inconsistencies, unusual transactions or events, and trends that indicate matters that may help identify risks of material misstatement, especially risks of material misstatement due to fraud. It also indicates the auditor may use automated tools and techniques to perform risk assessment procedures on large volumes of data. Therefore, the auditor can use a descriptive ADA to gather evidence to support the risk assessment for the overall entity and to identify the significant accounts and relevant assertions. For example, the auditor could create a visual analyzing the entire general ledger for significant fluctuations and trends. This could also include an analysis and visualizations for key financial statement ratios. When performing this type of analysis, the ADA may confirm the original risk assessment or indicate the need to revise it. If unexpected fluctuations are noted, the ADA may have identified new risks the auditor has yet to consider.

As stated, ADAs can also be used to examine unexpected fluctuations in greater detail, allowing the auditor to pinpoint specific high-risk areas. By obtaining a better understanding of the high-risk areas, the auditor can then plan to focus the audit work on these areas, thereby improving the audit's efficiency. For example, if an auditor notes a significant increase in accounts receivable, they can drill down into the accounts receivable details to identify the specific accounts causing the increase. The auditor can then plan to focus the audit work on any accounts identified as high-risk, such as those overdue. Examples of other possible risk assessment ADAs include:

- Analyze the general ledger for unusual transactions.
- Create visualizations of ratio analysis.
- Perform a quantity and price analysis for sales.
- Analyze changes to accounts receivable to assess the risk of material misstatement.
- Perform trend analysis.

Risk Response

ADAs can be used as tests of controls. They can be used to assess whether the controls in place are effective and to identify control weaknesses. For example, a common control over accounts receivable is the establishment of credit limits for credit customers. An ADA can be used to identify customers that exceeded their credit limits during the year, therefore testing whether this control was effective.

ADAs can be used to assist with detailed substantive analytical testing. They can be used to determine expected account balances for reasonability testing. They can also be used as tests of details to identify whether a material misstatement exists at the account or assertion level. For example, if an auditor identifies a valuation risk over inventory, the auditor can test net realizable value using an ADA to compare the most recent sales prices with inventory cost by item. Using an ADA for these tests, the auditor can test the entire population, therefore reducing sampling risk. Examples of how ADAs can be used as substantive tests include:

- Perform non-statistical and statistical models to predict revenues.
- Identify and isolate unusual items such as credits in Accounts Receivable.
- Test net realizable value of inventory.
- Identify credit notes issued after year end.
- Identify payments made after year end.

Audit Completion

Lastly, ADAs can be used at the end of the audit to support the overall conclusion. At the end of the audit, CAS 520 requires the auditor to perform analytical procedures to assess if the financial statements are consistent with the knowledge of the business obtained during the audit. ADAs can be used to perform these final analytical procedures on the adjusted financial statements.

9.1.3 Techniques Used for Audit Data Analytics

Several techniques for performing business data analytics are outlined in a book by Provost and Fawcett, including visualizations, matching, clustering, and statistical techniques. These techniques can also be used to perform audit data analytics. These will now be discussed and further summarized in table 9.1. These techniques are also used in this chapter as we present various examples of ADA.

Visualizations

As highlighted earlier, this is a technique that focuses on presenting data visually. This is a good technique when performing ADAs as risk assessment procedures or when examining exceptions. When information is presented visually, such as in a line graph or bar chart, an auditor may quickly see trends or find outliers and exceptions. As demonstrated in figure 9.1, identifying trends and exceptions from a data table often requires more effort and further analysis, which may lead to missing trends and outliers.

Matching

This is a tool that can be used to identify exceptions and to identify possible fraud. This involves comparing items to identify those that do or do not match. For example, when auditing sales, an auditor will check that the amounts ordered, delivered, and invoiced all match. When items do not match, it may indicate a possible sales misstatement that requires follow-up. On the other hand, matching can also be performed to search for matches where none should exist, which may indicate possible fraud. For example, an auditor may conduct a test to match bank account numbers from the payroll master file and the accounts payable master file. No matches should be found, because suppliers and employees should not have the same bank account numbers. If a match is found, it may indicate that an employee has set up a fictional accounts payable vendor and is routing payments to their personal bank account.

Clustering

This is a tool used to group items with similar characteristics into clusters. For an auditor, this is helpful to organize large amounts of data and to identify outliers that require examination. For example, an auditor has a client that uses only wire payments to pay its most frequently used suppliers. The auditor clusters suppliers by the number of wire transfers made over the year. Because only high-volume suppliers should be paid this way, clusters with only a few wire transfers are exceptions that need further examination.

Statistical Techniques

These techniques include regression analysis and data distribution. **Regression analysis** can be used as a predictive substantive analytical procedure by taking past data and developing a mathematical formula to represent that data. The mathematical formula can then be used to develop an expected amount or account balance. This can then be compared with the actual account balance for reasonableness. The auditor can also examine the distribution of data to identify outliers. For example, an auditor can examine data and identify their normal distribution. Items that lie outside of two standard deviations from the mean would be considered outliers that require further investigation.

regression analysis representing past data as a mathematical formula that can be used as a predictive substantive analytical procedure

These techniques are summarized in table 9.1.

TABLE 9.1 Data analytic techniques

Technique	Description	Helpful for
Visualization	Information is presented visually	• Risk assessment procedures • Identification of trends
Matching	Searching for items that should or should not match	• Fraud identification • Exception identification
Clustering	Grouping items with similar characteristics	• Exception identification • Exception reduction
Statistical techniques	Regression analysis and data distribution	• Substantive analytics • Exception identification

Professional Environment 9.1 discusses some of the software programs that can be used to perform these techniques.

9.1 Professional Environment Tools to Assist with ADAs

To perform ADAs, given the volume of data and the techniques available, software is generally needed. While some firms have developed proprietary software, there are a variety of software programs available for purchase or as open resources. These are some of the most common tools.

1. IDEA: IDEA is CaseWare's data analysis software. CaseWare has been providing auditing solutions to firms across Canada for many years. It has expanded into the audit data analytics realm with its IDEA software. IDEA allows the auditor to import a client's data and then clean and analyze large amounts of data. In many cases, it permits the analysis of 100 percent of a client's data. While there is a cost to IDEA software, there is an educational program that provides IDEA software to educators and students free of charge. This educational version includes a workbook with exercises.
2. ACL (now Galvanize): This audit and risk management software allows for data analysis. ACL has long been used in the audit profession to run CAATs.
3. Power BI: Power BI is a business analytic tool owned by Microsoft. It allows users to connect, share, model data, and create visualizations. The basic version of Power BI is free; however, upgrades are available for purchase.
4. Tableau: Tableau is analytics software owned by a Seattle-based company. It allows the import of data in many formats and supports the easy creation of data visualizations and dashboards. Tableau provides a software licence for Tableau Desktop to educators and students free of charge as part of its Tableau academic program.

Q: Selecting the right software tool is important for firms planning to use ADAs. What things might a firm consider in making this decision?

Cloud 9 Integrated Case

Sharon and Josh now understand that audit data analytics involve using software to examine large datasets. Now that they understand what it's all about, Sharon and Josh agree there are likely benefits to be realized if they can incorporate ADAs in the Cloud 9 audit. They first need to further explore the processes Cloud 9 uses to collect the data and get a sense of the data available. They like the idea of using visuals. They feel this may be a great way to communicate to management, as well as with less senior members of the audit team. They still feel nervous as they recognize there is much about these new procedures they do not know, and they wonder about the impact these new tests may have on the audit budget. They recognize that to plan an ADA, they'll need to use professional judgement and have a strong knowledge of the business. They decide to book a time to meet with Jo Wadley, the engagement partner with the most experience with the client, to discuss where and how she thinks they can use ADAs in the Cloud 9 audit.

Before You Go On

9.1.1 Define audit data analytics.

9.1.2 Describe the stages of an audit when audit data analytics can be used.

9.1.3 List four techniques that can be used to perform audit data analytics.

9.2 Data Considerations

LEARNING OBJECTIVE 2

Explain the key considerations related to data when performing audit data analytics.

Now that we have defined audit data analytics, we will consider the types of data that can be used and the data access considerations that impact whether audit efficiencies are realized. The auditor should also consider data quality. This includes data consistency, data completeness, and data cleansing. As with all audit evidence, the auditor should consider the relevance and reliability of the data and how the test results will be documented.

9.2.1 Types of Data

Clients collect a large amount of data from a wide variety of sources, including both structured and unstructured data. **Structured data** are data that reside in a fixed field within a record or file.[2] These are the data auditors are most familiar with because they include the data captured, processed, and maintained in accounting systems, such as general ledgers and journals. These are the data most used today in performing ADAs. **Unstructured data** are data that do not reside in traditional databases.[3] They include emails, texts, and images, as well as information posted on the Internet and social media. The use of unstructured data is less common in audits today, but it is likely to grow as the technology supporting its use evolves.

structured data data that reside in a fixed field within a record or file

unstructured data data that do not reside in traditional databases

9.2.2 Data Access

Audit efficiencies can be realized by using ADA techniques and tools. As mentioned, ADA software may enable an auditor to perform a test faster and more comprehensively than to do it manually. But efficiencies may not be realized if the auditor cannot readily access the data. It is prudent for the auditor to resolve data access issues in the early planning stages of the engagement.

Important considerations with respect to obtaining and accessing a client's data include the following:

- *The auditor should have direct access to a read-only copy of the data.* Direct access often leads to time savings because it means the auditor does not have to wait for the client to fulfill information requests. However, direct access requires client agreement. Due to stringent data privacy and security requirements, clients may resist this. The auditor needs to work with the client to resolve these issues. It is the auditor's responsibility to ensure there is strong security over a client's data while they are in their possession. The auditor should also request a read-only copy to ensure they cannot alter a client's data.
- *The auditor should gain an understanding of what data the client has available.* There is no point in planning an ADA if the data needed are not available! This is not a good use of time and resources. Understanding what data are available also prevents collecting the wrong data or discovering issues with the data later, which will likely cause delays and add to the cost of the audit. Also, by understanding what data are available, the auditor can request what is needed at the beginning of the audit, again eliminating the need to wait on the client to fulfill information requests.
- *The auditor should understand the size of the dataset.* The auditor needs to ensure they can store and process the data. Often the datasets requested are very large and if the auditor's system cannot process them quickly, it will cause audit delays.

9.2.3 Data Quality

It is important that the auditor consider the quality of data to assess its usability when planning an ADA. This starts with considering the consistency, completeness, and cleansing of the data.

Consistency

Sometimes businesses use more than one system. For example, different geographic locations may use different software. This means that within the one entity, the same data are collected using different systems. This can create concerns with respect to ensuring the data are consistent. Do the same data fields reflect the same information? Are the data captured in a consistent format? For example, dates can be entered different ways. In some countries, dates are entered month/day/year and in other countries, they are entered day/month/year. If things such as dates are not formatted in the same way, data manipulation is needed for the data to be usable.

Completeness

Completeness of the data is critical to ensure meaningful analysis. If an ADA is performed using an incomplete dataset, it will not provide a complete picture and will result in an inappropriate conclusion. As mentioned, clients can use more than one system to collect the same data. Because data may be captured in different cells, there is a risk that data are altered or lost when they are transferred. The auditor needs to understand how the client ensures data are not lost or altered during data movement, otherwise the data may not be usable.

When receiving a dataset, the auditor needs to verify it is complete. With respect to financial information, completeness is often established by reconciling amounts to the general ledger. For example, if examining a sales dataset, the auditor will agree the total sales figure from the sales file provided by the client to the total sales reported in the general ledger. If these figures do not agree, then it indicates sales are missing and the test should not be performed until the two amounts are reconciled. Completeness is also usually established by verifying sequential numbers. For example, a business may use pre-printed sequential cheques to settle accounts payable. If the cheque sequence is broken in the cash payment dataset, then the cash payment data may not be complete.

Completeness is also represented by obtaining the full population for analyzing. This cannot be achieved if the auditor is not provided a complete dataset. This can happen if the client does not understand the purpose of the data request or makes an error when providing the data. For example, if the auditor asks for sales data, and they get only the physical store sales while the e-commerce sales are omitted, then the dataset is not complete. Therefore, it is important the person gathering the data understands the data request and is experienced with data extraction.

Cleansing

Besides completeness and consistency, it is important that the auditor review the dataset for other data errors. **Data errors** include inaccurate, duplicate, incomplete, and inconsistent data. Many data collection processes include application controls to ensure data are complete and accurate. For example, controls are often imbedded in data collection systems to ensure data are not accepted when information is missing or incorrect. However, data errors may still occur and they need to be corrected by data cleansing. **Data cleansing** involves identifying and correcting missing, incorrect, and duplicate fields, as well as reformatting the data so they are in a consistent format. Many software programs help with data cleansing. For example, Microsoft Excel includes functions to format cells in a consistent manner and to identify duplicate rows. The auditor should always maintain an original copy of the data before the data are cleansed and should document all data preparation procedures.

data errors inaccurate, duplicate, incomplete, and inconsistent data

data cleansing identifying and correcting missing, incorrect, and duplicate fields, and reformatting data in a consistent format

The CPA Canada Guide to Audit Data Analytics indicates it is important the auditor consider the extent of the errors and the usability of the data. While some data cleansing may be needed, a large number of errors may indicate an issue with the controls over data gathering and an ADA may be no longer appropriate. It is also worth noting that data preparation can be very time consuming and this should be considered when planning the audit and the ADA. If a great deal of time is needed to prepare the data for use, this should be considered when planning the ADA.

9.2.4 Data Relevance and Reliability

CAS 500 requires the auditor to consider the relevance and reliability of the information to be used as audit evidence. Remember that **relevance** is the extent to which the information is logically connected to an assertion and **reliability** is the extent to which the information reflects the true state of the information. These concepts also apply to the data used in an audit data analytic.

relevance the extent to which information is logically connected to an assertion

reliability the extent to which information reflects its true state

Relevance

For an audit procedure to be relevant, it should relate to the account and relevant assertion. For example, if the auditor is performing an ADA to gather evidence over inventory existence but performs an ADA focusing on inventory valuation, then it has little relevance to the intended test. A risk with ADAs is that with so much data collected and available, an auditor will perform numerous ADAs without a specific audit purpose and therefore they will not be relevant.

Reliability

The reliability of evidence is often assessed in term of its nature, source, and consistency. For example, recall that unbiased, externally generated evidence, evidence gathered by the auditor, and evidence that is consistent between sources is generally considered reliable. These concepts similarly apply to data. Publicly available data and data prepared under a system of strong internal controls is generally considered reliable. **Figure 9.3** from the CPA Canada Guide to Audit Data Analytics includes a list of characteristics that impact the relevance and reliability of data. Generally, it indicates that structured, numerical, financial data generated under a strong system of internal controls are considered more reliable than unstructured, non-financial data not generated under strong internal controls.

Nature

- Financial, non-financial
- Accounting process and control-related
- Product and service categories
- Demographic
- Economic
- Geographic
- Business sector
- Regulatory
- Historic
- Forward-looking
- Time-sensitive

Sources

- Controlled by the accounting department of the audited entity (in-house records) or stored externally (for example, in the cloud)
- Controlled by persons outside of the accounting department of the audited entity (with various possible storage media)
- External to, and not controlled by, the audited entity

Format

- Numerical (for example, quantity, currency), text, symbols, other characters
- Structured (for example, data in a fixed field within a record or file)
- Unstructured (for example, text)

Timing

- Point-in-time, period of time
- Rate of change (time lags, continuity)

Extent

- Volume
- Scope (variety of subject matters and sources)

Level of Aggregation

- Financial statement item, account balance, component of an account balance
- Annual, monthly, daily, hourly, some smaller timing frequency
- Consolidated, segmented (for example, by division, location)
- Database files, tables, and fields

FIGURE 9.3 **Examples of data characteristics that may affect data relevance and reliability**

Source: Adapted from CPA Canada Guide to Audit Data Analytics, Chartered Professional Accountants of Canada, 2018

Reliability should be considered as the auditor assesses the level of assurance required from an audit test. For example, where the auditor is performing a risk assessment procedure, the need to establish reliability may not be as high as when the ADA is a test of details.

9.2.5 Documentation

It is important that the auditor document the work performed in the working paper file. CAS 230 outlines documentation requirements. It indicates that the nature, timing, and extent of the procedures performed; the results and evidence obtained; and significant matters and conclusions should be documented to the level of detail where an experienced auditor can reperform the test and come to the same conclusion. This is required whether the auditor performs manual testing or ADAs. There are, however, special documentation considerations with ADAs. The CPA Canada Guide to Audit Data Analytics indicates that given the size of the datasets, the auditor may not want to keep the raw data in the file. Instead, the auditor may want to document the test results in the form of a visualization. When this is the case, the auditor should take a screen shot of the parameters specified for the test to keep in the audit file. It is important the audit file documentation allow for the same test to be reperformed and the same results obtained with the same data.

The CPA Guide also outlines the following as to what the auditor should consider documenting when using ADAs:

- Objectives of the procedure
- Risks of material misstatement that the procedure intended to address
- The sources of the underlying data and why the data were selected
- The ADA and related tools and techniques used
- The tables or graphics used, including how they were generated
- The steps taken to access data and how they were extracted and transformed for use
- The evaluation of matters identified as a result of applying the ADA, including where additional items were investigated and how items may have been filtered
- The identifying characteristics of the specific items or matters tested
- The name of the auditor who did the work and the date it was performed
- The name of the auditor who reviewed the work and the date the review was performed

9.2.6 The Data Life Cycle

data life cycle the life span of data, from when they are collected, maintained, used, stored, and then finally destroyed

As we have been exploring data quality when planning an ADA, we have been discussing data at different stages of the data life cycle. The **data life cycle** is the movement of data from when they are collected, maintained, used, stored, and then finally destroyed. The data life cycle is shown in **figure 9.4**.

1. When the auditor obtains a copy of the client's data, this is the data collection or creation stage. Usually the auditor acquires a copy of the client's data, but data can also be collected by data entry, such as when a customer completes a customer order or enters information on a website or by scan, such as scanning bar codes.
2. After the data are collected, the auditor considers the accuracy, completeness, and timeliness of the data, and data errors are cleaned. This is the processing stage of the data life cycle.
3. Once the data are prepared, the auditor performs the test and interprets the results, thereby using the data. This is the data usage stage.
4. Once the audit is complete, the audit file is archived. This means while the file is not active, it is still kept for peer review purposes and in case the audit file is needed in the future. This includes any data used to support the audit opinion. These data are then in the maintenance stage.
5. After a period of time, the audit file and the data in it are no longer needed and can be deleted. For an auditor, this is usually determined by the firm's quality assurance manual. This is the deletion stage of the data life cycle.

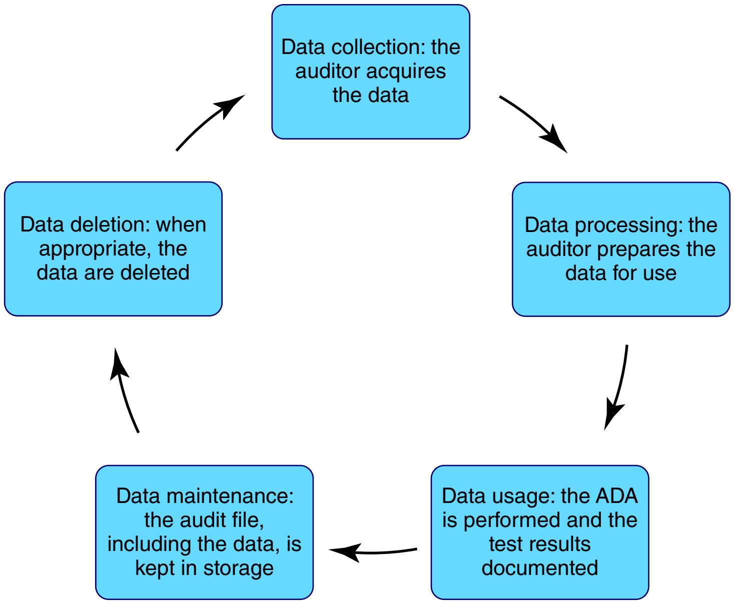


FIGURE 9.4 **The data life cycle**

Cloud 9 Integrated Case

Josh and Sharon meet with Jo, who thinks Cloud 9 would be a good candidate for ADAs. Because this is a repeat client, they know Cloud 9 has a strong system of internal controls, and so she thinks there will be minimal issues with the data quality. She explains she has heard other audit partners talk about engagements where they tried to use audit data analytics and had problems because the data were collected using more than one system. It resulted in formatting and consistency issues, and it took a lot more time to prepare the data than expected. Jo has heard of situations where dates and data were in different formats and it took so much time to merge and clean the data that at the end of the day, no audit efficiencies were realized. She hopes with Cloud 9, these issues can be avoided. Josh and Sharon are excited to get started and they wonder what their next steps should be.

Before You Go On

9.2.1 Define structured and unstructured data.

9.2.2 What are two things that impact the reliability of data?

9.2.3 List three documentation requirements.

9.3 The Audit Data Analytic (ADA) Five-Step Process

LEARNING OBJECTIVE 3

Describe the five-step process for performing an audit data analytic and apply this process when using audit data analytics as a risk assessment procedure.

Now that we have a better understanding of the nature of the data, let's further explore how ADAs may be used in an audit. We know ADAs can be used at any stage of the audit. However, as with any audit test, it is important that the auditor spend adequate time planning the procedure.

To do this, the CPA Canada Guide to Audit Data Analytics suggests a five-step process for planning, performing, and evaluating ADAs. This process involves (1) planning the ADA, (2) preparing the data, (3) assessing the relevance and reliability of the data, (4) performing the test, and (5) evaluating the test results. This process is presented in **figure 9.5** and explained below. While it is helpful for the auditor to use this or a similar process as a framework to plan and perform ADAs, it is important to note that the five-step process is not required by auditing standards.

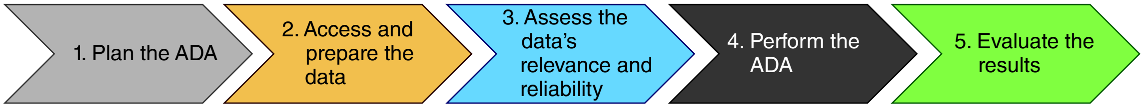


FIGURE 9.5 **Five-step process for planning, performing, and evaluating ADAs**

As we summarize and describe the five-step process, we will apply it to an ADA to be planned and performed by W&S Partners during the audit of AthleticsWear Inc., a long-time client. AthleticsWear Inc. is a retail business, with annual sales of approximately $25 million, that sells high-end unisex athletic wear.

9.3.1 Plan the ADA

The first step for the auditor is to plan the ADA. In order to do this effectively, the auditor needs to have a good understanding of the client, its business, and whether the system of internal controls over the data collection is generally effective. If the data are compromised, there is little value in performing an ADA. An outcome based on poor-quality data (a compromised population) will be flawed.

After gaining an understanding of the client's business and data collection processes, the auditor can then determine what type of ADA to perform, including what account and assertions to test. This will be influenced by the preliminary risk assessment and the data available. After the accounts and assertions are determined, the auditor can then identify the data needed and plan the details of the test, including how to document the test results.

The following is a list of questions the auditor should consider in planning the ADA:

- Are the data relating to the relevant account and assertion available to conduct an ADA?
- Does the entity have adequate controls over the data collection processes?
- What tools or software will be used to conduct the test?
- What is the best way to summarize the test results?

To illustrate, W&S Partners planned an ADA for the AthleticsWear Inc. audit. AthleticsWear Inc. is a retailer of specialty athletics wear. It sells its products both directly to customers and through four retail stores in Vancouver, Calgary, Toronto, and Montreal. It has been a client of W&S Partners for the past three years. The audit partner for the engagement, Jo Wadley, has determined the audit team should perform an ADA as a risk assessment procedure given the entity's volume of sales. W&S Partners has an understanding of the controls in place over the collection of the sales information. Based on their knowledge of the internal controls, they feel it is acceptable to move forward with the use of an ADA.

The audit partner believes it makes sense to perform an ADA to examine sales trends to identify any unexpected or unusual changes that could impact the risk of material misstatement with respect to the occurrence, accuracy, and completeness of sales. The information related to sales growth and marketing activities is summarized below:

- W&S Partners has seen the client show strong sales growth over the past three years due to the strong demand for its stylish athletic wear, and the audit team expects this trend to continue.
- In October of the prior year, AthleticsWear started selling products using e-commerce. Online sales will now be in place for a full year and W&S Partners expects to see significant sales growth in this area.

- In line with the retail industry, sales are expected to be greater during the last quarter of the year, when retailers realize their strongest sales during the holiday season.
- Through discussions with management, W&S Partners learned that in the last quarter of the year, AthleticsWear introduced a new wicking T-shirt. Management noted that while sales of this new product were strong, it displaced some of the sales of its cotton T-shirts, one of the company's best sellers. Based on this information, the only expected change to the product mix was a decline in the sales of cotton T-shirts, replaced with the sales of the wicking shirts.

Based on the information obtained, W&S Partners decided to perform an audit data analytic as a risk assessment procedure to examine sales trends by quarter and then by location over a four-year period. The audit team also decided to look at the quantity of items sold over the same four-year period. To perform the ADA, the firm plans to use the sales data and quantities sold over the last four years provided by the accounting department. They plan to use software to create visuals to summarize and document the test results. Planning of the ADA is documented in **table 9.2**.

TABLE 9.2 Planning the ADA as a risk assessment procedure

Purpose	Account and Assertion	Data Required	ADA to Perform
To examine year-over-year sales to identify trends and unexpected changes that may impact the risk assessment of the sales account	Sales: occurrence, accuracy, and completeness	• Sales data from the general ledger for the year under audit and the prior three years • Quantities of each product sold from the client's sales database for the year under audit and the prior three years	• To examine sales trends by quarter over four years • To examine sales by location over four years • To examine the quantity of products sold over four years

9.3.2 Access and Prepare the Data

The second step of the ADA process is accessing and preparing the data. Once the ADA has been selected and the data population identified, the auditor needs to assess the condition and format of the data. As discussed, it is important for the auditor to conduct the test with clean data. Even though the auditor has concluded that the controls over the data collection are effective, recall that no system of internal controls prevents errors 100 percent of the time and that errors can still happen. Therefore, data errors should be identified and cleaned.

The following is a list of questions to consider when preparing the data:

- What is the format of the data?
- Are there missing data? Are there duplicate data?
- Are the data in a consistent format?
- To what extent do the data need to be cleaned?
- Do the data agree to the general ledger?

Recall that W&S Partners plans to use four years of sales data generated by the entity. The sales data were captured and stored in a typical general ledger format; therefore, the data were formatted consistently. The data were collected and maintained within the accounting department so they were available and retrievable. The audit team confirmed that all sales data, including online sales and sales from all four locations for the entire year, were included in the dataset. W&S tested the completeness of the data by agreeing the total sales per the sales data file to the sales amount in the trial balance, as well as the financial statements for the year under audit. They also agreed total sales from the sales data file for prior years to the audited financial statements. These procedures validated the completeness of the data. W&S plans to test the controls over the sales cycle to provide further assurance over the data. The auditor plans to use Tableau software to create the visualization, and so the data were imported. The data were cleaned using the Tableau data cleansing function, which removed any duplicate items. A report was generated recording the changes made during the cleansing process.

9.3.3 Consider the Data's Relevance and Reliability

The third step of the process involves assessing the data's relevance and reliability. This was discussed in detail earlier in the chapter. Recall that the reliability of the evidence is impacted by how and who collected the data and whether information is produced under a system of effective internal controls. W&S Partners notes the data are collected by a POS system that is aggregated within the accounting department in general ledger format. This is numerical, structured data collected by a knowledgeable accounting department that understands the importance of controls over data collection. This is a risk assessment procedure and the auditor plans to perform other audit procedures regarding the sales account, so the data are considered sufficiently reliable to continue to conduct the test.

The following is a list of questions to consider with respect to the relevance and reliability of the data:

- Will the data provide evidence to support the related assertion(s)?
- How were the data generated, and how will that impact the reliability?
- Are the data structured or unstructured? Are they in general ledger format?

9.3.4 Perform the ADA

notable items unexpected trends, outliers, and exceptions that require follow-up when performing an audit data analytic

The fourth step is to perform the actual test. For AthleticsWear Inc., the auditor performed the test as planned and examined sales trends over a four-year period. The auditor used Tableau software to generate the graphs and visuals. When performing the ADA, the auditor was looking for trends that were inconsistent with the knowledge of the business that might indicate a higher risk of material misstatement than originally believed. When an auditor finds unexpected trends, outliers, and exceptions that require follow-up, they are referred to as **notable items** (per the CPA Canada Guide to Audit Data Analytics). When a large number of notable items are found during a risk assessment procedure, they may indicate the original risk assessment needs to be revised.

In conducting the test, W&S Partners produced an overall visual of sales by quarter over four years, as shown in **figure 9.6**.

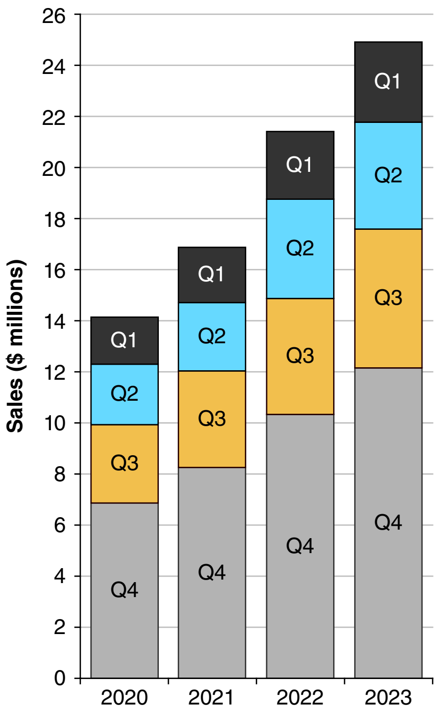


FIGURE 9.6 **Visualization of sales by quarter over four years**

The visualization confirms that sales grew over the four-year period and they increased by about $3.6 million or 16.9 percent from the prior year ($21.3 million to $24.9 million). There was an increase each quarter, with almost half of the annual sales taking place in the last quarter of the year. These results were consistent with the results of the retail industry in general.

W&S Partners also performed an ADA examining sales trends by location for the most recent year under audit and the last three years, as shown in **figure 9.7**. It was noted that sales also increased at each of the brick-and-mortar locations over each of the four years. However, sales growth in the current year was slower than in the past, while e-commerce sales more than tripled in the current year, as this was its first full year. These sales trends were consistent with the knowledge of the business and discussions with management.

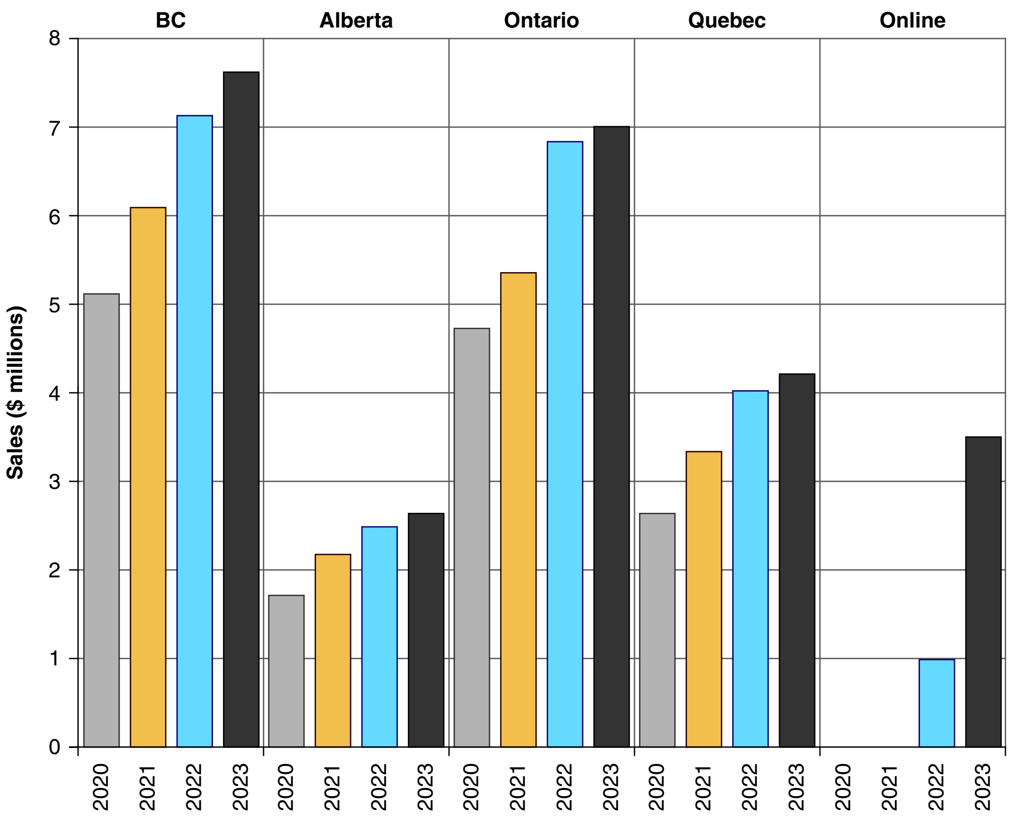


FIGURE 9.7 **Visualization of sales by location over four years**

Lastly, W&S Partners prepared a visualization examining unit sales by product type, as shown in **figure 9.8**. It was noted that for most products, the quantity sold remained consistent or grew over the four-year period. This was true for all products except the wicking T-shirt, a new product, and the cotton T-shirt, where quantities sold were reduced by approximately half from the prior year. This change in product mix was expected and consistent with the product sales and discussions with management.

W&S Partners did note that there was little to no growth in the sales of down coats and bucket hats, and the quantity sold appeared quite low compared with other product sales. While this did not impact the risk assessment of sales, it may indicate an inventory valuation issue for these two products. As a result, W&S Partners planned to do substantive testing on these two products when they audit the inventory account.

9.3.5 Evaluate the Results

Performing the ADA is important to confirm expectations and identify notable items. It is also important to evaluate the results (including notable items) and form a conclusion. If a large number of notable items is found, it may indicate there is an issue with the test, and the test

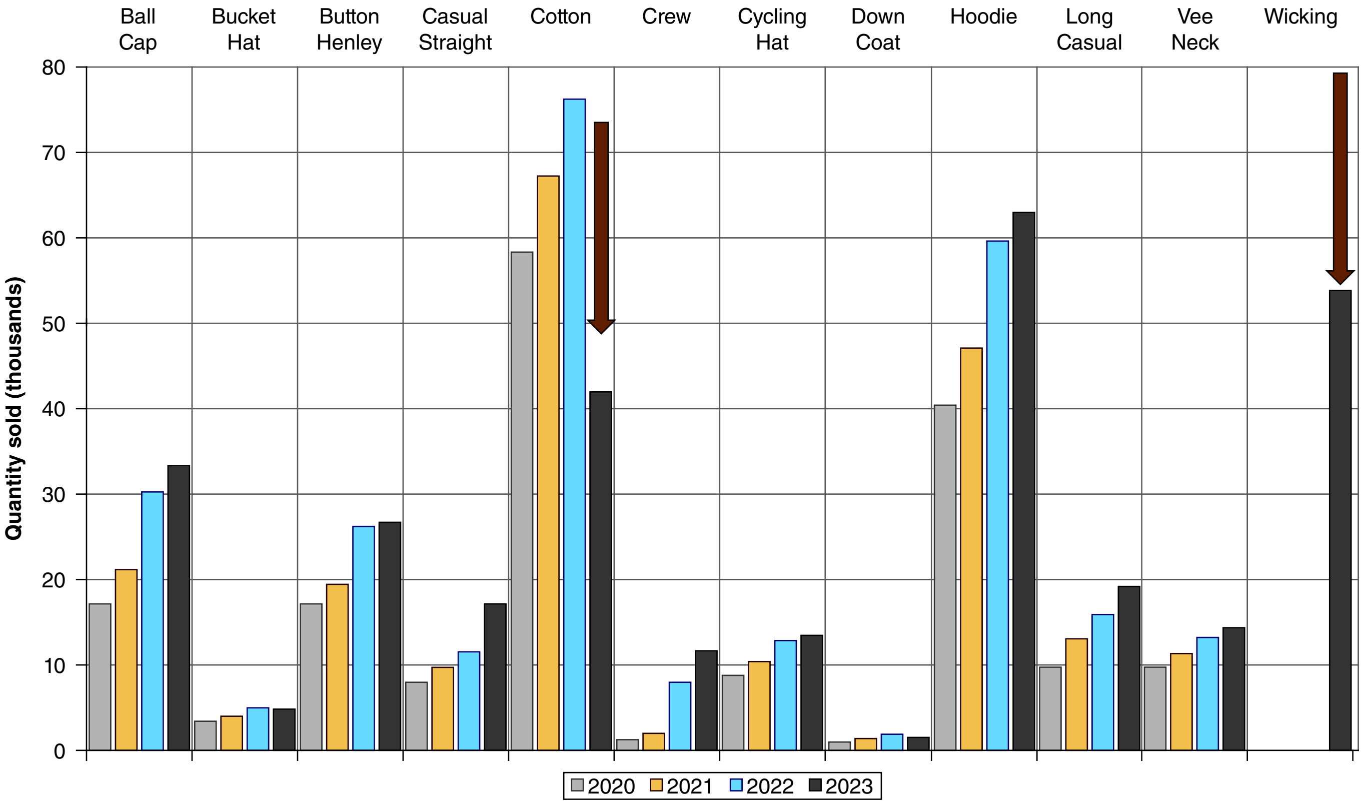


FIGURE 9.8 **Visualization of quantities sold by product type**

may need to be revised and reperformed. To meet the requirements of CAS 230, the auditor should also document the results of the test. The IAASB indicates that where analysis results in numerous items for investigation, documentation requirements may increase compared with if the auditor chose to use sampling techniques. To assist, the auditor may export the results to a format (spreadsheet or word document) that is suitable to be included in the auditor's engagement file.[4]

The following are questions to consider when evaluating the results:

- Do the test results indicate more testing may be required or the test needs to be revised and reperformed?
- How will the exceptions be documented in the audit file?

When W&S Partners evaluated the results of the ADA, they concluded the test met its objective. Because the test results were consistent with expectations, the audit team did not modify its original risk assessment regarding the occurrence, accuracy, and completeness of sales. They did note there was a potential risk of inventory obsolescence with respect to the down coats and bucket hats, and they made a note to investigate these high-risks items.

9.3.6 Additional Issues to Consider when Performing an ADA as a Risk Assessment Procedure

Now that we have learned the five steps in the ADA process, let's look at additional issues that auditors need to consider when performing an ADA as a risk assessment procedure.

Notable Items

Recall that when performing an ADA, often the auditor is looking for notable items—exceptions or outliers—which may confirm the original risk assessment or suggest it needs to be revised. As outlined in **figure 9.9**, notable items may indicate new risks or items that provide more information about risks already identified that allow the auditor to better design procedures to address those risks.

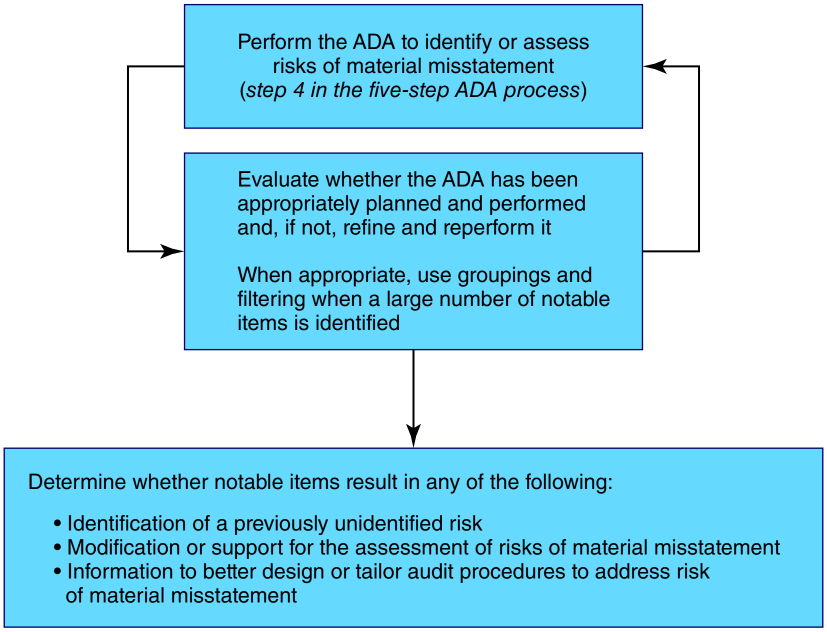


FIGURE 9.9 Process to identify and address notable items when using an ADA in performing a risk assessment procedure

Source: CPA Canada Guide to Audit Data Analytics, Chartered Professional Accountants of Canada, 2018

How does an auditor address the notable items? It depends on the nature of the notable items and how many appear. The CPA Canada guide suggests the following process:

- When few exceptions are identified, the auditor may be able to examine each one to determine what impact, if any, they might have on the original risk assessment.
- Where a great number of notable items are identified, dealing with them manually is likely not possible. First, when a large number of notable items appear, the auditor should consider if there was an issue with the population and whether the test may need to be revised and reperformed. For example, when performing an ADA over cash receipts from sales, an auditor found a larger number of notable items than expected. Upon examination, the auditor found many of the exceptions were cash receipts but they did not relate to cash receipts from sales. Instead, they were cash receipts from bank loans and related parties. These transactions appeared as exceptions when in fact they should have been excluded from the test population. The auditor removed these items from the population, reperformed the test, and the number of exceptions was reduced substantially. When items are erroneously identified as exceptions or anomalies, they are referred to as **false positives**.

false positives items that are erroneously identified as exceptions or anomalies

- If the auditor determines there was no issue with the test design or the population selected, yet there are too many notable items to examine manually, one method to reduce the number of items to examine is to cluster items with similar characteristics. The auditor can then perform additional work on each cluster, instead of examining items individually. Clusters may indicate there is a greater risk of material misstatement or a new risk, or they may provide information so the auditor can better tailor audit procedures.

For example, let's assume W&S Partners performs an ADA on AthleticsWear's inventory to assess the risk of valuation. W&S Partners performs a test to determine the number of days each product has been held as inventory. Notable items are those that have been in inventory more than 180 days. The test produced a large number of notable items. W&S Partners grouped the notable items by product type and found there were three clusters: down coats, bucket hats, and button Henley shirts. The potential valuation risk relating to the down coats and bucket hats had already been identified when the sales ADA was performed. The identification of the button Henleys as slow-moving items presented a possible new risk. W&S Partners revised the audit plan to perform additional substantive testing on these three products, adding the Henley shirts to examine when testing inventory valuation.

Risk Assessment and the Testing of the General Ledger

Another area where auditors commonly use ADAs is to analyze the general ledger to support CAS 240, which requires the auditor to assess the risk of fraud. CAS 315 also indicates that automated techniques may be used to examine journal entries or entire populations to identify variations from the normal or expected processing procedures which may result in the identification of risks of misstatement. Therefore, by analyzing the general ledger, the auditor may identify journal entries with odd characteristics that may indicate a higher risk of misstatement due to fraud or error (**table 9.3**). This is especially helpful when a client maintains its general ledger using only automated procedures. Besides supporting the risk assessment, this helps make journal entry testing more efficient and effective. This is primarily because using ADAs to analyze journal entries enables the auditor to review the entire population rather than just a sample with relative ease and speed. Functions to sort, filter, and look up particular journal entry characteristics are readily available in programs used for analytics. They can even be found in commonly used programs such as Excel. In some cases, per CAS 315, when only automated procedures are used to maintain the general ledger and prepare the financial statements, entries may exist in only electronic form and therefore may be more easily identified through the use of automated techniques, such as ADA.

TABLE 9.3 **Planning the ADA testing of the general ledger**

Purpose	Account and Assertion	Data Required	ADA to Perform
To analyze the general ledger to extract and test the appropriateness of the underlying journal entries to assess the risk of material misstatement due to fraud or error	Various accounts • Existence, occurrence, accuracy, cut-off, completeness	• General ledger data for the period under audit to the date of the audit report	• Conduct a variety of tests to identify journal entries with unusual characteristics, such as entries posted during holidays

To review journal entries, the same five steps are used as outlined previously. To summarize, let's revisit each step required when carrying out ADA testing and apply it to general ledger testing.

1. *Plan the ADA*. As already noted, there should be a planned purpose for the testing and scope of review. For example, the general ledger may be analyzed in order to extract and test the appropriateness of the underlying journal entries. The auditor will perform a variety of tests to look at such things as the amounts, timing, and accounts used for posting journal entries. For example, an auditor may look for transactions just below, at, or above transaction approval thresholds, entries posted by unauthorized individuals, and entries posted outside of regular work hours, such as weekends and holidays. These tests are performed to identify entries that appear unusual and may indicate a higher risk of fraud or error. It is important to remember that the focus of the ADA should align with the understanding the auditor gained about the internal controls for recording journal entries, closing procedures, and the financial reporting process.
2. *Access and prepare the data*. It is generally easier to prepare the general ledger data than other data produced by a client, because a consistent format is required for capturing and processing each journal entry as part of the accounting system design. Regardless, data

cleansing may still be required to eliminate duplicate lines, or formatting concerns that will prevent the successful performance of an ADA.

The data file should reflect the entire fiscal period under review after all year-end postings have been confirmed as completed by the client. The auditor can compare the opening balances in the general ledger file with the previous year's ending trial balance, as well as the current trial balance, in order to validate the completeness of the data. The auditor can also total the debits and credits by account to arrive at a net amount for comparison with the current trial balance. It would also be appropriate to capture entries close to the beginning and end of the fiscal year, and up to the date of the audit report, to support specific testing of the cut-off assertion and to confirm that transactions have been recorded in the correct accounting period. The auditor should review the sequential ordering of the journal entries posted to further ensure the completeness of the dataset.

3. *Consider the data's relevance and reliability*. Since the purpose of the ADA is to test the appropriateness of the general ledger and the underlying journal entries, a direct data extract from the system would be deemed relevant for the test. The data extraction should include the journal entry account number, transaction date, posting codes, vouchers, who created the journal entry, and the amount of the journal entry.

   Ideally, an auditor would obtain direct read-only access to the system. This will allow them to export the data from the accounting system themselves and, in doing so, significantly reduce the potential for bias. Recall that the data's reliability and the persuasiveness of evidence increases when an auditor can obtain it directly. If an auditor relies on the client to generate the data and then provide them for testing, there is a potential for the file to be manipulated by adding or removing data, or for the file to reflect only what the client *thinks* the auditor requires.

4. *Perform the ADA*. Performing analysis on the journal entries and the general ledger requires several different criteria to be considered given the variety of exceptions that could indicate an error or misstatement. The general ledger acts as an excellent form of evidence to substantiate the responses obtained from management during inquiry, as well as overall support for the fairness of the financial statements. If the financial statements are intentionally misstated due to management override, it likely involves manipulation of the financial reporting process, often through the inappropriate recording of journal entries included in the general ledger. Therefore, the auditor will conduct a wide variety of tests to identify unusual entries.

   Table 9.4 provides a list of items the auditor might seek to identify in the ADA to investigate further for appropriateness as determined by the related assertion.

TABLE 9.4 Possible tests to perform to identify inappropriate entries

Review the Journal Entry to Identify the Following Items	Assertion
Unbalanced journal entries	Completeness
Items posted outside of regular work hours and scheduled processing times (holidays, overnight, weekends)	Occurrence
The nature and volume of entries before and after year end	Cut-off
Entries that fall below key approval limits (these should also consider aggregate recurring entry totals that would be above a threshold but when split up, fall below approval limits)	Existence and occurrence
Entries posted by unauthorized users	Existence and occurrence
Significant value journal entries	Accuracy
Items posted or approved by authorized users during their leave periods	Existence and occurrence
Lack of segregation of duties between the individual who posted and approved the entry	Existence and occurrence
Entries that indicate a potential adjustment or reversal (often noted by use of such words in the description)	Accuracy
Entries that are rounded	Occurrence
Entries posted to rarely used accounts	Classification

5. *Evaluate the results.* As with any ADA, the final step will be to evaluate the results of the test and to form a conclusion. A list of notable items should be summarized and categorized by type of exception noted. Since there were several criteria used, as outlined in table 9.4 in step 4, failing to group them will result in either inefficient or ineffective follow-up. There may be themes that can be identified and potential causes that the auditor can consider as part of their evaluation. By grouping items into themes and considering what could have led to the notable item, the auditor will have a more focused and informed follow-up testing program with the client. For example, if entries were identified as posted by an otherwise authorized individual during their leave period, was it a scheduled recurring entry such as depreciation and amortization, or is the leave period originally obtained correct? It is especially important to remember that auditors should always be alert to the potential for fraud and act with professional scepticism by critically assessing all audit evidence, including evidence gathered from ADAs.

As an example, an auditor conducted a test searching for journal entries posted at odd times—on weekends and holidays—and the results were presented in a visual, as shown in **figure 9.10**.

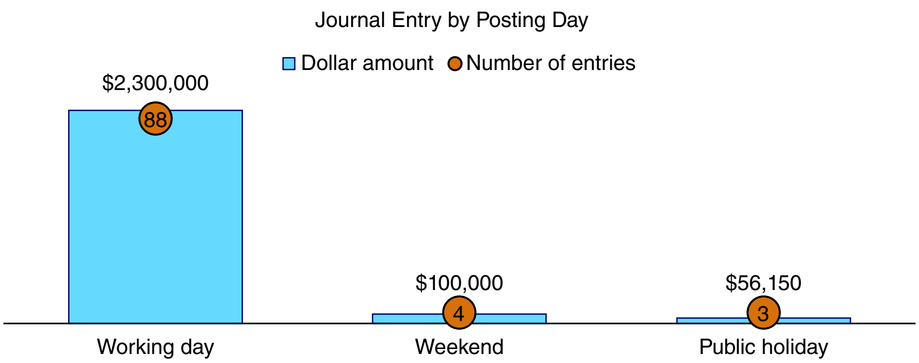


FIGURE 9.10 **Visualization of journal entries posted at odd times**

Based on this visual, the auditor determined there were seven entries that required further examination due to the unusual times they were recorded. Four were booked over the weekend and three were posted over public holidays. Let's look at an example for one group of exceptions, those posted during public holidays, which are presented in **table 9.5**.

TABLE 9.5 **Details of holiday posting**

General Ledger Posting Detail

Batch #	GL Date (MM/DD/YY)	Account	Account #	Debit	Credit	Auth
10814	07/01/23	Bank Fees	4010	75.00		LDL
10814	07/01/23	Cash	1050		75.00	LDL
10815	07/01/23	Accounts Receivable	1070	550.25		LDL
10815	07/01/23	Bank Fees	4010	25.00		LDL
10815	07/01/23	Cash	1050		575.25	LDL
11902	12/25/23	Wages Expense	4040	55,000.00		LDL
11902	12/25/23	Cash	1050		55,500.00	LDL

Table 9.5 reflects a listing of entries for which the posting date matched the date value of a holiday during the year (and thus outside of scheduled working periods). The entries on July 1, 2023, batches 10814 and 10815, are likely related to the monthly bank reconciliation activity. However, it is unlikely that the statement would already have been received and reviewed the day after month end. It is also unusual that it would have been considered an urgent priority to be performed on a statutory holiday (Canada Day). Batch 11902 posted on December 25, 2023, is highly suspicious because it is a direct entry to wages expense, is a rounded amount, and there are no associated withholding taxes. Additionally, wages expense would be incurred and then offset with a liability (wages payable) and not immediately paid in cash. The auditor will need to investigate these exceptions further and determine the validity of the transactions. While other tests will be performed, based on the results of this test, the auditor has increased the risk of material misstatement and plans to modify the testing as a response.

Now that you know the five steps of ADA, you may be wondering: how is this used in practice? Professional Environment 9.2 looks at how data analytics are being used in Canada.

9.2 Professional Environment How Data Analytics Are Being Used in Audits in Canada

The move toward audit data analytics is being viewed as a necessary response to the "disruption" that auditors face as clients adopt advances in technology. To help auditors, CPA Canada formed an Audit Data Analytics Committee to "conduct research and deliver quality thought leadership and guidance in audit data analytics."

While ADAs are evolving, it is interesting to see where things stand with ADAs today. To do this, the CPA's ADA committee surveyed nine public accounting firms about how they were using audit data analytics. The survey found that ADAs were mostly used as risk assessment procedures for entities with revenues of more than $25 million. Almost all of the respondents indicated they used ADAs for journal entry testing. Three of the nine respondents said they used ADAs for process mapping, document matches, general ledger analysis, and scanning data populations for various attributes. Two respondents said they used ADAs for aging and churn analysis for various accounts and changes in types, prices, and quantities of inventory items.

Based on this survey, CPA Canada concluded that ADA was not yet widespread in Canada. The greatest challenge reported was "with extracting the data—both the right data for the ADA and in the right format for the tool being used. This was further complicated when the entity used more than one ERP system." However, the survey also found that all respondents were committed to expanding the use of ADAs. Most felt that ADAs helped improve the identification and assessment of risks and helped with substantive procedures where there were large amounts of data. They felt that benefits were gained from looking at entire populations as they led to greater insights that they could share with management. Lastly, respondents reported that the ADAs and visuals helped communicate with those responsible for governance. As a result, survey respondents reported they were looking for more ways to use ADAs in the future.

Q: What are additional challenges small firms might encounter in implementing the use of ADAs?

Sources: "An Inside Look at How Auditors in Canada Are Using Data Analytics," CPA Canada, April 2019; "CPA Canada's Audit Data Analytics Committee: Its Mission, Key Activities and Members," CPA Canada, n.d., available at www.cpacanada.ca/en/business-and-accounting-resources/audit-and-assurance/canadian-auditing-standards-cas/publications/cpa-canada-audit-data-analytics-committee.

Cloud 9 Integrated Case

Josh and Sharon have no reason to believe there will be issues with Cloud 9 data. They have noted that the financial statement data were collected with one system and are consistently formatted. They meet to consider planning an ADA relating to journal entries for the Cloud 9 audit. They decide to use Tableau to create a visualization of the journal entries posted during the year. They decide to examine a variety of attributes, such as journal entries made at odd times and days, number of journal entries by person and by dollar amount, round dollar amount journal entries, and journal entries posted to odd accounts. They plan to create a variety of visuals and to summarize the test results. Their goal is to identify journal entries to assess the risk of fraud and material misstatement.

Before You Go On

9.3.1 What are the five steps an auditor could use to plan, perform, and evaluate an ADA?

9.3.2 What is a false positive?

9.3.3 What should the auditor do when they find a large number of notable items?

9.4 Audit Data Analytics as a Substantive Analytical Procedure

LEARNING OBJECTIVE 4

Illustrate how audit data analytics can be used as a substantive analytical procedure.

As discussed earlier in this chapter, ADAs can be used to perform substantive analytical procedures. Analytical procedures are the evaluation of financial information made by the study of plausible relationships among financial and non-financial data. For example, a common analytical procedure often involves evaluating the current-year payroll expense using the number of employees and the average rate of pay. Other examples of relationships that could be considered for substantive analytical procedures are the number of website visits to sales for an online retailer, the number of airline customers to airline costs, and retail square feet to retail sales.

Substantive analytical procedures were considered in a prior chapter. Recall that to meet the requirements of CAS 520, an auditor should use his or her knowledge of the business and develop an expectation for the ADA. The expected amount or balance can then be compared with the actual amount or balance for reasonableness. Regression analysis is a predictive analytic technique that allows the auditor to use a mathematical formula to determine an expected amount.

9.4.1 Regression Analysis

As stated, regression analysis allows the auditor to express a relationship between variables as a mathematical formula. This formula can then be used to develop an expected account balance. This expected amount is then compared with the client's actual account balance.

When using regression analysis, the auditor needs to identify the dependent and independent variables. The **dependent variable** is the item to be predicted or the account being audited, and the **independent variable** is the predictor. For example, if conducting a regression analysis for a retail store using square feet to predict sales, the square footage would be the predictor or the independent variable, and sales would be the dependent variable. With a regression analysis, the independent variable can be internal or external, and financial or non-financial. An internal financial predictor would be cost of goods sold used to predict sales. An internal non-financial predictor would be the number of airline passengers to predict airline expenses. An external financial predictor would be any published financial information, such as interest rates or share prices.

dependent variable the item to be predicted or the account being audited in a regression analysis

independent variable the predictor in a regression analysis

While there are many regression models, a **linear regression** presents one dependent and one independent variable as a mathematical equation. **Multiple regression** analysis is similar to a linear regression, but involves more than one independent variable. Regression analysis tends to be suitable for clients with a high volume of repetitive transactions, and where a relationship between variables exists. For example, a regression analysis is likely appropriate for a retailer where store square feet can be used to predict revenue. It is likely not suitable for a construction company with one long-term contract for the year.

linear regression a regression analysis that presents one dependent and one independent variable as a mathematical equation

multiple regression a regression analysis that presents more than one independent variable

An Example of Regression Analysis

Let's look at an example of an ADA using regression analysis. Dark Brew Inc. operates a chain of 25 coffee shops across Canada, and it has annual revenues of approximately $250 million. The company sells baked goods and a variety of beverages. Hot and cold coffee beverages account for approximately 85 percent of its sales. Dark Brew Inc. has a December 31 year end. It is a repeat engagement for the auditor. Given the auditor's past history with the entity, the auditor decides to perform a regression analysis as a substantive analytical procedure to forecast beverage sales for the year under audit. The auditor has already tested the internal controls over sales and cash receipts and found them to be effective.

The auditor follows the ADA five-step process as follows.

1. *Plan the ADA.* The auditor is planning to perform an ADA to obtain moderate assurance over sales. The related assertions are occurrence, completeness, and accuracy. The auditor has decided to use regression analysis to forecast sales by month for the year under audit to compare with the actual monthly sales to assess if there may be a material misstatement. At this stage, the auditor should determine the dependent and independent variable(s) and the acceptable difference. Generally, the acceptable difference would not exceed performance materiality, as any difference should be small enough to identify misstatements that individually or in total could result in a material misstatement.

   In this case, the auditor is planning to perform a linear regression using the number of kilograms of coffee beans purchased, which is the independent variable, to predict the dependent variable, sales, the account under audit. **Table 9.6** shows the planning related to the ADA regression analysis.

TABLE 9.6 **Planning the ADA regression analysis**

Purpose	Account and Assertion	Data Required	ADA to Perform
To predict sales by month for the year under audit and compare with the actual monthly sales to assess if there is a material misstatement	Sales: occurrence, completeness, accuracy	• Sales data by month for the last three years • Number of kg of coffee purchased by month over the last three years	To conduct a linear regression analysis to forecast sales based on the kilograms of coffee purchased

   The auditor plans to use four years of monthly sales. The sales data will be obtained from the accounting department. The auditor also requires data regarding the kilograms of coffee purchased. Given the volume of coffee that Dark Brew purchases, it has a contract with one coffee supplier to get the best possible purchase price. The coffee data will be obtained directly from the coffee supplier. These data will be provided by month over the same time period.

   While planning the substantive analytical ADA, the auditor determines an acceptable difference. CAS 320 indicates the auditor determines performance materiality to assess the risk of material misstatement and to determine the nature, timing, and extent of further audit procedures. Therefore, the auditor determines performance materiality is appropriate as an acceptable difference, which for this engagement is $1.5 million. If the difference between the expected amount and the actual amount is negative, it indicates sales could be understated. If the difference is positive, then there could be a potential sales overstatement.

2. *Access and prepare the data*. The monthly sales data are obtained from the accounting department and downloaded into an Excel file. The kilograms of coffee delivered is obtained from the coffee bean supplier, also in an Excel file. To ensure the sales data file is complete, the auditor agreed the sales data file over the last four years to the prior years' audited sales figures. For the current year, the total sales figure in the sales data file was agreed to total sales in the trial balance. The auditor compared the total kilograms of coffee beans purchased per the client's records with the total coffee beans in the supplier's spreadsheet and determined the amounts agreed. The auditor determined the data were clean and complete and moved on to assessing the relevance and reliability of the data.

3. *Assess the data's relevance and reliability*. The auditor is aware that the information was produced from a strong system of internal controls and plans to test these controls. The auditor concludes the sales data are reliable.

   The kilograms of coffee beans delivered by the supplier is the selected predictor of sales for the year. This is a non-financial external predictor. Because it is external evidence, it is more reliable than an internal measure. The auditor concluded the coffee bean data are sufficiently reliable for the moderate level of assurance required from the test, and proceeded to conduct the test.

4. *Perform the ADA*. This step involves building the model and performing the test. There are several software tools that can be used to conduct the regression analysis. In this example, the auditor used Microsoft Excel. The auditor first prepared a scatterplot, as presented in **figure 9.11**, to get an understanding of the data and to assess whether there is any seasonality in the data that needs to be considered.

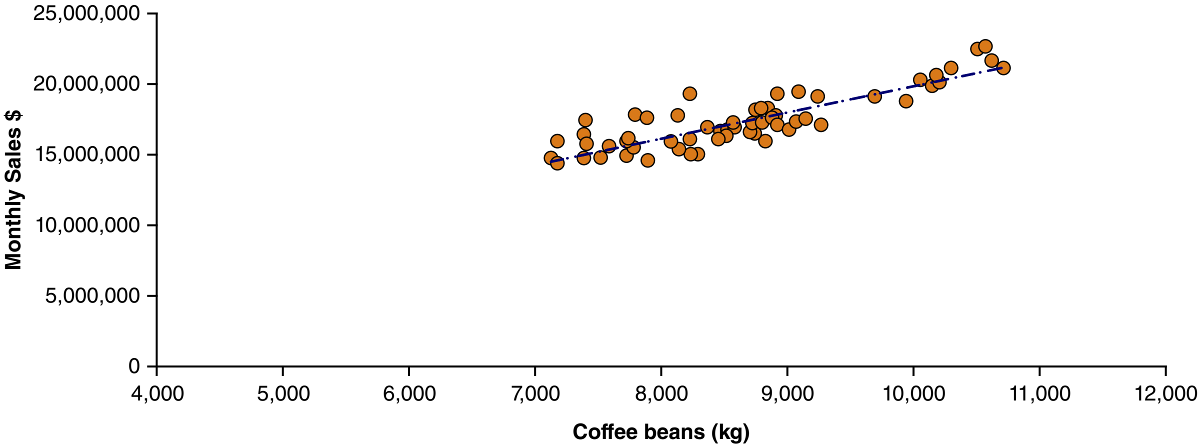


FIGURE 9.11 **Scatterplot of sales and coffee beans purchased**

The auditor confirms there appears to be a linear relationship and there does not appear to be any seasonality in the data. The following is the regression equation:

$$\text{Predicted sales} = (1{,}858.3 \times \text{kg of coffee}) + 1{,}240{,}936$$

At this stage of the regression, it is appropriate to assess the quality of the model. This was done by reviewing the correlation coefficient and the standard error of the model. The correlation coefficient was 0.76, which indicated a fairly strong relationship between the data. The auditor also noted the standard error was less than performance materiality, which provided additional confidence regarding the model. The auditor then used the regression formula to develop the predicted monthly sales and compared it with the actual monthly sales, as shown in **table 9.7**. The reasons why May and December are highlighted will be explained later.

TABLE 9.7 **Results of regression model**

Month	Predicted Sales $	Actual Sales $	Difference between Predicted and Actual Sales $
January	21,219,236	21,803,231	583,995
February	20,387,247	21,137,433	750,186
March	20,863,750	20,257,895	–605,855
April	21,052,839	20,832,717	–220,122
May	**20,854,296**	**19,021,439**	**–1,832,857**
June	21,771,374	21,186,079	–585,295
July	21,574,723	21,672,099	97,376
August	20,737,061	20,788,500	51,439
September	20,332,412	20,791,218	458,806
October	19,978,816	20,113,914	135,098
November	20,423,174	20,994,356	571,182
December	**21,171,964**	**23,104,430**	**1,932,466**

5. *Evaluate the results*. The auditor compared the actual and the expected sales, and identified the differences. Recall that differences greater than performance materiality ($1.5 million) required follow-up. This resulted in two months requiring further examination: May and December (the highlighted months). The May sales are below the expected amount and December sales are above the expected amount. The differences found for the other months were within the acceptable difference and so no further work was required for these months.

   The auditor asked Dark Coffee Inc.'s management what might have caused the differences found in May and December. Management explains that in May, two of its coffee shops in British Columbia were being renovated. During this time, the drive-through at both locations was open for business but the eat-in restaurant was closed. This resulted in both locations showing lower sales during the partial closures. The auditor verified this explanation by reviewing the construction contracts and the construction invoices to confirm that renovations were indeed underway during this time. Using past sales data, the auditor also quantified the May sales that related to the in-store dining in the past three years. This amount was compared with the decline in sales. The auditor found that this explanation accounted for most of the difference. The auditor concluded the decrease in sales was reasonable and not due to a misstatement.

   For December, where sales were greater than the expectation, the auditor also obtained an explanation from management. Management explained that they introduced several specialty beverages for the holiday season, which they sold at a higher selling price. The auditor drilled down to examine the sales by product during December. The auditor found that when quantified, the new product did indeed account for most of the increase in sales. However, because there is a greater cut-off risk in December, the auditor decided to perform additional cut-off testing to be sure there was no material misstatement.

Cloud 9 Integrated Case

After identifying the high-risk journal entries to further examine, W&S Partners are now looking at other areas where they might use ADAs. Jo Wadley recently read about the use of regression analysis in auditing as a data analytics technique. She has approached Sharon and Josh and asked them to consider using regression analysis with Cloud 9. They aren't sure how to get started, so she reminds them of the purpose of regression analysis. She encourages them to brainstorm areas of the audit where relationships are logical and readily apparent. They will then need to identify an appropriate dependent and independent variable for that area to perform the regression analysis. As a result, Josh and Sharon brainstorm some areas and arrive at potential use of regression analysis for Cloud 9 sales. What variables might they use for Cloud 9 and with what purpose?

Before You Go On

9.4.1 How can a regression analysis be used in an ADA?

9.4.2 When a regression analysis is used in auditing, what is the independent variable?

9.4.3 How does regression analysis identify a notable item?

9.5 Audit Data Analytics as a Substantive Test

LEARNING OBJECTIVE 5

Illustrate how audit data analytics can be used as a substantive test.

9.5.1 Substantive Testing

As we have seen, ADAs can be used as risk assessment procedures and substantive analytical procedures. They can also be used as tests of details. Recall that substantive testing involves corroborating transactions and balances in the accounting records. These tests are performed to detect a material misstatement at the account and assertion level. When performing tests of details on large populations, auditors have typically used sampling. Even when using sampling, tests of details can be very detailed, time-consuming work. As noted, an advantage of using an ADA as a test of details is that it may allow the auditor to test 100 percent of a population relatively quickly. This provides the auditor a higher level of assurance regarding the risk of material misstatement while reducing the time needed to perform the test.

Before performing an ADA as a substantive test, the auditor has already assessed the inherent risk and control risk at the account and assertion level, as required by CAS 315. Also, before performing substantive tests, the auditor has likely tested the controls and concluded that the entity has strong IT general controls, strong IT application controls related to the assertion being tested, and strong controls over electronic data interchange and the exchange of electronic information about a transaction between the client and its customers or suppliers.[5]

9.5.2 ADA Example of Accounts Receivable and Revenue

We will now provide an example of an ADA performed as a test of details on accounts receivable and service revenue. W&S Partners is testing the accounts receivable for a shipping company, Goods to You Inc., that offers shipping and delivery services to wholesalers and distributors across the country. The company provides shipping and delivery services that produced service revenues of approximately $85 million and accounts receivable of $16.2 million during its last fiscal year. W&S Partners sent out accounts receivable confirmations as part of their audit procedures; however, few were returned. As a result, the audit team performed alternate procedures. They decided to compare the invoices issued with the cash received for the year under audit. If the cash had been received for the services provided, then it would provide evidence as to the occurrence of the service revenue and the existence of the accounts receivable at year end.

Goods to You Inc. had a December 31, 2023, year end and the audit started in mid-April 2024. When planning the audit, W&S Partners assessed the inherent risk as moderate to high because of the volume of sales transactions. The auditor tested the controls over sales and cash collections and determined they were effective; therefore, control risk was assessed as low. Performance materiality for the engagement was set at $425,000. W&S Partners applied the five-step process to plan, perform, and evaluate the ADA as follows.

1. *Plan the ADA*. The purpose of the ADA is to perform a test of details on accounts receivable and service revenue. The test will provide evidence over the existence of accounts receivable at year end and the occurrence of sales during the year. The data needed is a listing of all sales invoices issued during the year, from January 1 to December 31, 2023. The auditor also needs the cash receipt data for the year as well as the cash receipts subsequent to year end (from January 1 to March 31, 2024), when the accounts receivable would have been collected. The required data will be provided by the accounting department. Table 9.8 shows information on performing a test of details on accounts receivable and service revenue.

TABLE 9.8 Planning the ADA test of details on sales and accounts receivable

Purpose	Account and Assertion	Data Required	ADA to Perform
To substantiate the accounts receivable at year end and the revenue during the year	Accounts Receivable: existence Sales: occurrence	• Listing of all sales invoices issued for the year including sales details such as invoice date, invoice number, and invoice amount • Cash receipts for the year • Accounts receivable listing at year end • Cash receipts from Jan. 1 to March 31 subsequent to year end relating to the prior year	• To corroborate service revenue during the year by matching invoices issued during the year with the cash receipts • To corroborate the accounts receivable at year end by matching subsequent cash receipts

2. *Access and prepare the data*. The auditor obtained the data from the client and tested them for accuracy and completeness. W&S Partners tested for duplicate invoices and duplicate cash receipts. They assessed completeness by testing the numerical sequence of invoices and cash receipts. Members of the audit team also reviewed for incomplete, incorrect, or missing fields and concluded there were no significant data issues.

   The auditor then reconciled data files provided to the accounting records to ensure the completeness of the data. The auditor agreed the cash receipts listing to the cash receipts journal. The auditor then adjusted the data to isolate the cash receipts that related to customer sales for the year.

   Figure 9.12 is the total cash receipts relating to 2023.

	For the year ended Dec. 31, 2023
Cash receipts per cash receipts journal	$95,697,973
Less: Cash received during the year for bank loan	10,000,000
Less: Cash received during the year for the sale of assets	1,270,000
Cash received for sales to customers	$84,427,973

FIGURE 9.12 **Total cash receipts for 2023**

   W&S Partners rolled forward the accounts receivable balance and agreed the ending balance to the general ledger and the financial statements (**figure 9.13**).

Accounts Receivable, audited December 31, 2022	$15,306,667
Add: Sales to customers for 2023	85,358,695
Less: Cash collections from customers	(84,427,973)
Accounts Receivable balance, December 31, 2023	$16,237,389

FIGURE 9.13 **Accounts receivable balance at end of 2023**

3. *Assess the data's relevance and reliability*. The data were collected by the client's accounting information system. The auditor noted that the data generated are externally initiated and then processed internally. The auditor also assessed the general and application IT controls, as well as the controls over the revenue cycle. It was concluded the controls were effective. Because the data were processed under a system of effective controls, the auditor concluded the data were sufficiently reliable to continue to perform the test.
4. *Perform the ADA*. The fourth step is to perform the test. The auditor performed the test by using IDEA auditing software to determine the cash receipts received, as well as the cash receipts that did not agree to the invoice amount (both over and under). The test was performed for the invoices issued during the year and then again relating to the cash collected after year end relating to the accounts receivable.

   The auditor prepared **table 9.9** summarizing the test results.

TABLE 9.9 **Results of cash receipts matching test**

Category	Dollar Amounts	Percentage
Total sales for the year subject to matching	$85,358,695	
Cash = Invoice amount	68,366,916	80.09%
Cash < Invoice amount	473,596	0.56%

(continued)

TABLE 9.9 Results of cash receipts matching test (*continued*)

Category	Dollar Amounts	Percentage
Cash > Invoice amount	280,794	0.33%
Total cash collected	69,121,306	
No cash received	16,237,389	19.02%
	$85,358,695	
Total accounts receivable	$16,237,389	
Cash = Invoice amount	14,499,788	89.30%
Cash < Invoice amount	742,511	4.57%
Cash > Invoice amount	64,368	0.40%
Total cash collected	15,306,667	
No cash received	930,722	5.73%
	$16,237,389	

5. *Evaluate the results*. It was noted that 80.09 percent of the sales were collected during the year and the collected amount agreed exactly to the invoice amount. It was noted that some invoices were overpaid and others were underpaid, with a balance of 19.02 percent or $16.2 million of accounts receivable outstanding at year end. The auditor drilled down into the unmatched and unpaid amounts to identify if they represented misstatements and reviewed the groups for similar characteristics.

Where the cash received was greater than the invoice, the auditor scanned the exception report and noted the amounts were less than performance materiality. Upon inquiry, the auditor found that these items related to invoices that were either double paid or overpayments by various customers in error. The client indicated these customers were advised to apply the overpayments as payment for future services. The auditor concluded the overpayments did not impact the original assessment of internal controls. Since the total amount was not material, it was carried to the schedule of unadjusted errors to be reclassified as accounts payable.

Where the cash was less than the invoice amount, the auditor found the underpaid invoices related primarily to one customer that was disputing the invoices for delivery services at one of its busiest warehouses. The customer was not pleased because a number of deliveries were late and short paid the invoices relating to that one location. The client indicated that early in April they came to an agreement with the customer, and the customer agreed to pay a small portion of the amount owing and the client will write off $325,000 of the balance. The remaining $930,722 that was unpaid related to a number of outstanding invoices for various slow-paying customers the client believed it would collect, except for $394,353 relating to outstanding invoices from a customer that no longer used the Goods to You Inc. shipping and delivery services. The auditor discussed this amount with the client and the client agreed this was unlikely to be collected.

The auditor concluded there is a possible valuation error of $719,353 ($325,000 + $394,353). This amount was carried to the schedule of unadjusted errors and the auditor will ask management to make the necessary adjustment.

9.5.3 ADA Example of Payroll

ADAs are also effective when using matching techniques to test payroll transactions and balances. We will revisit the AthleticsWear audit being performed by W&S Partners. The audit team is planning an ADA to gather evidence to support the occurrence assertion for wage expenses. Since there is a risk related to payroll in terms of fraudulent payments, they will also address this risk with the ADA procedures. W&S Partners will perform the ADA using the five-step process.

1. *Plan the ADA*. The purpose of the ADA is to perform a test of details on wages expense. The test will provide evidence over the occurrence of wage expense during the year; that is, the hours worked agree to the hours paid, and all payments made were to actual employees during the year. The data needed are in the weekly payroll register from January 1 to December 31, 2023. The auditor also needs the timesheet data for the same time period. (Employees electronically enter their hours worked and this is centrally maintained.) W&S Partners has also identified the need to obtain the employee master file from human resources, which includes individual status (e.g., start date, termination date), wage rate, and demographic information. **Table 9.10** shows information on planning the ADA as a test of details on wages expense.

TABLE 9.10 Planning the ADA test of details on wages expense

Purpose	Account and Assertion	Data Required	ADA to Perform
To substantiate the payroll expenses for the year	Wages Expense: occurrence	• Weekly payroll register files for the year from January 1 – December 31, 2023 • Weekly timesheet data for the year from January 1 – December 31, 2023 • Wages Expense at year end • Employee master file • Organizational chart • Security access log (indicates employees with permitted entry status)	• To corroborate wages expense recorded during the year by: • matching the hours worked to the hours paid by matching the payroll register files to the timesheet entries • comparing payroll register files to the employee master file to confirm active status at time of payroll transaction

2. *Access and prepare the data*. The auditor obtained the data from the client and tested it for accuracy and completeness. W&S Partners tested for duplicate entries for which there were no exceptions, and also assessed completeness by testing the numerical sequence of payroll transactions. Members of the audit team reviewed for incomplete, incorrect, or missing fields and identified the following items:
   - Date formats differed between the two files (the register and timesheet data). This resulted in the need to change both files to reflect a similar format for ease in comparison of DD-MM-YYYY.
   - The ID fields in the timesheet data is based on a free form text field and sometimes included an actual '#' sign as a prefix. All '#' signs had to be removed for the IDs to be cross-referenced with the payroll register.
3. *Assess the data's relevance and reliability*. The data were collected by W&S auditors by directly exporting the payroll transactions from the client's system. Controls were deemed to be effective for the payroll cycle and as a result the auditor concluded the data were sufficiently reliable to continue to conduct the test.

   To make sure that the data provided are complete, and therefore the file is appropriate for testing, the auditor agreed the total wage expense in the payroll register to the wages expense reported in the general ledger. The auditor also ensured the weekly timesheet files started January 1 and ended December 31 to make sure that the full year was included in the data obtained.

   To verify the employee master file, the auditor reconciled the total number of employees with an "active" status with the organizational chart, and then to the security access logs. (This outlines the number of individuals with permitted entry to the building.) By performing this three-way match, the auditor is able to determine the completeness of the employee population.
4. *Perform the ADA*. The auditor first performed the ADA by completing the following steps using auditing software:
   - Summarized the payroll data by week in both the timesheet file and the payroll register file (**table 9.11**).
   - The totals were then compared first by week, and then by employee ID to identify any exceptions (non-matching amounts).

TABLE 9.11 Summarized payroll and timesheet data

Payroll Register Data (A)		Timesheet Data (B)		Result (A) – (B)
February 14–20, 2023	$18,192	February 14–20, 2023	$17,879	$313
ID 819	$1,200	ID 819	$1,200	$0
ID 820	$923	ID 820	$923	$0
ID 821	$1,235	ID 821	$922	$313

A second test was performed to ensure all payments made were to actual employees. This test used the employee master file as the basis. The steps conducted were:

- The auditor searched for any new employees added during the year by start date and isolated their ID number. Using the employee ID number, the auditor then compared the start date recorded in the master file with the date of the first payment associated with that ID in the payroll register.
- All employees with a "terminated" status were identified by ID and by termination date. For any employees who had a terminated date prior to the fiscal period, the auditor ran a search of all payroll transactions to confirm there were no matches or payments made. For employees who had a terminated date that occurred during the fiscal period under review, the auditor used the ID and effective date of termination to isolate whether any payroll transactions occurred after the termination date.

5. *Evaluate the results*. The auditor prepared a table summarizing the test results, where the total weekly payroll was compared with the weekly timesheet total for the entire year (52 weeks). The exceptions found are shown in **table 9.12**.

TABLE 9.12

Test 1 – Non-matching totals

Date	Weekly Payroll Register Data Total	Weekly Timesheet Data Total	Description of Exception
February 14–20, 2023	$18,192	$17,879	$313 – ID #821
June 6–12, 2023	$18,398	$19,983	$(1,585) – ID #680
June 13–19, 2023	$19,983	$18,398	$1,585 – ID #680
June 20–26, 2023	$19,101	$18,902	$199 – ID #165

Test 2 – Employee Master File Exceptions

Date	Weekly Payroll Register Data ID Search Results	Employee Status in Master File	Description of Exception
June 6–12, 2023	No record found	Active	ID #680 Start date June 8, 2023
June 20–26, 2023	Record found	Terminated	ID #165 End date December 31, 2021

In the first test, there were four exceptions noted. The first exception appears to be an error related to employee ID #821 in the amount of $313. There is no immediate explanation for this item and as a result, it will need to be investigated further by the auditor.

The second exception in the first test, a difference of $(1,585) during the week of June 6–12, 2023, appears to indicate a possible underpayment to employees based on the actual payroll register totals to that of the timesheet data. Based on the auditor notes in the description column, the exception is attributed to employee ID #680. This employee ID also came up as an exception in the second test performed. According to the timesheet data, employee ID#680 worked during their first week, June 6–12, 2023; however, there was no corresponding data (evidence of pay) on the payroll register for that week. We are able to see from the third exception that the same ID appeared to be overpaid in June 13–19, 2023. While it would be logical to conclude that the employee had a delayed first payment (which at times occurs to allow for updates to the system upon hiring), further investigation would be appropriate to validate the accuracy of the payments to employee ID #680 for the period June 6–19, 2023. It would be appropriate for W&S Partners to follow up to verify the paperwork on file for the employee's start date and actual timesheet, to verify the accuracy and completeness of the full payment.

The fourth exception in the first test appears to be an overpayment attributed to employee ID #165. The second test also noted an exception for this ID. By performing two comparisons as part of the ADA, the auditor identified a red flag for fraud risk. During the week of June 20–26, 2023, an employee with a terminated status, ID #165, appears to have been paid. The auditor at W&S Partners will need to follow up with management of the area to investigate further. An elevation in fraud risk will result in a higher overall audit risk for the engagement. The purpose of investigation with management should be to obtain clarity on why a terminated ID would have been active for that period of time (such as an individual temporarily rehired, or an incorrect termination date) and supported by corroborative evidence. If it is determined upon evaluation of the evidence that fraud has likely occurred, control risk is also elevated. All fraud, regardless of quantitative materiality, must be communicated by the auditors. Furthermore, CAS 450 indicates that misstatements may not be isolated and that where the auditor identifies a misstatement, they should consider that it may be the result of a breakdown in internal controls. Therefore, it would also be appropriate for the auditor to consider the impact of this error on internal controls.

Before You Go On

9.5.1 What is an advantage of using an audit data analytic as a substantive procedure?

9.5.2 What do exceptions indicate when performing an ADA as a substantive procedure?

9.5.3 What data are needed when performing an ADA in wage expenses?

9.6 Features of a Good Visualization

LEARNING OBJECTIVE 6

Describe the features of a good data visualization.

As previously mentioned, visualizations are often used to communicate the results of an ADA. In many of the examples provided, we have been able to interpret large amounts of data and summarize test results in a fast and easy-to-understand manner because often a visualization of data can be interpreted more quickly than a data table. As part of the ADA planning, the auditor decides what type of visual will best summarize the test results. Many software programs now make creating and modifying visualizations very easy.

In deciding the best visualization, the auditor needs to understand what the visualization is trying to communicate. Some visualizations are better for certain purposes. For example, bar charts tend to be good for comparisons, bubble charts are good to identify outliers, and line charts tend to be good to show changes over time. Pie charts are good for showing parts of a whole, such as expenses. Scattercharts are appropriate for regression analysis.

A good visualization stands alone: the user can understand it without any additional information. **Figures 9.14** and **9.15** present two visuals of the same data, created using computer software. While they both present two years of monthly sales for the same entity, they are clearly visually different.

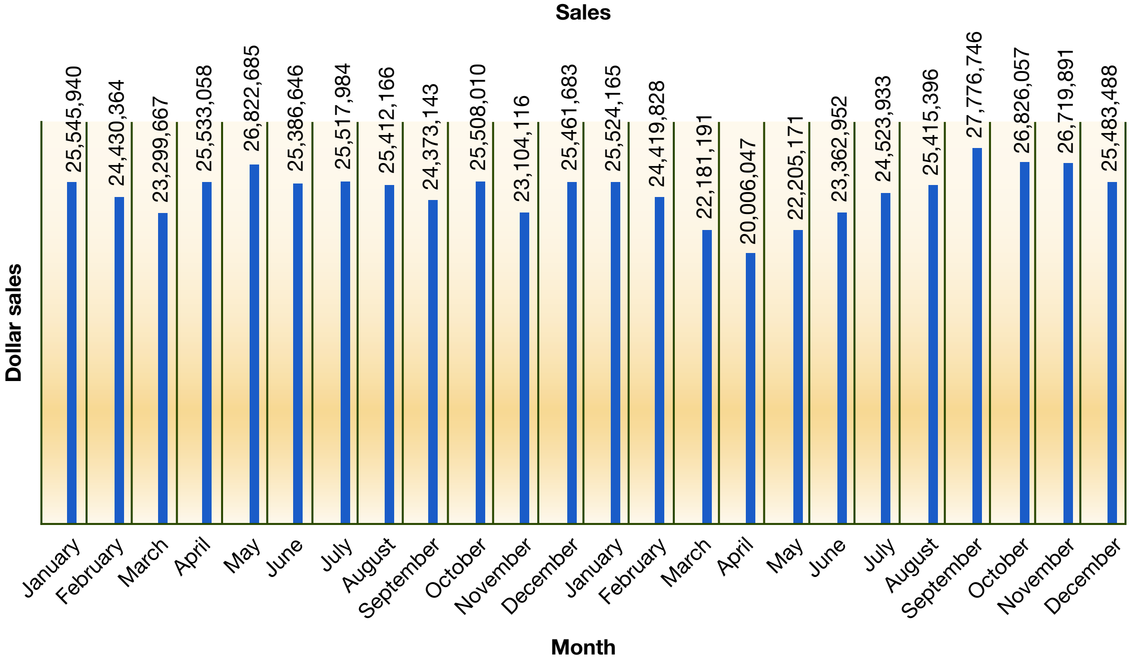


FIGURE 9.14 **Bar chart of monthly sales**

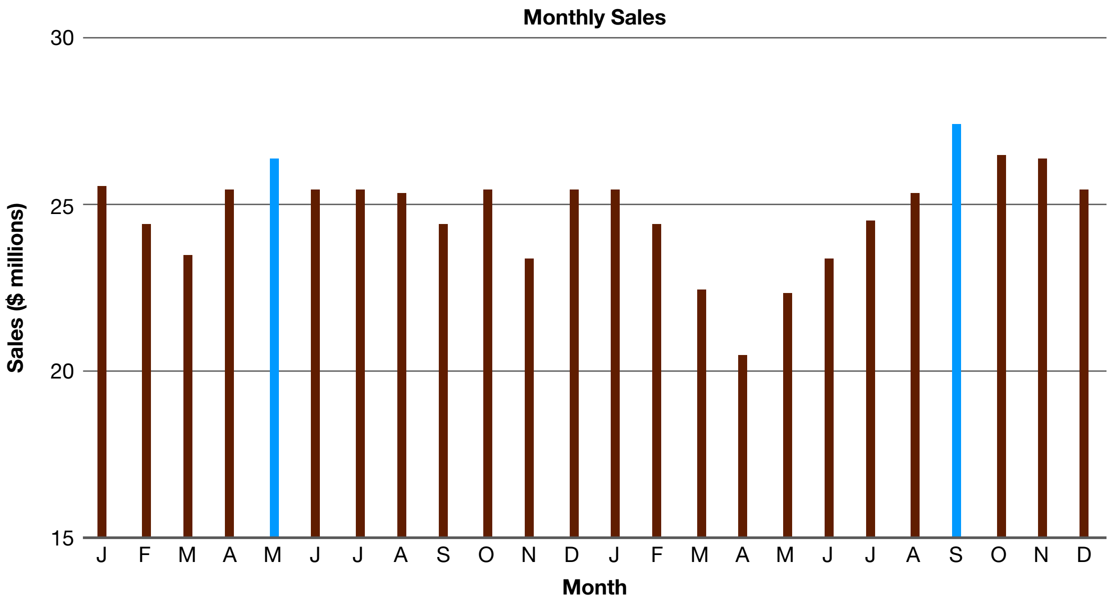


FIGURE 9.15 **Alternative bar chart of monthly sales**

The first visual is hard to read and difficult to interpret. The second is less cluttered and is easier to interpret. These visuals demonstrate key concepts with respect to visuals: the level of detail, axis scaling, and the use of colour can impact the effectiveness of the visual.

- **An appropriate level of detail.** An effective visual has the right level of detail. In **figure 9.14**, the title simply refers to sales and the x-axis refers to the months, and there are so many words and details, it appears cluttered and busy. In **figure 9.15**, the title clearly states the visual represents monthly sales, and the axes are clearly labelled. In this case, the user can understand what the visual is trying to convey by reading the heading and the axes. A good visual provides only the details needed, in an easy-to-read manner.

- **Appropriate axis scaling.** The axis for an effective visual allows the user to correctly interpret the data. In figure 9.14, the scale of the y-axis is too small and as a result, sales appear relatively stable. To compensate, the dollar amounts have been provided, which are adding to the clutter. By increasing the scaling in figure 9.15, sales fluctuations become evident. For a bar chart, if the scale is too small, significant fluctuations may remain hidden because the changes between the bars appear small. If the scale is too large, the bars will show a greater change and small fluctuations may appear significant.
- **A balanced use of colour.** An effective visual minimizes the use of colour except to draw the user's attention to significant items. It can be tempting to create colourful visualizations, especially given the tools available to do so; however, balance is required. When too much colour is used, it can be distracting, as in figure 9.14. Colour should be used to highlight key information, as in figure 9.15, where colour brings the user's attention to the months with the greatest sales. The choice of colour is also important. It is a good idea to avoid red and green, as users may be colour blind. Good visualization tends to use a maximum of two colours.

To summarize the considerations above, it is important to remember that when deciding what visualization to use, the auditor should:

- Understand the goal of the visualization.
- Provide the appropriate level of detail.
- Ensure the axis is the right scale.
- Minimize colour except to highlight key points.

Cloud 9 Integrated Case

Sharon would like to perform an additional ADA to substantiate the sales transactions for Cloud 9. She discussed alternatives with Josh and they decided they could possibly compare the sales data with the accounts receivable and cash receipts data to verify proper cut-off. By comparing the accounts receivable and cash receipt entries with the sales revenue by date, non-matching items (dates for which they do not net out to zero) would be considered notable items that they would follow up on to identify the accuracy of the transaction entries.

Before You Go On

9.6.1 How much detail should be provided for a visualization?

9.6.2 How might scaling impact the ADA?

9.6.3 What should the auditor consider when selecting colours for the ADA?

Summary

1 Describe audit data analytics, when they can be used during an audit, and some of the approaches available to perform these procedures.

Audit data analytics (ADAs) involve examining large datasets, usually using computer software, to look for trends, exceptions, and outliers. Often the test results are presented as visualizations. ADAs can be used at any stage of an audit. They can be used at the beginning of the audit during the risk assessment stage when the focus is on audit planning. They can be used during the risk response stage of the audit, as they can be used to conduct tests of controls, substantive analytical procedures, and tests of details. Lastly, ADAs can be used at the end of the audit as the auditor looks to complete the audit and performs analytical procedures to support the overall audit conclusion. Common techniques for ADAs include visualizations, matching, clustering, and statistical techniques.

2 Explain the key considerations related to data when performing audit data analytics.

Most ADAs involve structured data, which are in a fixed field or cell such as general ledger data. For an auditor to gain efficiencies, it is important that an ADA is well planned. This includes obtaining a read-only copy of the data from the client, understanding what data are available, and understanding the size of the data set. Data quality must be considered before performing an ADA. It is important that the data are in a consistent format, complete, and accurate, otherwise the data need to be cleaned before they can be used. The auditor should also consider the relevance and reliability of the data.

As with all audit work, documentation should be in sufficient detail to allow an experienced auditor to reperform the test and come up with the same results. As the auditor obtains, prepares, uses, maintains, and destroys the data, the data move through the data life cycle.

3 Describe the five-step process for performing an audit data analytic and apply this process when using audit data analytics as a risk assessment procedure.

It is important the auditor spend adequate time planning an ADA. A five-step process, including planning the test, preparing the data, assessing the relevance and reliability of the data, performing the test, and evaluating the test results, ensures an ADA is planned well. When performing an ADA, the auditor likely identifies notable items. When there are too many notable items to examine each one individually, the auditor should assess if there was an issue with the test design resulting in false positives. Once the auditor determines the notable items are not false positives, the auditor can then cluster and group the exceptions to identify those with similar characteristics and then perform more audit work on the clusters.

4 Illustrate how audit data analytics can be used as a substantive analytical procedure.

ADAs can be used to perform substantive analytical procedures. Regression analysis is an example. This is a predictive analytic technique that allows the auditor to use a mathematical formula to determine an expected amount to compare with the actual amount or account balance for reasonableness. When using regression analysis, the auditor needs to identify the dependent and independent variables. The dependent variable is the item to be predicted or the account being audited, and the independent variable is the predictor. The auditor needs to determine an acceptable difference, which is usually an amount less than performance materiality.

5 Illustrate how audit data analytics can be used as a substantive test.

ADAs can be used as a substantive test to corroborate transactions and balances in the accounting records. An advantage of using an ADA as a test of details is that it may allow the auditor to test 100 percent of a population quickly. This provides the auditor a higher level of assurance regarding the risk of material misstatement while reducing the time needed to perform the test. Substantive testing of ADA examples includes matching cash received to invoiced amounts and matching payroll transactions and balances.

6 Describe the features of a good data visualization.

Visualizations are often used to communicate the results of an ADA. In deciding the best visualization, the auditor needs to understand what the visualization is trying to communicate. A good visualization stands alone and conveys its message without any additional information. Preparing an effective visual also involves including the appropriate level of detail, colour, and axis scaling.

Key Terms

Self-Test Questions

Answers can be found in *WileyPLUS*.

9.1 An auditor performs an audit data analytic and compares current-year and prior-year general ledger accounts to identify significant trends. What type of data analytic is this?

a. descriptive
b. diagnostic
c. predictive
d. prescriptive

9.2 Taking data from two different sources and comparing them to identify exceptions relates to which one of the following ADA techniques?

a. visualizations
b. item matching
c. clustering
d. statistical techniques

9.3 Structured data is defined as:

a. data that reside in a fixed field within a record or file.

b. data that do not reside in a fixed database.

c. data that are heavily controlled by an organization.

d. data that would not be appropriate for relational databases.

9.4 Which of the following is a data error?

a. missing data

b. duplicate data

c. incorrect data

d. all of the above

9.5 The following represent key considerations in accessing data except:

a. understanding the data available.

b. the size of the dataset.

c. obtaining read-only access.

d. determining the accuracy of the data.

9.6 A false positive indicates:

a. higher probability of a material misstatement.

b. further testing is required.

c. an item was incorrectly identified as notable.

d. an item was correctly identified as notable but does not require further testing.

9.7 Which of the following is true when evaluating results of an ADA procedure and drawing conclusions?

a. further testing should not be required for ADAs in order to interpret results.

b. results should be interpreted by an individual with sufficient business knowledge.

c. it is not appropriate to engage the client to assist with interpretation.

d. documentation should focus on the output of the ADA and the final conclusion reached by the auditor.

9.8 The dependent variable in regression analysis is:

a. the item to be predicted or the account being audited.

b. the item known to be the predictor.

c. normally identified as an external factor.

d. not required for all applications of regression analysis.

9.9 Which of the following is false with respect to ADA as a substantive test?

a. the auditor can test the entire population.

b. the test may detect a material misstatement.

c. the five-step process to help plan the test is not applicable.

d. the auditor has likely concluded that the client has effective general it controls.

9.10 Which of the following visualizations would be best suited for identifying outliers?

a. scatterplot

b. pie chart

c. bar chart

d. bubblechart

Review Questions

9.1 Define audit data analytics.

9.2 What are four techniques that could be used to perform audit data analytics?

9.3 What are five things the auditor should document when performing an ADA?

9.4 Describe the five-step process an auditor should apply when planning and performing an ADA.

9.5 How can an ADA assist with the risk assessment during an audit?

9.6 If an auditor performs an ADA and identifies a significant number of notable items, what should they do?

9.7 What are some specific ADA tests that could be performed to identify unusual journal entries?

9.8 How can regression analysis be used as an audit test?

9.9 Give two benefits of using an ADA as a test of details.

9.10 List and describe three things the auditor should consider when designing a visual that will impact its effectiveness.

Professional Application Questions

Basic Moderate Challenging

9.1 Types of audit data analytic Basic **LO 1, 3**

The following are possible audit data analytics that an auditor could perform:

1. Analyze the inventory by SKU for a retailer to assess if there is a problem with net realizable value.
2. Develop a mathematical model to estimate retail sales using store square footage.
3. Match employee addresses and customer delivery addresses for potential fraud.

4. Evaluate the revenue recorded for a construction company using percent complete by comparing actual costs with budgeted costs.
5. Perform a detailed analysis of the changes to accounts receivable by customer to segregate new and repeat customers.
6. Perform a three-way match comparing the quantity sold, the purchase order, and the shipping document.

Required

For each of the above items, answer the following:

a. Is the ADA a risk assessment procedure, a test of control, or a substantive analytical procedure?
b. What financial statement assertion(s) is the test providing evidence over?
c. What specific data are needed to conduct each test?

9.2 Data insights **Basic** **LO 2, 6**

Figure 9.1 on page 9-4 provides a visualization and a data table.

Required

What questions would you have for your client regarding the information?

9.3 Relevance of data **Basic** **LO 2**

Hariet Hemingway, CPA, has identified an opportunity to use data analytics in her audit program. She remembers from a recent team training session that the data should be relevant and reliable but isn't sure how to apply relevance. She's approached you for clarification on how to apply the concept of relevance to audit data analytics.

Required

a. Describe to Hariet the importance of relevant data when using ADAs.
b. Hariet has returned to you to verify she is using relevant data. Her goal is to conclude on the accuracy of the payments made to vendors for the year. She has obtained a list of all purchase orders for the past two complete years and is going to verify that none are missing by analyzing the sequential purchase order numbers. She has also obtained the Accounts Payable general ledger balances and will compare these with the purchase order total by month. Provide Hariet with feedback on her approach.

9.4 Steps in the ADA process **Basic** **LO 2, 3**

Martha Godfrey, CPA, is including audit data analytics in an audit for the first time. Excited about what she has accomplished, she tells you that it was much easier than expected. She began by planning the ADA and made sure the relevant assertions would be covered. She then approached the client to request the data. At first the client indicated they would not have time to help with the data gathering. Upon further discussion, management assigned a recently hired member of their team who had the time available to walk through the requirements of the test to be performed and gather the necessary data. Martha and the new employee found a way to make the data gathering efficient. The employee found a report that is regularly run, which appeared to provide similar output to what Martha requires. They used that as the first point to extract data and then added some data from another report to provide Martha with what she needed. When preparing the audit budget, Martha suggested that the only area where additional time would be needed was for evaluating the ADA results. When the test was performed, there was a longer list of notable items than expected. In response, Martha sent a request to the client asking for explanations for each of the notable items. She is waiting for the responses. She is happy she has completed her first application of ADAs.

Required

a. What should Martha have considered before approaching the client to request the data?
b. Did Martha follow the five steps of ADAs? Suggest what she did correctly and/or what she should have done differently.
c. Besides asking the client for more information, how should Martha handle the long list of notable items?

9.5 Preparing data for ADA and data relationships **Challenging** **LO 2, 3, 6**

You have obtained a client's data file and you plan to use it to analyze the movement of the inventory and the provision for sales discounts to customers. To begin, you will need to access the Excel file Invoice data_cleansing located in *WileyPLUS*. Open the file, perform the following steps, and answer the related questions.

Required

a. Cleanse the data in the file by identifying and updating blank fields and ensuring that all values are in a consistent format for each field.

b. Add a calculated field to the worksheet labelled "Price per Unit." The field should calculate the price per unit for each invoice. Change the field to a currency format.

c. Create a line graph that will allow you to readily identify any notable items related to the price per unit. The x-axis should be invoice date.

d. Document the work you have performed in a working paper. Explain why a line graph was the visualization selected.

e. Evaluate the results and document your initial conclusions. You will likely want to refer back to the source data to understand the notable items.

f. What areas of the financial statements are likely to be impacted by these notable item(s)?

g. The auditor realizes the same data file can be used to understand the customer relationships and outliers in terms of pricing. Using the same data:

  i. Sort by the Customer Number field.

  ii. Using the subtotal function, calculate the average for each change in the customer number.

  iii. Create a radar style chart, which presents the data in a circular visualization, to identify customers with outlying average purchase prices (both below and above average).

  iv. What impact might the above information have on your audit procedures?

9.6 Visualization techniques and cause analysis **Moderate** **LO 2, 3, 6**

You are working on the Devon Inc. audit. The company is responsible for managing large-scale construction projects for its customers. During the risk assessment phase, you noted a higher risk in the area of contract management that provides the costs for each project, and therefore you need to conduct testing in this area. You decide to perform an ADA.

You have been provided with the construction project file, and you would like to use visualization as a technique to identify customers that have notable items related to them. The target gross margin on all projects is approximately 50 percent, with a variance of +/– 3 percent.

Required

Using a visualization tool of your choice (Excel, Power BI, or Tableau), access the construction project file through the chapter resources on *WileyPLUS* and:

a. Identify any notable item(s) given the targeted gross margin provided.

b. Identify two or three potential causes for the notable item(s).

c. Explain how you will follow up on the notable item(s).

d. What visual did you select? Why? Discuss your visualization with respect to level of detail, axis scaling, and use of colour.

e. What should be documented with respect to this test to meet the documentation requirements?

9.7 Using matching to test travel expenses **Moderate** **LO 1, 3, 5**

You are auditing Hawthorne Industries. The preliminary risk assessment resulted in a high potential for fraud given the number of offices it has across Canada and the high volume of travel-related expenses, as well as the weak controls around expense management. The travel expense account has been assigned to you for substantive testing and you would like to design an ADA to perform the testing. The data you have available include:

- The general ledger
- Corporate credit card data (in aggregate, as well as employee daily totals, location of charges, and vendor category, e.g., restaurant, fuel, hotel)
- Payroll records that include start/end date, vacation and absenteeism data, and role

Required

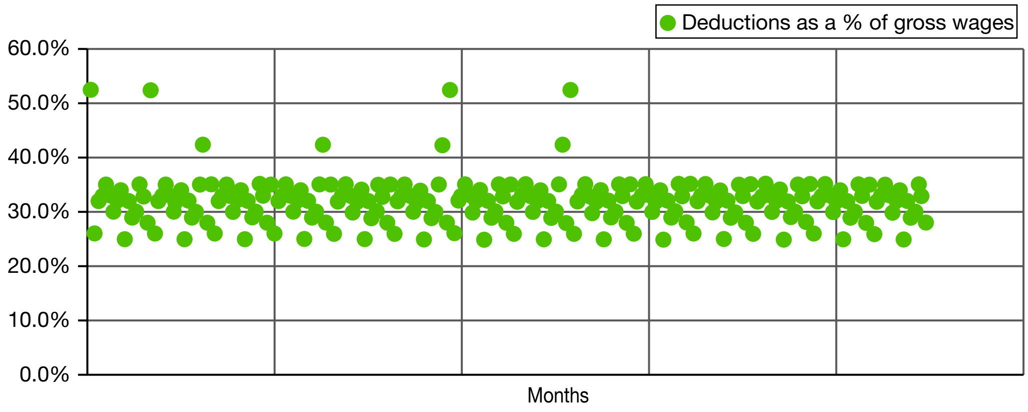
a. What are the main assertions related to this account?

b. Suppose you have decided to conduct a matching technique to perform your ADA to conclude on the assertion(s). Describe the procedures you would perform to do so.

c. What type of risk exists regarding travel expenses for which ADAs may be particularly helpful compared with traditional sampling? Explain.

9.8 Substantive testing of payroll **Moderate** **LO 1, 2, 5, 6**

You have just been assigned to the audit of Ferguson Manufacturing. You have been asked to help a new CPA who is performing audit data analytics using the client's payroll file. The only analytic that has been performed thus far is calculating the reasonability of deductions as a percentage of gross wages for the 12 months of the year. The results were summarized in the following scatter chart:



Required

a. Provide an interpretation of the visualization. Include any notable items you identified in your interpretation, along with potential causes, and the steps you would take next.

b. Access the full dataset associated with the payroll records for the year 2020 in *WileyPLUS*. Complete the additional substantive tests on the data:

- Reasonability of wage rate by job title
- Accuracy of the gross wage and net pay calculations

c. Create a working paper for the audit file that includes the following:

- Documented steps you performed
- Your initial conclusions
- Areas requiring further investigation

d. What did you document to meet documentation requirements?

9.9 Use of data analytics in journal entry testing **Moderate** **LO 2, 3**

Rajiv Khan, CPA, is using audit data analytics to assist with the testing of journal entries. He has obtained a general ledger data extract directly from the financial accounting system to work with. Rajiv is trying to identify unusual journal entries recorded during 2023 and would like your opinion on his test approach. His approach so far includes analyzing the general ledger for the following items:

- Journal entries posted close to the end of the year
- Journal entries that contain words that indicate an adjustment was made, such as "error," "reverse," and "adjust"
- Journal entries posted by unauthorized users

Required

a. Provide five additional items that Rajiv should look for with respect to journal entries. For each item, state why there would be value in identifying such an item.

b. Explain to Rajiv why it would be appropriate to obtain the general ledger transactions up to the date of the audit report as well. Your explanation should include how the data would be used and the assertion it would support.

c. What should be documented to meet documentation requirements?

9.10 Predicting revenues using regression analysis **Moderate** **LO 1, 4, 6**

An auditor is auditing the financial statements of a privately owned local hotel. The hotel has 200 guest rooms and in the last year, it generated $12.8 million in revenues. The auditor assessed the system of internal controls as effective and therefore decided to perform an ADA. The auditor has decided to perform a substantive analytical ADA using the average nightly and vacancy rates to develop an expected revenue amount for the year and by month. This will be compared with the actual revenues.

Required

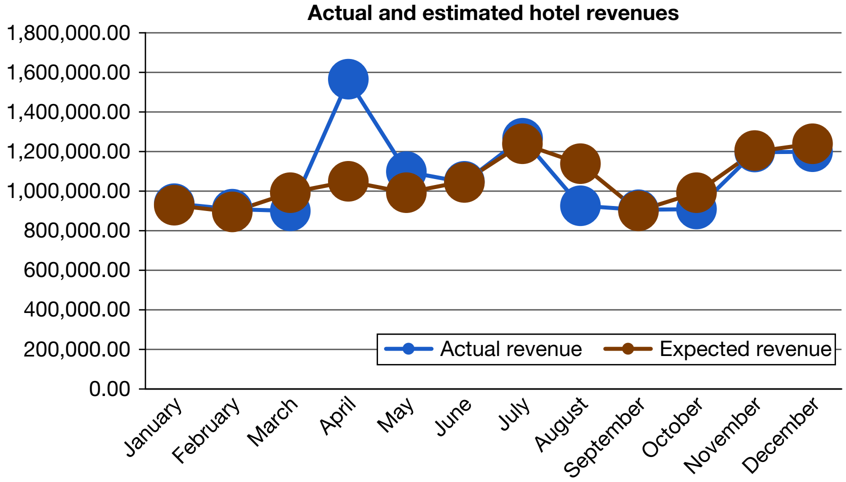
a. What assertions will be addressed by this procedure?

b. What are the dependent and independent variables?

c. How will the auditor determine what is an acceptable difference?

d. Assume the auditor conducted the test and produced the results in the chart below. The auditor determined that an acceptable difference was $300,000. Identify the exception and discuss how the auditor should deal with this notable item.

e. The auditor created the visualization below. How can it be improved?



9.11 ADA as a substantive test **Challenging** **LO 3, 5**

BN&P, CPAs, are auditing a travel business. Various groups have booked tours, resulting in significant accounts receivable balances at year end. Because they have not had success with confirmations in the past, BN&P decide to perform an ADA with accounts receivable. Because the tours generally are paid for within a short time frame, they decide to examine cash receipts collected after year end to obtain assurance over accounts receivable. Using the ADA, they produced the following results:

Accounts Receivable at year end subject to testing	$5,465,000	100.0%
Cash collections equal accounts receivable	4,250,000	77.8%
Cash collections less than accounts receivable	575,000	10.5%
No cash collected	640,000	11.7%
	$5,465,000	

Required

a. What assertions are BN&P testing?

b. What do the test results mean?

c. What should BN&P do with respect to the notable items identified?

9.12 The state of data analytics in the profession **Moderate** **LO 1, 2, 3**

Required

Watch the video provided by CPA Canada at https://youtu.be/6qPZJfe5jXc and answer the following questions:

a. Is the primary purpose of using audit data analytics to discover material misstatements? Why or why not?

b. What might be some challenges that CPAs and firms have when trying to implement ADAs? How can they be addressed? (You may find it helpful to search for the page on the CPA Canada website called “An Inside Look at How Auditors in Canada Are Using Data Analytics” by CPA Canada and review it.)

Case Study—Cloud 9

The general ledger for Cloud 9 and a transcript of a meeting with Carla Johnson is provided in Appendix A.

Required

a. During discussions with management, Josh asked how often the product prices are changed. Carla Johnson, the Financial Controller, responded that they didn't change that often. Describe a data analytics technique that could be used to corroborate Carla's statement using the five-step approach. Be specific in identifying a logical source that Josh might be able to obtain data from in order to better understand pricing fluctuations.

b. It is decided to conduct a regression analysis for Cloud 9 with respect to sales and the number of "likes" on Cloud 9's social media pages for each quarter over a number of fiscal years. What assertions will be addressed by this procedure? What are the dependent and independent variables? What data are needed? How will W&S Partners determine the acceptable difference?

Research Question 9.1

Jim Boitisse, an audit partner at Hemingway CPAs, has learned about two additional techniques that can be used in audit data analytics. They are analysis using the principles of Benford's Law, and fuzzy logic.

He has asked you to research both concepts and report back on their purpose. He would also like you to include when they each might be useful in an audit.

Required

Prepare a memo to Jim Boitisse in response to his request.

Further Reading

CPA Canada Guide to Audit Data Analytics, Chartered Professional Accountants of Canada, May 2018

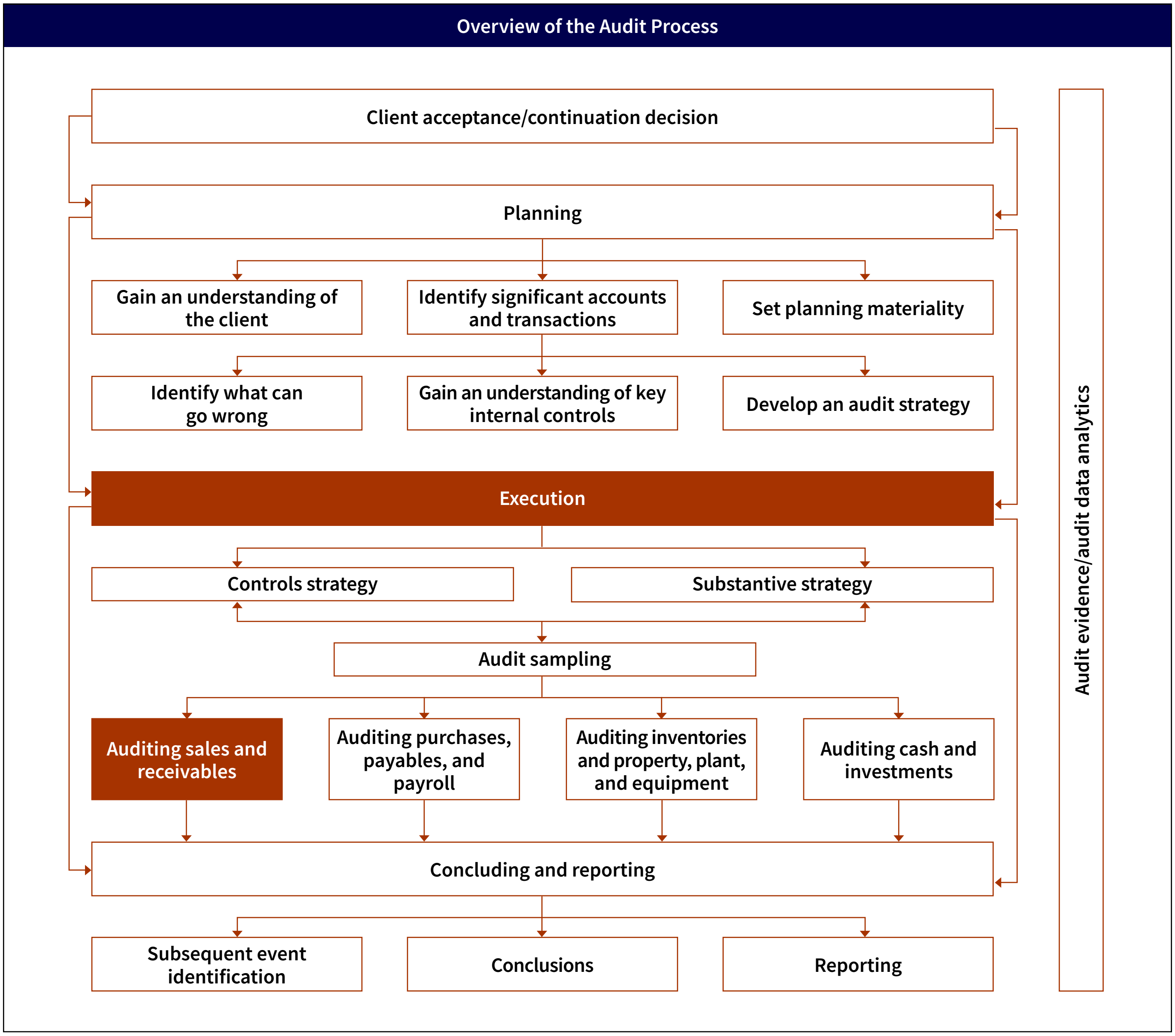
Non-Authoritative Support Material Related to Technology: Audit Documentation when Using Automated Tools and Techniques, IAASB, April 2020

Notes

1. Robert K. Minniti and Kelen F. Camehl, Integrating Audit Data Analytics into the Audit Process, AICPA, 2018.
2. Jim Lindell, Analytics and Big Data for Accountants, AICPA 2017.
3. Ibid.
4. Non-Authoritative Support Material Related to Technology: Audit Documentation when Using Automated Tools and Techniques, IAASB, April 2020.
5. Ray Johnson and Laura Wiley, *Auditing: A Practical Approach with Data Analytics*, John Wiley & Sons, 2019.

CHAPTER **10**

Auditing Sales and Receivables



LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
After studying this chapter you should be able to:		Standards addressed in each learning objective are as follows:
1 Identify the audit objectives applicable to sales and receivables	**10.1** Audit Objectives	CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
2 Describe the functions and control procedures normally found in information systems for processing sales, cash receipts, and sales adjustment transactions	**10.2** The Process for Credit Sales Transactions **10.2.1** Credit sales transactions **10.2.2** Cash receipts transactions **10.2.3** Sales adjustment transactions	CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
3 Outline audit strategy considerations including the risk of material misstatement and tests of controls for sales, cash receipts, and sales adjustment transactions	**10.3** Audit Strategy **10.3.1** Understanding the entity and its environment **10.3.2** Analytical review **10.3.3** Inherent risk assessment **10.3.4** Internal controls **10.3.5** Final assessment	CAS 315 *Identifying and Assessing the Risks of Material Misstatement* CAS 500 *Audit Evidence* CAS 530 *Audit Sampling*
4 Indicate the factors relevant to determining an acceptable level of detection risk for the audit of sales and receivables	**10.4** Determining an Acceptable Level of Detection Risk	CAS 315 *Identifying and Assessing the Risks of Material Misstatement* CAS 330 *The Auditor's Responses to Assessed Risks*
5 Design a substantive audit program for sales and receivables	**10.5** Designing Substantive Procedures **10.5.1** Initial procedures **10.5.2** Analytical procedures **10.5.3** Tests of details of transactions **10.5.4** Tests of details of balances **10.5.5** Evaluating adequacy of the allowance for doubtful accounts **10.5.6** Disclosure	CAS 330 *The Auditor's Responses to Assessed Risks* CAS 505 *External Confirmations* CAS 540 *Auditing Accounting Estimates and Related Disclosures*

Cloud 9 Integrated Case

Now that Josh Thomas has a better understanding of audit data analytics and he has concluded on the entity-level controls at Cloud 9, it is time for the audit team to focus on the transaction cycles. Sharon Gallagher, the audit manager, has asked Josh and his team to start documenting an understanding of the controls at the transaction level for the accounts receivable and sales cycle. Sharon explains that this documentation should include details on the procedures and controls in place that Cloud 9 incorporates when processing sales, receivables, cash receipts, and sales allowances. Josh wonders why this level of detail is necessary. Sharon explains that the documentation will allow the audit team to identify the points within the accounting process where errors or fraud can occur. These points are more likely where information is changed, there is significant human involvement, or access to systems is not restricted. In essence, it is where something in the process can go wrong. The audit team will then concentrate on those points that have a financial statement impact. This documentation will support their assessment of the system's strengths and weaknesses, which will influence the remainder of the planning process.

Chapter Preview

The purpose of this chapter is to examine the audit of the sales cycle, which includes accounts receivable, sales, cash receipts, and sales adjustment accounts. This involves the identification of the audit objectives that apply to the relevant classes of transactions and the account balances for each of the financial statement assertions.

We begin this chapter by describing (1) the audit objectives for sales and receivables; (2) procedures involved in sales, cash receipts, and sales adjustment transactions; and (3) the accounting system and control procedures commonly associated with these accounts. We consider factors relevant to developing the audit plan, including assessing the inherent and control risks, determining the appropriate audit strategy, and, where appropriate, including the use of tests of controls.

Lastly, we discuss the design of substantive procedures, including analytical procedures and tests of details of transactions and balances for these accounts.

10.1 Audit Objectives

LEARNING OBJECTIVE 1

Identify the audit objectives applicable to sales and receivables.

In the auditing of sales and receivables, the key issues are to ensure the following:

- The receivables do actually exist and are collectible, and adequate allowances have been made for balances where collectibility is doubtful. (The relevant financial statement assertions are existence and accuracy, valuation, and allocation.)
- The sales are genuine and are neither understated nor overstated. (The relevant financial statement assertions are completeness and occurrence, respectively, and also accuracy and cut-off.)

It is essential to understand the systems and controls in place for processing transactions that result in sales and, when sales are made on credit, the resulting receivables. Sales can be made either for cash, such as when customers pay for goods with cash in a department store, or on credit, such as when a large footwear wholesaler buys running shoes from a footwear manufacturer. In the latter case, a sale (revenue) has occurred and a receivable (asset) has to be collected.

When auditing sales and receivables, the auditor's objective is to obtain sufficient appropriate evidence about each relevant assertion for the applicable classes of transactions and balances. The main audit objectives for these transaction classes and account balances are shown in **table 10.1**. These objectives are those that would apply to most merchandising entities selling on credit; they are not intended to apply to all entities.

To achieve each of these specific audit objectives, the auditor may use a combination of tests of controls and substantive procedures as determined by the audit strategy adopted. Each audit objective is numbered (OE1, OE2, C1, AV42, and so on) in table 10.1. Using this numbering system, we can reference specific controls and audit procedures described in this chapter to the applicable audit objective. Some of the assertions for classes of transactions are combined with assertions for account balances in the numbering system: occurrence and existence (**OE**), completeness for transactions and completeness for balances (**C**), accuracy and

TABLE 10.1 Selected specific audit objectives for sales and receivables

Transaction and Related Disclosure Objectives	
Occurrence (**OE**)	Recorded sales represent goods that were shipped to customers during the period (**OE1**). Recorded cash receipts represent cash received from customers during the period (**OE2**). Sales adjustment transactions represent authorized discounts, returns and allowances, and bad debts applicable to the period (**OE3**). Disclosed revenue events have occurred and pertain to the entity (**OE4**).
Completeness (**C**)	All goods shipped to customers during the period are recorded (**C1**). All cash received from customers during the period is recorded as cash receipts (**C2**). All discounts, returns and allowances, and bad debts arising during the period are recorded as sales adjustments (**C3**). All revenue cycle disclosures that should have been included in the financial statements have been included (**C4**).
Accuracy (**AV**)	All sales, cash receipts, and sales adjustment transactions are properly (accurately) recorded (**AV1**). Sales cycle information is disclosed accurately and at appropriate amounts (**AV2**).
Cut-off (**CO**)	Particularly relevant to transactions around the year end; all sales, cash receipts, and sales adjustment transactions arising before the period end are recorded in the current period and those arising after the period end are included in the next accounting period (**CO1**).
Classification (**D**)	All sales (**D1**), cash receipts (**D2**), and sales adjustment (**D3**) transactions are recorded in the correct accounts.
Presentation (**D**)	Sales transactions and events are appropriately aggregated or disaggregated, clearly described, and the related disclosures are relevant and understandable (**D4**).
Account Balance and Related Disclosure Objectives	
Existence (**OE**)	Accounts receivable represent amounts owed by customers at the end of the reporting period (**OE5**).
Rights and obligations (**RO**)	Accounts receivable at the end of the sales reporting period represent legal claims of the entity on customers for payment (**RO1**).
Completeness (**C**)	All amounts owed by customers at the end of the reporting period are included in accounts receivable (**C5**).
Accuracy, valuation, and allocation (**AV**)	Accounts receivable represent gross claims on customers at the end of the reporting period and agree with the sum of the accounts receivable subsidiary ledger (**AV3**). The allowance for doubtful accounts represents a reasonable estimate of the difference between gross accounts receivable and their net realizable value (**AV4**).
Classification (**D**)	Accounts receivable are recorded in the correct account (**D5**).
Presentation (**D**)	Accounts receivable and the related allowance for doubtful accounts are appropriately aggregated or disaggregated, clearly described, and the related disclosures are relevant and understandable (**D6**).

accuracy, valuation, and allocation (**AV**), and classification with presentation (**D**) as these assertions relate to the financial statement presentation and disclosures. These combinations reflect the fact that audit evidence obtained to support an assertion for transactions will also give some comfort for a balance assertion. For example, an audit test that gives some comfort to the auditor that a sales transaction has occurred will also give some comfort that a valid receivable exists; hence, occurrence and existence are combined.

Table 10.1 summarizes assertions for both classes of transactions and account balance audit objectives.

Cloud 9 Integrated Case

Josh has prepared a diagram documenting his understanding of Cloud 9's sales and receivables cycle. This diagram documents his understanding of how a sales order is initiated through to when the cash is deposited in the bank (see **figure 10.1**). He has included initiating a sales order from the customer through to shipping the goods; invoicing the customer through to posting the transaction in the general ledger; and receiving the payment and recording the payment from the customer. Based on this diagram, Josh is preparing to write a narrative of the process.

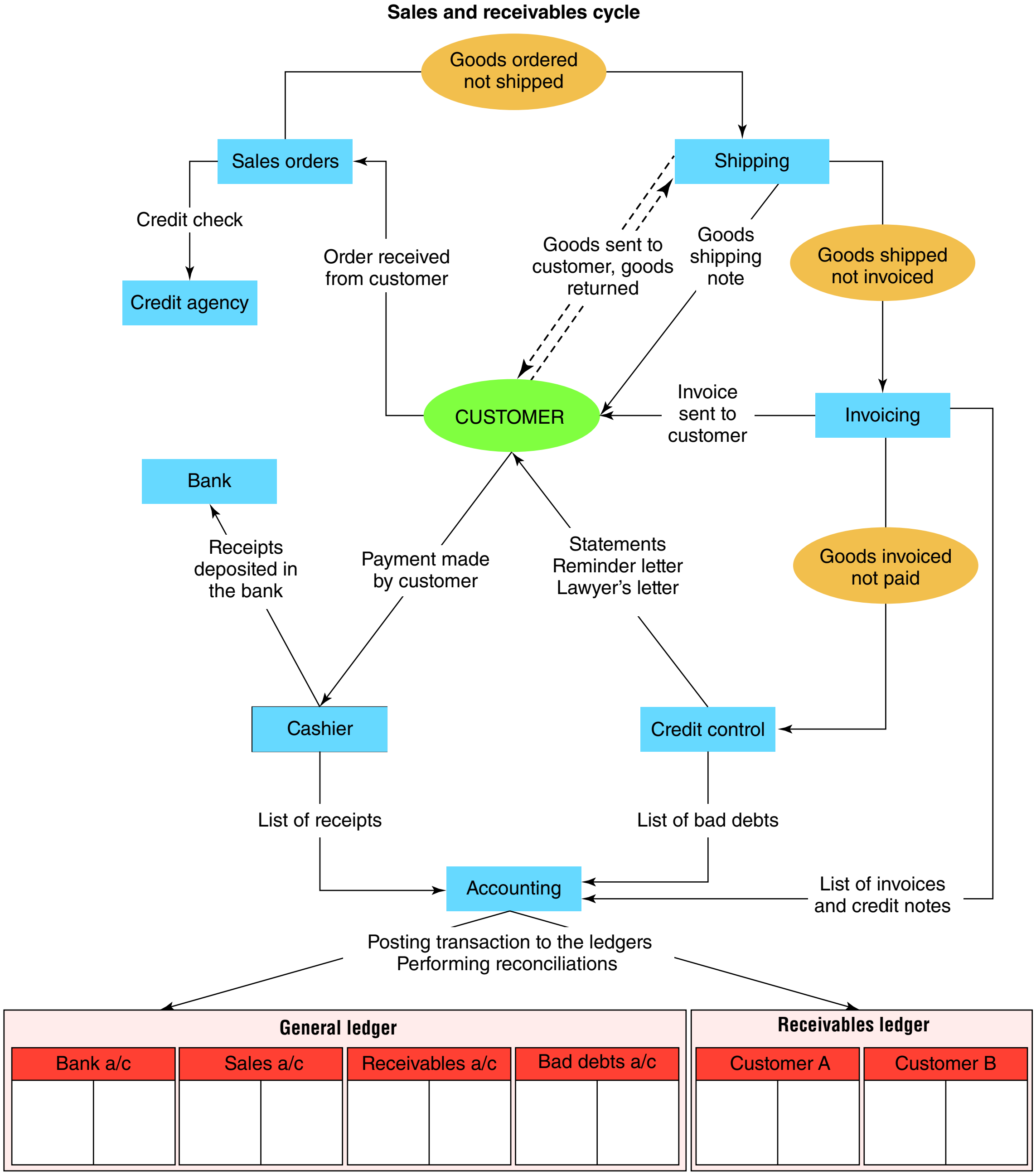


FIGURE 10.1 Credit sales cycle

Before You Go On

10.1.1 What three assertions are most at risk when auditing the sales and receivables cycle?

10.1.2 Define the audit objective of accuracy with respect to sales.

10.1.3 What does the completeness assertion for sales and receivables mean?

10.2 The Process for Credit Sales Transactions

LEARNING OBJECTIVE 2

Describe the functions and control procedures normally found in information systems for processing sales, cash receipts, and sales adjustment transactions.

The sale process starts when a customer places an order for goods with the company. Sales orders may be taken over the counter, via the telephone, by mail order, through sales representatives, by facsimile, or via the Internet. The goods may be picked up by the customer or shipped by the seller. The accounting for sales transactions may be done manually or with a computer, in real-time or batch processing mode. We begin by identifying the separate functions involved in making sales transactions, the documents and records used in processing the transactions, and the control procedures interwoven into each to reduce the risk of misstatements in the financial statements. Control procedures include information processing controls, physical controls, the segregation of duties, authorization controls, account reconciliations, and performance reviews. Information processing controls specific to credit sales transactions include authorization and independent checks.

10.2.1 Credit Sales Transactions

The processing of credit sales transactions involves the following:

- accepting customer orders
- approving credit
- filling and shipping sales orders
- invoicing customers
- recording the sales

These functions and the applicable control procedures are explained in the following sections.

Accepting Customer Orders

The first step in the sales cycle is the acceptance of a sales order. The acceptance of sales orders is normally performed by the sales department. When sales orders are received, they need to be checked for their authenticity, the acceptability of terms and conditions, and the availability of inventory. Orders submitted in writing or electronically on a **customer order** provide ready evidence of legitimacy in that they indicate goods were ordered by an actual customer, which supports the occurrence (**OE1**) assertion.

customer order a document indicating the goods requested by a customer that provides evidence of authenticity

Telephone or email orders from businesses are sometimes authenticated by requiring a purchase order number from the customer. Specification of a purchase order number provides reasonable assurance that the order has been issued in accordance with the customer's purchasing procedures. Terms and conditions relate to matters such as prices, delivery dates, and modifications. Sales clerks accept only orders that meet the entity's normal terms. In some businesses, it is necessary to check the availability of the goods in inventory before accepting an order. Any orders not meeting the above checks need to be referred to a manager with the authority to accept orders that depart from normal entity policy.

Once accepted, the order is recorded on a multi-copy **sales order**, which is a form showing the description of the goods, the quantity ordered, and other relevant data. It is signed by the clerk accepting the order and serves as the basis for internal processing of the customer order. Sales orders are commonly pre-numbered in case they are misplaced and business is lost as a result. This supports the completeness (**C1**) assertion for sales. It also represents the start of the transaction trail of documentary evidence and confirms the existence of a valid order. It thus relates to the audit objective occurrence (**OE1**) in table 10.1.

sales order a form showing the description of the goods, the quantity ordered, and other relevant data, which serves as the basis for the internal processing of the customer order

Approving Credit

Before a customer order is forwarded to the warehouse, a credit check should be performed. This should be required for both new customers and existing customers. New customers should complete a credit application and a credit report should be obtained from a credit rating agency. If the credit rating is acceptable, the credit manager determines an appropriate credit limit and creates a new record in the **accounts receivable master file** (see figure 5A.4). For existing customers, a credit department employee compares the amount of the order with the customer's authorized credit limit and the current balance owing by the customer. This comparison may also be done electronically through the entity's computerized information system. Credit approval may be refused if the order would take the balance over the customer's credit limit or if the account is overdue. To indicate approval (or non-approval) of credit, an authorized credit department employee signs or initials the sales order form and returns it to the sales order department, or does so electronically, following prescribed procedures.

accounts receivable master file a computer file containing customer details such as contact information, address, and approved credit limit

For an auditor, controls over credit approval reduce the risk of a sales transaction being initially recorded in an amount in excess of the amount of cash expected to be realized, and thus contributes to the audit objective of accuracy (**AV1**). The expectations of realizing some of these amounts will change over time, resulting in the need for an allowance for doubtful accounts, as generally the longer an amount remains unpaid, the less likely it will be collected. Controls over credit approval enable management to make a more reliable estimate of the size of the allowance needed. Strong controls over extending credit reduce the likelihood of sales being made on credit to customers unable to pay in the future (accuracy, valuation, and allocation **AV4**).

Filling and Shipping Sales Orders

Once the credit check has been completed, a copy of the approved sales order form (or an electronic notification) is sent to the warehouse as authorization to fill the order and release the goods to the shipping department (or the shipping area). This approved sales order form should be required before goods are removed from the warehouse, and the inventory account is relieved. This ensures that goods removed by warehouse personnel without appropriate authorization will appear as an inventory shortage for which they are held accountable. To reduce the likelihood of such inventory shortages, there should be a segregation of the following duties: the custody of inventory, the maintenance of the inventory records, and the physical check of goods on hand.

Segregating responsibility for shipping from the responsibility for approving and filling orders prevents shipping clerks from making unauthorized shipments (**OE1**). In addition, shipping clerks are normally required to make independent checks to determine that goods received from the warehouse are accompanied by an approved sales order form or an electronic authorization.

The shipping function involves preparing multi-copy **shipping documents** (see figure 5A.8).

shipping document a form authorizing the release of goods from inventory and the delivery of the goods to the customer

Shipping documents on pre-numbered forms are usually produced by the computer information system using order information already logged into the system with appropriate delivery data added (such as quantities shipped, carrier details, and freight charges). Subsequent checks of the numerical continuity of the shipping documents invoiced ensure completeness (**C1**) of recorded sales transactions. Pre-numbering shipping documents also helps in establishing cut-off at year end (**CO1**) as the auditor can ensure that the last goods shipped out are the last goods invoiced, and that orders shipped after year end are invoiced after year end. Gatekeepers are sometimes required to check that drivers of all vehicles leaving the premises possess shipping documents for the goods in their vehicle, as a double-check against failure to record deliveries.

Shipping documents provide evidence that goods were shipped and thus of the occurrence (**OE1**) of the credit sale, giving rise to a claim against the customer within accounts receivable. Some entities obtain a copy of the shipping document signed by the customer on receipt of the goods, as evidence of the claim on the customer.

Invoicing Customers

The invoicing function involves preparing and sending **sales invoices** (see figure 5A.9) to customers. Applicable control objectives for invoicing are:

sales invoice a form detailing the goods or services supplied to a customer and the amount owing

- All deliveries are invoiced to customers.

- Only actual deliveries are invoiced (and there should be no duplicate invoices or fictitious transactions).
- Deliveries are invoiced at authorized prices and the invoice amount is accurately calculated.

Control procedures designed to achieve these objectives are likely to include the following:

- segregating invoicing from the foregoing functions (**OE1**, **C1**)
- checking the existence of a shipping document and matching it to the approved sales order before each invoice is prepared (**OE1**)
- using an **authorized price list** in preparing the sales invoices (**AV1**)
- performing independent checks on the pricing and mathematical accuracy of sales invoices (**AV1**)
- comparing control totals for shipping documents with corresponding totals for sales invoices (**OE1, C1**)

authorized price list a list of selling prices for each product

Copies of the sales invoices are usually maintained in the invoicing department.

Recording the Sales

The main control objective is to ensure that sales invoices are recorded accurately and in the proper period, which is usually when the goods are shipped.

The recording process involves entering sales invoices in a **sales journal**, posting the invoices to the **accounts receivable subsidiary ledger**, and posting the sales journal totals to the general ledger. It is common practice for invoices to be entered separately in the sales journal and the accounts receivable sub-ledger. The accounts receivable sub-ledger balance is periodically compared with the general ledger control account (**AV3**). Failure of the balances in the accounts receivable sub-ledger to agree in total with the control account in the general ledger indicates that an error has been made. A further control is the use of prelists, whereby the total of invoices entered in the sales journal is checked against the total of sales invoices posted to the accounts receivable sub-ledger (**AV1**). Sales invoices should also be entered in numerical sequence and a check should be made on missing numbers (**C1**). A **monthly customer statement** should be sent to each customer to give the customer an opportunity to alert a designated accounting supervisor (who is not otherwise involved in the execution or recording of sales transactions) if the balance does not agree with the customer's records (**OE1**).

sales journal a journal listing completed sales transactions

accounts receivable subsidiary ledger a ledger recording the details of transactions by customer and balances owing by invoice

monthly customer statement a listing sent to each customer of transactions with that customer that have occurred since the date of the previous statement, which shows the closing balance due

As indicated previously, balances in the accounts receivable sub-ledger should be regularly and independently checked against the balance in the control account in the general ledger. Periodic performance reviews by sales executives of sales analyzed by product, division, salesperson, or region—along with comparisons with budgets—contribute to controls over sales transactions.

Many entities now use online systems, and once an order has been entered into the computer information system, the computer can be programmed to validate the customer credit, check inventory availability, and issue the necessary instructions to the shipping department. On delivery of the order, the shipping department enters the necessary shipping details and the computer automatically produces the invoice and updates the accounts receivable master file as well as the related inventory and general ledger files. Additionally, the computer information system maintains a **sales transactions file** or equivalent data within a database system. Important controls in such a system include access controls, programmed application controls, and controls over standing data files.

sales transactions file a computer file listing details of all sales transactions

Access controls should permit read-only access to transaction and master files except for authorized individuals. Those people with authority should have prescribed limits to that authority; for example, the credit manager may have the right to override rejections of orders when an order marginally breaches a customer's credit limit, and similarly the sales manager may have the right to amend price or discount rates for individual customers or sales transactions.

Programmed application controls should include checks to ensure the following:

- Only orders from customers on the accounts receivable master file are accepted.
- Only orders for goods in the entity's product range are accepted.
- The numerical continuity of documents is assured.
- Transactions are chased at regular intervals.
- Duplicate document numbers are rejected.
- Unreasonable quantities, amounts, and dates are questioned.

The correctness of master file data is of particular significance in a computer information system. Master file data in a sales system include authorized customers, their credit limits, and product sales prices. Access controls should ensure that only authorized managers can amend master file data; for example, only the credit manager should be able to add new customers and vary the credit limits of existing customers, and only the sales manager should be able to amend selling prices. As an added precaution, master file data should be periodically printed out for review and approval.

10.2.2 Cash Receipts Transactions

The processing of receipts from cash and credit sales involves the following cash receipts functions:

- receiving cash
- depositing cash in the bank
- recording the receipts

Receiving Cash

A significant risk over cash receipts is that cash paid by customers is stolen before it is recorded. For control purposes, accountability measures must be in place from the moment cash is received, and the cash must be safeguarded. A second risk is the possibility of errors occurring in the subsequent processing of the receipts.

For over-the-counter receipts, a cash register or point-of-sale terminal is normally used. These devices provide:

- immediate visual display for the customer of the amount of the cash sale and the cash tendered
- a printed receipt for the customer and an internal record of the transaction on a computer file or a tape locked inside the register
- printed control totals of the day's receipts

The customer's expectation of a printed receipt and supervisory surveillance of over-the-counter sales transactions help to ensure that all cash sales are processed through the cash registers or terminals (**C2**). In addition, there should be an independent check of the agreement of cash on hand with the totals printed by the register or terminal (**OE2**, **C2**, **AV1**). The cash is then forwarded to the cashier's department for deposit in the bank, together with the register- or terminal-printed totals.

Many customers pay by credit or debit cards. These payments are processed via online terminals linked to the bank or other card issuer that validates the transaction. Staff need to be properly trained in the use of such terminals and in procedures to be followed where the transaction is refused. Procedures must be in place for reconciling card sales with cash register totals as part of the daily agreement of cash on hand. Amounts due from card issuers also need to be recorded and checked against subsequent payments. The use of credit and debit cards also facilitates the acceptance of online, mail, or telephone orders from customers without the need for creditworthiness checks once the card transaction has been validated. Because no cash handling is involved, such transactions reduce the risks of misappropriations, and are often preferred despite the commission payable to the card issuer.

There should always be at least two clerks responsible for opening mail so they would need to be in collusion in order to misappropriate cash receipts from the mail. If cheques are received, they should be immediately restrictively endorsed for deposit only. This is done by impressing a rubber stamp imprinted with the words "for deposit to the account of ..." on the face of the cheques. If they fall into the wrong hands, such cheques cannot subsequently be endorsed for payment to the person acting fraudulently. All these procedures ensure that mail receipts are not misappropriated (**C2**).

remittance advice a form accompanying cash or cheques paid by a customer, indicating the customer's details and the items being paid

Most cash receipts are attached to or accompanied by a **remittance advice** (see figure 5A.10) indicating the payer and the particulars of the payment. The cheques are forwarded to the cashier's department for banking with a copy of the listing made (which is referred to as a prelist). Remittance advices (or other details of the payment enclosed with the cash receipt) are forwarded to the accounts receivable department for posting to the accounts receivable sub-ledger.

However, the use of cheques for payment is diminishing and most major customers now pay by bank credit transfer. Such payments may be identified as part of the bank reconciliation process. Because this can lead to delays in recording receipts, entities receiving payments this way usually have online access to their bank account (which may be linked to the accounts receivable master file), which automatically detects credit transfers and updates the accounts receivable records.

Depositing Cash in the Bank

All cash receipts must be deposited intact daily. Intact means all receipts should be deposited, not used to make payments. This reduces the risk that cash receipts will not be recorded (**C2**). The resulting bank deposit record establishes the occurrence of the transactions (**OE2**).

deposit slip a listing of cash, coins, and individual cheques for deposit with the bank, endorsed by the bank teller, a copy of which is retained by the entity

When cashiers receive over-the-counter and mail receipts, they should check that the cash agrees with both the accompanying register total and the prelist (**OE2**, **C2**, **AV1**). Details of cash receipts are then entered on a daily cash summary and the bank **deposit slip** is prepared in duplicate. The cash is deposited in the bank and the copy of the deposit slip is receipted by the bank and retained by the cashier. The daily cash summary is forwarded to the general accounting department.

Recording the Receipts

cash receipts journal a journal recording cash receipt transactions for posting to the ledgers

To ensure that only valid transactions are entered, access to the accounting records or computer programs should be restricted to authorized personnel (**OE2**). In manual or partly computerized systems, the duties of journalizing the cash receipts and of posting the receipts to customer accounts should be segregated. The daily cash summary is used to enter the **cash receipts journal**, distinguishing between receipts from cash sales and from credit sale customers. Posting the receipts to the accounts receivable sub-ledger may be done based on the remittance advices received from the mailroom (**AV3**). It is common for accounts receivable clerks to use a terminal to enter mail receipts into a cash receipts transactions file, which is subsequently used in updating both the accounts receivable sub-ledger and general ledger master files.

To ensure the completeness and accuracy of recording mail receipts, independent checks are made of:

- the agreement of the amounts journalized and posted with the amounts shown in the record kept by the mailroom (the prelist)
- the agreement of total amounts journalized and posted for over-the-counter and mail receipts with the daily cash summary and deposit slips retained by the cashier (completeness, accuracy)

In addition, an employee not otherwise involved in executing or recording cash transactions should perform periodic bank reconciliations. These bank reconciliations should be regularly reviewed by a manager on a timely basis.

Opportunities for automating accounting for cash receipts involving currency and cheques are limited, which is why many companies now use online banking and direct debit and credit transfer systems. However, the use of point-of-sale cash register terminals provides controls over the pricing of goods sold and over inventory management, although fraud is possible, as Professional Environment 10.1 shows.

10.1 Professional Environment Possible Point-of-Sale Frauds

Frauds are committed more often, with greater financial losses, by employees than by customers, suppliers, or other third parties. One common type of employee fraud is point-of-sale fraud, where staff steal money when a sale is made. This is particularly problematic in businesses where there are a lot of low-value transactions and a large number of cashiers, such as in retail or fast food, which makes the fraud easier to conceal.

Fraud is different from theft. Fraud involves employees trying to hide the crime, whereas theft is done without any attempt to hide it, in the hopes the business won't notice the missing money.

Types of point-of-sale frauds

The two most common types of point-of-sale frauds are those where customers pay money to the business, and those where the business pays money to customers, usually by refunding money for returned goods.

In the first type, the most common fraud technique is using void sales. An actual sales transaction must take place, so that the customer hands over the money that the employee steals. However, the employee does not record the sale, so the business doesn't know the money is missing. The employee will either not ring up the sale or will ring up the sale but then void it. Usually the customer will not receive a receipt or else the receipt will not be a normal one. The customer takes the goods but it may be a while before the business notices that the inventory is missing. The cashier will have to alter the inventory records to try to hide the transaction. Another fraud technique is "under-ringing," where the cashier rings in less than the full amount of the transaction, such as charging a customer for a large coffee but only ringing up a small. The cashier then pockets the difference.

In the second type, the most common fraud technique is using a false return. An actual return of goods cannot take place, because the customer would want their money back and that amount would have to be recorded. Instead, the cashier records a false return, falsifying evidence that a customer returned goods and was given a refund. The false return will update the business's bank records to show the false refund to the false customer, so the amount doesn't need to be hidden. However, there was no real return of goods, so the employee will need to falsify the inventory somehow. They may use another inventory item as the returned item, and may even damage an item as a reason for return.

Preventing and detecting point-of-sale frauds

Businesses can implement the following basic controls to help prevent and detect point-of-sale frauds.

- Installing "smart" cash registers that link sales with real-time inventory records.
- Requiring a supervisor or two designated employees to process and approve all returns.
- Examining all returns where the physical goods are not attached or identified.
- Requiring all returns to include scanning the item and therefore recording the actual return of items at their actual sales price.
- Requiring a receipt to be issued for each sale and encouraging customers to ensure they receive a receipt for each sale.
- Requiring cashiers to sign in to the register with a unique ID and password for every transaction so each transaction can be traced back to a particular employee.
- Monitoring credit card numbers that are used to process numerous refunds.
- Reviewing daily transactions for suspicious activity, such as a large number of voided sales or returns.

Q: What is an auditor's responsibility with regards to employee theft or fraud?

Sources: "Point of Sale Fraud—Stealing Cash Receipts." Association of Certified Fraud Examiners, Brisbane Chapter, www.brisbaneacfe.org/library/occupational-fraud/point-of-sale-fraud-stealing-cash-recipts/; "POS Fraud," PCMS Group, www.pcmsgroup.com/retail_systems/pos_fraud.jsp; Oliver Menzel, "How to Tackle Employee Theft," *Hotelier Middle East*, April 2012.

10.2.3 Sales Adjustment Transactions

Sales adjustment transactions involve the following functions:

- granting cash discounts
- allowing sales returns and allowances
- determining bad debts

The number and dollar value of these transactions vary significantly among entities. However, material misstatements resulting from errors and irregularities in the processing of these transactions are considerable. Of main concern is the possibility of fictitious sales adjustments being recorded to conceal misappropriations of cash receipts. An employee may, for example, conceal the theft of cash received from a customer by writing the customer's account off against the allowance for doubtful accounts, or by overstating cash discounts or sales returns and allowances. Controls useful in reducing the risk of such frauds focus on establishing the validity of such transactions (**OE3**).

Such controls include:

- proper authorization of all sales adjustment transactions, such as requiring a senior manager to approve the write off of bad debts (**OE3**)

- use of appropriate documents and records, in particular, an approved credit memo for granting credit for returned or damaged goods, and an approved write-off authorization memo for writing off bad debts
- segregation of the duties of authorizing sales adjustment transactions and of handling and recording cash receipts

Cloud 9 Integrated Case

While documenting his understanding of the sales and receivables process at Cloud 9, Josh has identified the controls in place along the way. He will next perform a walkthrough of one transaction to ensure his documentation reflects what Cloud 9 is doing in practice.

Sharon indicates that once the walkthrough is complete, the audit team will need to assess the inherent and control risks at the assertion level for each account. Based on this assessment, they will then design a detailed audit program to address those risks.

Before You Go On

10.2.1 List and briefly describe the five steps involved in processing credit sales.

10.2.2 What is the most significant risk over cash receipts?

10.2.3 What are three controls an entity should enforce to reduce the risk of fraud over sales adjustment transactions?

10.3 Audit Strategy

LEARNING OBJECTIVE 3

Outline audit strategy considerations including the risk of material misstatement and tests of controls for sales, cash receipts, and sales adjustment transactions.

Audit strategy refers to the mix of tests of controls and substantive procedures to be applied in the audit. The main determinants of the mix are the assessed inherent risks and control risks. If the auditor believes controls are effective and it is efficient to do so, a combined audit may be planned. This involves conducting tests of controls and assessing their effectiveness. We elaborate on these concepts in this section.

10.3.1 Understanding the Entity and Its Environment

The auditor must understand the entity and its environment as part of the risk assessment process in order to recognize the potential for misstatements in the financial statements. In relation to sales and receivables, this will assist the auditor in:

- developing an expectation of total revenues by understanding the company's products, clients, markets, and capacity (maximum sales volume)
- developing an understanding of gross margins by understanding products, market share, and competitive advantage
- developing an expectation of receivable levels based on average collection periods for the client and the industry as a whole

The generation of revenue also drives some costs (e.g., cost of goods sold and selling expense) and, therefore, an understanding of the sales cycle can lead to an understanding of an entity's expenditure cycles and help in assessing the possibility of misstatements in these areas. The auditor can obtain this knowledge through experience with the client entity or other companies in the same industry, through trade associations, and by reading newspaper or industry articles about the industry.

10.3.2 Analytical Review

Analytical procedures are a cost-effective way of identifying areas where there is a potential for misstatement. These procedures at the planning stage are not to give the auditor evidence about financial statement assertions but are instead designed to highlight risky areas where audit testing is required. Analytical procedures work best when the auditor has in-depth knowledge of the entity and the industry in which it operates and can therefore create expectations of such items as sales levels, gross margins, and levels of receivables. Examples of analytical procedures include investigations and comparisons of:

- sales turnover ratio (sales/total assets)
- trends in sales levels—comparison over time, monthly analysis, comparison between business units
- gross margins, particularly where the entity sells a variety of products at different margins
- turnover ratio (credit sales/receivables)—consider any changes in payment terms or customer mix
- comparison of bad debts to sales revenue and total receivables—any unexplained changes to these levels

Where the financial statements are different from expectations, the auditor may consider this to be a risk, and specific procedures should be included in the audit plan to address these risks. As noted in a previous chapter, audit data analytics can be a useful tool when the auditor performs analytical procedures relating to sales. They allow the auditor to visually identify trends and outliers that may indicate a greater risk or a new risk of material misstatement. They also allow the auditor to drill down into account details to better pinpoint where the risks may be, so the auditor can plan to spend time focusing on the high-risk areas. For example, audit data analytics allow the auditor to examine gross margins by product, product line, and location to determine what products or locations may be of higher risk and then focus on these areas.

10.3.3 Inherent Risk Assessment

Sales transactions are the main source of operating revenue for most business enterprises. The accounts receivable produced by credit sales transactions are material to the balance sheet for all businesses except those where cash receipts are predominant. While the cash balance reported on the balance sheet may not be material, the flow of cash associated with sales transactions is nearly always material. The significance of sales adjustment transactions varies considerably from one entity to another. However, the bad debt expense is often significant to the profit and loss of entities that sell to customers on credit. Because sales and receivables are material for most businesses, the auditor must assess the risk of material misstatement for these transactions. This begins with an assessment of the inherent risk.

To determine where the inherent risks fall along the spectrum of inherent risk for financial statement assertions, the auditor should consider pervasive factors that may affect assertions in many transaction classes, account balances, and related disclosures as well as factors that may relate only to specific assertions affecting sales and receivables. These factors include:

- pressure to overstate sales, so as to report that announced sales or profitability targets were achieved when they were not; such reporting includes:
  - recording fictitious sales

  - holding the books open to record sales in the next period in the current year (improper cut-off)
- pressure to overstate cash and accounts receivable or understate the allowance for doubtful accounts in order to report a higher level of working capital in the face of liquidity problems or going concern doubts

Other inherent risk factors that could contribute to misstatements in sales and receivables assertions include:

- the volume of sales, cash receipts, and sales adjustment transactions, resulting in numerous opportunities for errors to occur
- contentious issues relating to the recording of revenue, such as the determination of whether the performance obligation has been settled
- susceptibility to misappropriation of liquid assets generated by cash receipts
- the use of sales adjustment transactions to conceal the theft of cash received from customers by overstating discounts, recording fictitious sales returns, or writing off customers' balances as uncollectible

The auditor needs to consider such inherent risks in deciding on the appropriate audit strategy for sales and receivables assertions. These kinds of risks are the topic of Professional Environment 10.2.

The main inherent risk is usually that of an overstatement of sales revenue and accounts receivable balances. In the audit of classes of transactions, this relates to the occurrence and measurement assertions for sales, and to the completeness assertion for cash receipts and sales adjustments. Internal controls in relation to the sales cycle are discussed in more detail below. In most entities, controls relative to these assertions for sales and cash receipts are effective and therefore the auditor is able to adopt a combined audit strategy for these transaction classes.

Cloud 9 Integrated Case

Josh knows that the sales transactions are the main source of revenue for Cloud 9; therefore, the sales and related accounts are material. Furthermore, Josh believes there is a high volume of sales and cash receipts at Cloud 9, which increases the likelihood of errors simply happening. He also thinks the addition of the retail store in the current year increases the likelihood of theft as the store will have cash and inventory on hand. As most retail customers pay with cash or credit cards, he determines that, for these sales, there should be little collection risk. However, as the wholesale sales are primarily on credit, collectibility may be an issue.

10.2 Professional Environment Liquor Sales Go Down the Drain

In Ontario, the province's liquor sales are regulated by the Liquor Control Board of Ontario (LCBO), a provincial crown corporation. Alcohol beverage sales are made through retail stores, special order services, and a number of agency stores. In 2018–19, sales for the LCBO hit $6.4 billion.

The agency also runs a diplomat discount program, where diplomats are offered significant discounts on liquor sales. This program was run on an honour system, and so it should not be surprising to hear that the man who ran the program pled guilty to defrauding the agency of $2.7 million over a 12-year period.

The importance of segregation of duties was disregarded by this program. Fraudulent schemes were implemented by a single employee who had complete control of the program. His methods were neither complicated nor sophisticated, but with a significant lack of internal controls, they didn't need to be. His deceptive methods included taking payment from customers but failing to record the sale and then taking the cash. This was possible due to the haphazard means of recording sales—it is reported that they were tracked in a notebook. He also manipulated sales amounts and remitted only a portion of the cash receipts. This was possible as payments could only be made by cheque, cash, or money order, and the majority were made in cash.

This fraud came to light by an anonymous tip received by the corporation, not because of any oversight regarding this program. It is clear that, due to a lack of strong controls, the LCBO saw its sales go down the drain.

Q: What impact do weak controls have on the audit approach and substantive procedures?

Sources: Alyshah Hasham, "Ex-LCBO Employee Pleads Guilty to $2.7M Fraud," *Toronto Star*, October 8, 2013; "Ex-LCBO Employee Facing Criminal Charges in Booze Scam," *Globe and Mail*, May 8, 2012; Colin Perkel, "LCBO Sues Long-Time Employee over Alleged Fake Sales to Diplomats," *Globe and Mail*, April 10, 2012; LCBO 2018–19 annual report.

10.3.4 Internal Controls

The control environment may enhance or negate the effectiveness of other internal control structure elements in controlling the risk of misstatements in sales and receivables assertions. Management's adoption of, and adherence to, high standards of integrity and ethical values is a key control environment factor in reducing the risk of fraudulent financial reporting through the overstatement of sales and accounts receivable. Related aspects include the elimination of incentives for dishonest reporting (i.e., undue emphasis on meeting sales or profit targets) and of temptations (i.e., an indifferent or ineffective board of directors and audit committee).

A number of special personnel policies and practices are often adopted for employees who handle cash receipts. These include having such employees take mandatory holidays annually and periodically rotating their duties. The point of these controls is to deter dishonesty by making employees aware that they may not be able to conceal their misdeeds permanently. Some embezzlements from banks and other entities, for example, have been traced to the seemingly dedicated employee who held the same job without taking a holiday for 10 or 20 years, so as not to disrupt the routine of concealment.

In addition to understanding the control environment, the auditor must understand management's risk assessment procedures and evaluate their effectiveness—particularly in relation to new products or markets, new accounting requirements, and business expansion. The effect of changes in the business on the information systems, control activities, and monitoring procedures also needs to be understood. The assessment of control risk and the testing of the effectiveness of control procedures are covered now.

Control Risk Assessment

The procedures described in this section are followed only where the process of obtaining the understanding of the internal control structure leads the auditor to believe that it is both possible and cost-effective to assess control risk as being less than high. Where this is not the case, the auditor notes this conclusion in the working papers and obtains the required audit evidence through performing primarily substantive procedures. This decision is made separately for each financial statement assertion, although the same conclusion tends to apply to most, if not all, assertions.

Credit Sales Transactions

Table 10.2 contains a partial listing of possible "what can go wrongs," necessary controls, potential tests of the operating effectiveness of controls, and the specific transaction class audit objectives for credit sales to which each relates. Using the understanding of the information system, the auditor identifies the presence of necessary controls and makes a preliminary assessment of control risk.

TABLE 10.2 Control risk assessment considerations—credit sales transactions

				Relevant Class of Transactions Audit Objective (from Table 10.1)			
Function	**WCGW**	**Necessary Control**	**Possible Test of Operating Effectiveness**	**OE1**	**C1**	**AV1**	**D1**
Accepting customer orders	Sales may be made to unauthorized customers.	Determination that the customer is on the approved customer list	Observe procedure; re-perform.	✓			
		Approved sales order form for each sale	Examine approved sales order forms.	✓			
Approving credit	Sales may be made without credit approval.	Credit department performs a credit check on all new customers	Inquire about procedures for checking credit on new customers.			✓	
		Customer's credit limit checked before each sale	Examine evidence of credit limit check before each sale.			✓	

(*continued*)

TABLE 10.2 Control risk assessment considerations—credit sales transactions (*continued*)

Function	WCGW	Necessary Control	Possible Test of Operating Effectiveness	Relevant Class of Transactions Audit Objective (from Table 10.1)			
				OE1	C1	AV1	D1
Filling sales orders	Goods may be released from the warehouse for unauthorized orders.	Approved sales order is required for all goods released to shipping	Observe warehouse personnel filling orders.	✓			
Shipping	Goods shipped may not agree with goods ordered.	Independent check by shipping clerk to agree goods shipped from warehouse with approved sales order	Examine evidence of performance of independent check.	✓	✓		
	Unauthorized shipments may be made.	Segregation of duties for filling and shipping orders	Observe the segregation of duties.	✓			
		Preparation of shipping document for each shipment	Inspect shipping document.	✓			
Invoicing customers	Invoices may be made for fictitious sales or duplicate invoices may be made.	Matching of shipping document and approved sales order for each invoice	Vouch invoices to shipping document and approved sales orders.*	✓			
	Some shipments may not be invoiced.	Matching of sales invoice with each shipping document	Trace shipping document to sales invoices.*		✓		
		Periodic accounting for all shipping documents	Observe procedure; re-perform.		✓		
	Sales invoices may have incorrect prices.	Independent check on pricing of invoices	Inspect copy of invoice for evidence of performance.			✓	
			Re-perform the check on the accuracy of pricing.*			✓	
Recording the sales	Fictitious sales transactions may be recorded.	Requirement of sales invoice and matching documents for all entries	Vouch recorded sales to supporting documents.*	✓		✓	
	Invoices may not be journalized or posted to customer accounts.	Independent check of agreement of sales journal entries and amounts posted to customer accounts with control totals of invoices	Review evidence of independent check; re-perform check; trace sales invoices to sales journal and customer accounts.*		✓	✓	
		Periodic accounting for all sales invoices	Observe procedures; re-perform.*		✓		
		Chart of accounts and supervisory review	Observe procedures; re-perform.*				✓
	Invoices may be posted to the wrong customer account.	Mailing of monthly statements to customers, with independent follow-up of customer complaints	Observe mailing and follow-up procedures.*		✓		

Note: * Sometimes performed as part of dual purpose tests.

Tests of Operating Effectiveness

Tests of controls designed to provide evidence of operating effectiveness involve a variety of procedures, including re-performance of certain control procedures by the auditor. The auditor needs to remember that the direction of testing should be backward (vouching) along the audit trail when the objective is to test controls over the occurrence assertion, and forward (tracing) along the audit trail when the objective is to test controls over the completeness assertion. As an example, a sample of invoices from the sales journal would be vouched back to sales orders or shipping documents to test occurrence; to test completeness, a sample of sales orders or shipping documents would be traced to the sales journal to determine that all the transactions were recorded. The auditor must document the tests of controls performed, the evidence obtained, and the conclusions reached. A formal audit program that incorporates several of the tests from table 10.2 is presented in **figure 10.2**.

FIGURE 10.2 **Partial audit program for tests of controls—credit sales**

Prepared by: ________ **Date:** ________

Reviewed by: ________ **Date:** ________

Cloud 9 Ltd.
Planned tests of controls — Credit sales transactions
Year ending December 31, 2023

ASSERTION/TEST OF CONTROLS	W/P REF.	AUDITOR	DATE
Occurrence			
1. Observe procedures, including segregation of duties, for: • approving sales orders • filling sales orders • shipping sales orders • invoicing customers • mailing monthly statements to customers and following up on customer complaints			
2. Select a sample of sales transactions from the sales journal and verify transaction dates, customer names, and amounts by vouching entries to the following matching supporting documents: • sales invoices • shipping documents • approved sales orders			
Completeness			
3. Examine evidence of the use of and accounting for pre-numbered sales orders, shipping documents, and sales invoices. Scan the sequence of sales invoice numbers in the sales journal.			
4. Select a sample of approved sales orders and trace to matching: • shipping documents • sales invoices • entries in the sales journal			
Accuracy			
5. For the sample in step 2 above, examine evidence of: • proper credit approval for each transaction • an independent check on proper pricing of invoices • an independent check on the mathematical accuracy of invoices			
6. For sales invoices processed in batches, examine evidence of an independent check on the agreement of totals for sales journal entries and amounts posted to customer accounts with batch totals.			

(*continued*)

ASSERTION/TEST OF CONTROLS	W/P REF.	AUDITOR	DATE
Cut-off			
7. Obtain the number of the last goods shipped at year end, select a sample of shipping documents before this number, and agree: • to sales invoices dated in the current period • entries in sales journal before the period end			
8. Following on from step 7, select a sample of the first shipping after this number and agree: • to sales invoices dated in the next accounting period • entries in the sales journal are not recorded until the following accounting period			

FIGURE 10.2 **Partial audit program for tests of controls—credit sales (*continued*)**

Sometimes, control testing also provides substantive evidence as to the correctness of recorded amounts, and these are known as dual purpose tests. The auditor must be particularly careful in drawing conclusions from such tests. From substantive tests, it may be concluded that misstatements are significant only if material. However, all misstatements suggest that control procedures have not been properly performed. These deviations from prescribed procedures could have caused misstatements in transactions of any size. Therefore, as a test of controls, it is the number of misstatements that is important, not their size. Detections of misstatements of any size, therefore, may require the assessment of control risk to be revised.

test data approach a method of testing controls in a computerized information system environment, where the auditor prepares fictitious transactions and tests the fictitious data using the entity's software. The output is then compared with the expected output.

embedded audit facility procedures written directly into the program of a specific computer application allowing the auditor intervention to capture or process data for audit purposes

integrated test facility a type of test of controls that requires using a fictitious entity and entering fictitious transactions for that entity with the regular transactions, and then comparing the result with the expected output

systems control audit review file an embedded audit facility that enables auditors to specify parameters of interest, such as transactions meeting specified criteria, which are then recorded on a special audit file for subsequent review by the auditors

generalized audit software software auditors use under a variety of data organization and processing methods

Computer Information Systems

Tests of the operating effectiveness of controls over a computer information system are usually undertaken by computer-assisted audit techniques (CAATs). The two main categories of CAATs are (1) those that test the operation of programs and related programmed application controls directly and (2) those that test data held on computer files.

In the first category, the most common techniques used for testing controls over the processing of sales transactions are the **test data approach** and the use of embedded audit facilities. Test data are composed of simulated transactions. One batch of data consists of transactions replicating the normal types of transactions processed by the system. A second batch consists of transactions that should activate those programmed application controls of significance to the audit, such as orders exceeding credit limits. Both batches are processed by a copy of the program, and the results are compared with expected results determined manually. Test data are best suited to batch processing systems where the relevant program can be isolated and a copy can be taken for audit purposes. With real-time processing, it is less satisfactory and most such systems incorporate embedded audit facilities. One kind of **embedded audit facility** is the **integrated test facility** (ITF) based on dummy accounts to which test data can be processed on a real-time basis. Another is a **systems control audit review file** (SCARF). This facility enables auditors to specify items of interest, such as orders where credit limits are overridden by the credit controller. The facility will then log all such transactions and record them on a special audit file for subsequent review by the auditors.

For tests applied to sales transactions held on computer files, the auditor can use **generalized audit software** for large computer systems and proprietary database packages for smaller, PC-based systems. Both techniques can be used to access data on computer files according to criteria specified by the auditor and to perform a wide range of mathematical functions on that data. For tests involving the inspection of documents, the software can be programmed to select a sample of documents. If statistical sampling techniques are being used, the software can be programmed with the sampling elements, such as the preliminary assessment of inherent and control risk and the tolerable deviation rate. The software selects a suitably random sample and, after testing by the auditor, calculates the achieved deviation rate. For re-performance, the software can be programmed to perform the entire test. In re-performing invoice pricing, for example, the auditor can program the software to select a sample of invoices and compare unit sales prices on those invoices with sales prices held on the master file, and to report differences.

Cash Receipts

Table 10.3 illustrates a partial listing of potential misstatements, necessary controls, possible tests of the operating effectiveness of controls, and related classes of transaction audit objectives for cash receipt transactions. The particulars of the items listed in the table vary among entities, based on such factors as the method of data processing used. As we explained for credit sales, the potential misstatements and necessary controls would be the basis of a checklist used to assess design effectiveness. Similarly, an audit program for tests of the operating effectiveness of controls for cash receipts transactions can be prepared based on the potential tests of controls shown in table 10.3.

TABLE 10.3 Control risk assessment considerations—cash receipts

Function	What Can Go Wrong	Necessary Control	Possible Test of Operating Effectiveness	Relevant Class of Transactions Audit Objective (from Table 10.1)			
				OE2	C2	AV1	D2
Receiving cash receipts	Cash sales may not be recorded.	Use of cash registers or point-of-sale devices	Observe cash sales procedures.		✓		
		Periodic surveillance of cash sales procedures	Inquire of supervisors about the results of surveillance.		✓		
	Mail receipts may be lost or misappropriated after receipt.	Restrictive endorsement of cheques immediately on receipt	Observe mail opening, including the endorsement of cheques.		✓		
		Immediate preparation of prelist of mail receipts	Observe the preparation of records.	✓	✓	✓	
Depositing cash in the bank	Cash and cheques received for deposit may not agree with the cash count list and prelist.	Independent check of agreement of cash and cheques with register totals and prelist	Examine evidence of independent check.*	✓	✓	✓	
	Cash may not be deposited intact daily.	Independent check of agreement of validated deposit slip with daily cash summary	Re-perform independent check.*	✓	✓		
Recording cash receipts	Some cash receipts may not be recorded.	Independent check of agreement of amounts journalized and posted with daily cash summary	Re-perform independent check.*		✓		
	Errors may be made in journalizing cash receipts.	Preparation of periodic independent bank reconciliations	Examine bank reconciliations.*	✓	✓	✓	
	Cash receipts may be posted to the wrong customer account.	Mailing of monthly statements to customers	Observe mailing of monthly statements.	✓	✓	✓	✓

* Sometimes performed as part of dual purpose tests.

Sales Adjustments

Sales adjustment information systems are more diverse than sales and cash receipt systems, so it is not practicable to illustrate typical potential misstatements and necessary controls. However, tests of controls that are likely to be appropriate include:

- recalculating cash discounts and determining that the payments were received within the discount period
- inspecting credit memoranda for sales returns for indication of proper approval and accompanying receiving reports for evidence of the actual return of goods
- inspecting written authorizations and supporting documentation (i.e., correspondence with the customer or collection agencies) for the write off of bad debts

10.3.5 Final Assessment

Based on the evidence obtained from the procedures performed to obtain an understanding of the internal control structure and related tests of controls, the auditor makes a final assessment of inherent risk and control risk. For each significant audit objective where the assessment of control risk is less than high and a combined audit strategy is being selected, reasons for this assessment must be documented.

This assessment of inherent and control risk enables the auditor to plan the level of substantive procedures to be performed. Because many tests of controls are dual purpose tests, they provide evidence of errors in amounts as well as deviations from controls. Therefore, the auditor usually draws up the detailed audit program based on the preliminary assessment of control risk. This improves audit efficiency in that tests of the operating effectiveness of controls that use sources of evidence on which the substantive tests of details are also based are performed simultaneously with those substantive procedures. The auditor must ensure that control deviations are properly identified and that their implications for the assessment of control risk are properly considered in deciding whether further substantive procedures need to be performed.

Cloud 9 Integrated Case

After Josh completed his assessment of the inherent and control risks over the sales and receivables cycle, he submitted his assessment to Sharon for review. Sharon agreed that the inherent risks were high; however, the documentation indicated that there were effective controls in place that could be tested and perhaps relied upon. The initial audit strategy over the sales and receivables cycle was to perform a combined audit.

The audit team went to the Cloud 9 office and performed tests of controls. The control testing involved observing various staff members perform their duties, inspecting assorted documents, and re-performing procedures related to the sales and receivables cycle.

After a week at the client's office, Josh and the rest of the audit team finished testing and assessing the controls at Cloud 10. Again, the audit team sent their completed working papers to Sharon and to Jo Wadley for review. At this stage of the audit, it is important for the more senior members of the audit team to review the results of the control testing and judge whether there is sufficient and appropriate evidence to support the decision to continue to use a combined audit strategy.

With the controls now tested, it is time to plan the substantive testing, as the audit team's attention turns to this phase of the audit.

Before You Go On

10.3.1 List four inherent risks over the sales and receivables cycle.

10.3.2 What is a dual purpose test?

10.3.3 What are three possible tests of controls over the operating effectiveness of cash receipts?

10.4 Determining an Acceptable Level of Detection Risk

LEARNING OBJECTIVE 4

Indicate the factors relevant to determining an acceptable level of detection risk for the audit of sales and receivables.

In terms of the accounts receivable, the main consideration is the gross amount due from customers on credit sales and the related allowance for doubtful accounts. To design substantive procedures for these accounts, the auditor must first determine the acceptable level of detection risk for each significant related assertion. Given that the verification of accounts receivable requires consideration of sales, sales adjustment, and cash receipts transactions, the procedures also provide evidence for the income statement balance of sales, and the balance of cash in the balance sheet.

For a specified level of audit risk, detection risk is inversely related to the assessed levels of inherent risk and control risk. Thus, the auditor must consider these assessments when determining the acceptable level of detection risk for each accounts receivable assertion. Several pervasive inherent risks that affect sales and receivables transactions and balances were discussed earlier. The combined effects of these factors (especially those contributing to the risk of credit sales being overstated) may result in assessments of inherent risk as being high for:

- the existence and accuracy, valuation, and allocation assertions for accounts receivable
- the accuracy, valuation, and allocation assertion for the related allowance account

Assessments of inherent risk as being lower may be appropriate for the other assertions.

The control risk assessment for accounts receivable assertions depends on the control risk assessments for the related classes of transactions, credit sales, cash receipts, and sales adjustments, with the following exception: when transactions decrease the transaction class, the control risk assessment for occurrence and completeness will impact the assessment of the account balance assertion in the opposite direction. Thus, because both cash receipts and sales adjustment transactions decrease the accounts receivable balance, the assessment for the occurrence assertions will impact the assessment for the completeness assertion for the accounts receivable balance. Similarly, the assessment for the completeness assertion for these transaction classes affects the assessment for the existence assertion for the accounts receivable balance.

The audit program will be based on the original assessment of control risk. If tests of controls subsequently lead to a revised assessment of control risk, then the design of substantive procedures in terms of their nature, timing, or extent will also need to be revised. Some auditors use a matrix similar to the one illustrated in **table 10.4** to document and correlate the various risk components that must be considered in the design of substantive procedures for each account balance assertion.

The risk levels specified in this matrix are illustrative only and vary based on the entity's circumstances.

Consider the following with regard to the existence and occurrence assertions:

- Overall audit risk needs to be low to ensure there is a low risk of giving the wrong audit opinion in relation to existence and occurrence.
- The inherent risk has been assessed as high. The auditor understands the entity and its environment and has concluded that there is a high likelihood that existence or occurrence errors will arise (i.e., there is a high risk that transactions are recorded that do not relate to sales transactions that actually occurred or balances are included for which no receivable actually exists).
- The combined control risk is low, indicating that the auditor has obtained an understanding of the internal controls related to existence and occurrence and performed tests of controls on their effectiveness and has concluded that there is a low risk that any errors that do arise (and this is likely given the high inherent risk identified above) will not be detected and corrected by the internal controls.

TABLE 10.4 Correlation of risk components—accounts receivable

Risk Component	Existence or Occurrence	Completeness	Rights and Obligations	Accuracy, Valuation, and Allocation	Classification and Presentation
Audit risk	Low	Low	Low	Low	Low
Inherent risk	High	Moderate	Low	High	Moderate
Control risk—sales transactions	Low	Low	Moderate	Moderate	Moderate
Control risk—cash receipts	Low	Low	Low	Low	Low
Control risk—sales adjustments	Moderate	Low	Moderate	High	Moderate
Combined control risk[1]	Low	Moderate	Moderate	High	Moderate
Acceptable detection risk[2]	Moderate	Moderate	High	Low	Moderate

[1] This is the most conservative (highest) of transaction class control risk assessments used as the combined risk assessment.

[2] Based on the levels of audit risk, inherent risk, and combined control risk indicated above for each assertion category.

- The combined control risk for existence and occurrence is made up of the existence and occurrence control risk for sales transactions and the completeness control risk for cash receipts and sales adjustments, all of which are low. The logic for this is as follows (notice that all of the following lead to potential existence problems in the balances):
  - An *occurrence* problem with sales transactions (a sale has been included in the accounts but no valid sale was made) leads to an *existence* problem in the receivables balance (the non-existent sale was recorded so a receivable was created that is not valid).
  - For cash receipts, a *completeness* problem (cash has been received but not recorded) leads to an *existence* problem in the receivables balance (the receivable does not exist because it has been paid).
  - For sales adjustments, such as bad debts, a *completeness* problem with bad debts (a receivable has gone bad but is not recorded) leads to an *existence* problem in the receivables balance (the receivable does not exist because the account has gone bad).
- Having assessed inherent risk and control risk, the auditor will now determine the acceptable level of detection risk that will allow the overall audit risk for existence and occurrence to be low. Given that inherent risk is high and control risk is low, the auditor has determined that a moderate level of detection risk is appropriate to achieve the required audit risk. This level of detection risk will be used by the auditor to determine the nature, timing, and extent of substantive procedures that need to be performed. The level and detail of substantive procedures performed is a matter of professional judgement. The auditor will be performing more than the minimum level of testing (detection risk has not been set high) but the auditor will not be performing the maximum level of testing, either (this would be relevant if detection risk was set low).

Before You Go On

10.4.1 What income statement accounts impact accounts receivable? Why?

10.4.2 If tests of controls subsequently lead to a revised assessment of control risk, how will this impact the audit?

10.4.3 Explain how the assessment of the assertions for credit sales, cash receipts, and sales adjustments affects the assessment of the assertions over accounts receivable.

10.5 Designing Substantive Procedures

LEARNING OBJECTIVE 5

Design a substantive audit program for sales and receivables.

The next step is to finalize the audit program to achieve the specific audit objectives for each account balance assertion. The specific audit objectives covered here are the ones listed in the "Account Balance Objectives" section of table 10.1.

Table 10.5 lists possible substantive procedures to be included in an audit program. This table does not represent a formal audit program because it is not tailored to any specific

TABLE 10.5 **Possible substantive procedures for accounts receivable assertions**

		Account Balance Audit Objective (from Table 10.1)				
Category	**Substantive Procedure**	**OE5**	**RO1**	**C5**	**AV no.**	**D no.**
Initial procedures	1. Perform initial procedures on accounts receivable balances and records that will be subjected to further testing. (a) Trace the opening balances for accounts receivable and related allowance to the previous year's working papers. (b) Review activity in general ledger accounts for accounts receivable and related allowance, and investigate entries that appear unusual in amount or source. (c) Obtain the accounts receivable trial balance and determine that it accurately represents the underlying accounting records by: • adding the trial balance and determining agreement with the total of the subsidiary ledger or accounts receivable master file and the general ledger balance • testing the agreement of customers and balances listed on the trial balance with those included on the subsidiary ledger or master file				✓3, 4	
Analytical procedures	2. Perform analytical procedures. (a) Determine expectations. (b) Compare current and previous year balances. (c) Calculate significant ratios such as: • gross profit • days sales in accounts receivable (d) Obtain explanations for unexpected changes. (e) Corroborate explanations.	✓		✓	✓3, 4	
Tests of details of transactions	3. Vouch a sample of recorded accounts receivable transactions to supporting documentation (see also step 6(c)). (a) Vouch debits to supporting sales invoices, shipping documents, and sales orders. (b) Vouch credits to remittance advices or sales adjustment authorizations for sales returns and allowances or bad debt write offs.	✓	✓	✓	✓3	
	4. Perform cut-off tests for sales and sales returns. (a) Select a sample of recorded sales transactions from several days before and after year end, and examine supporting sales invoices and shipping documents to determine that the sales were recorded in the proper period.	✓		✓		

(*continued*)

TABLE 10.5 **Possible substantive procedures for accounts receivable assertions (*continued*)**

Category	Substantive Procedure	Account Balance Audit Objective (from Table 10.1)				
		OE5	RO1	C5	AV no.	D no.
	(b) Select a sample of credit memos issued after the year end, examine supporting documentation, and determine that the returns were recorded in the proper period. Also, consider whether the volume of sales returns after the year end suggests the possibility of unauthorized shipments before year end.					
	5. Perform cash receipts cut-off test. (a) Observe that all cash received before the close of business on the last day of the fiscal year is included in cash on hand or deposits in transit, and that no receipts of the subsequent period are included. (b) Review documentation such as daily cash summaries, duplicate deposit slips, and bank statements covering several days before and after the year-end date to determine the proper cut-off.	✓		✓		
Tests of details of balances	6. Confirm accounts receivable. (a) Determine the form, timing, and extent of confirmation requests. (b) Select and execute a sample and investigate exceptions. (c) For positive confirmation requests for which no reply was received, perform alternative follow-up procedures. • Vouch subsequent receipts identifiable with items constituting the account balance at the confirmation date to supporting documentation, as in step 3(b). • Vouch items constituting the balance at confirmation date to documentary support, as in step 3(a). (d) Summarize the results of confirmation and alternative follow-up procedures.	✓	✓		✓3	
	7. Evaluate the adequacy of the allowance for doubtful accounts. (a) Add and cross-add the aged trial balance of accounts receivable and agree the total with the general ledger. (b) Test aging by vouching amounts in aging categories for sample of accounts to supporting documentation. (c) Evaluate the adequacy of the allowance component for each aging category and in total.				✓4	
Classification and presentation	8. Compare the presentation of the financial statements with applicable accounting standards. (a) Determine that accounts receivable are properly classified by type and expected period of realization. (b) Determine whether there are credit balances that are significant in the aggregate and should be reclassified as liabilities. (c) Determine the appropriateness of the disclosure and accounting for related party or factored accounts receivable.				✓3	✓5, 6

information system, there is no working paper heading, and there are no columns for supporting working paper references, initials, and dates. Instead, for instructional purposes, there are columns to indicate the categories of substantive procedures and the specific account balance audit objectives from table 10.1 to which each procedure applies. Several

57 Short
58 Normal
59 long

of the procedures apply to more than one audit objective, and each objective is covered by multiple possible procedures. The procedures are explained in the sections that follow, including comments on how some procedures can be tailored, based on the planned level of detection risk to be achieved.

10.5.1 Initial Procedures

The starting point for verifying accounts receivable and the related allowance account is to trace the current period's opening balances to the closing audited balances in the previous year's working papers (when applicable). Next, the auditor should review the current period's activity in the general ledger control account and related allowance account for significant entries that are unusual in nature or amount and require special investigation.

An **accounts receivable trial balance** (listing all customer balances) is obtained, usually from the entity. To determine that it is an accurate and complete representation of the underlying accounting records, the auditor should add this listing and compare the total with both the toal of the subsidiary ledger from which it was prepared and the general ledger control account balance. The auditor should also compare a sample of the customer details and balances shown on the trial balance with those in the subsidiary ledger, and vice versa. The sample can then serve as the physical representation of the population of accounts receivable to be subjected to further substantive procedures.

accounts receivable trial balance a listing of individual customer balances at a particular date on the accounts receivable master file or accounts receivable sub-ledger

An example of an **aged trial balance** of an accounts receivable working paper is presented in **figure 10.3**. This working paper not only provides evidence of performance of the initial procedures just described, but of several of the other substantive procedures discussed in subsequent sections. The initial procedures in verifying the accuracy of the trial balance and determining its agreement with the control account in the general ledger relate mainly to the clerical and mathematical accuracy and therefore the accuracy, valuation, and allocation assertion.

aged trial balance an accounts receivable trial balance in which customer balances are analyzed by the period since each sales transaction was entered

The auditor can use computer-assisted audit techniques to perform substantive procedures on information stored on computer files through the use of computer audit software. Both generalized audit software and database packages can be used to print a trial balance directly from the accounts receivable master file, test the aging of a sample of accounts, and verify the total and its agreement with the control account in the general ledger.

10.5.2 Analytical Procedures

Tests of details are usually planned on the basis that the analytical procedures confirm expectations. It is preferable to perform analytical procedures early in the final audit so any necessary changes to tests of details can be determined before the start of that part of the audit.

The first stage in applying analytical procedures is to review the understanding of the entity, obtained during the planning phase, to determine whether any changes to sales and receivables balances are to be expected.

The second stage is to identify absolute changes in amounts between this year and previous years. This is normally done in the course of preparing the lead sheet for sales and accounts receivable. On this schedule, previous and current year ledger balances making up the financial statement disclosures are recorded side by side, making any differences readily apparent.

The third stage involves the use of more sophisticated relationships, such as ratios and trends. This procedure can be performed on accounting data held on computer files, using computer audit software. Significant ratios are gross profit and average collection period. If gross profit is higher than expected, it could be that sales have been overstated to boost revenue, such as by a deliberate cut-off error. An increase in average collection period indicates potential problems in collecting receivables, with the consequent need for a greater allowance. Wherever a change in relationships cannot be readily explained, the auditor must

57 Short
58 Normal
59 long

Bates Ltd. **Aged trial balance—Accounts receivable—Trade** **December 31, 2023**									
						Prepared by: A.C.E Reviewed by: P.A.R		W/P ref. B-1 Date: 2/13/24 Date: 2/20/24	
			Account no. 120						
			Past Due						
		Over 90 days	61 – 90 days	31 – 60 days		Balance per books 12/31/23		Balance per audit 12/31/23	
	Account name				Current		Adjustments		
	Ace Engineering		2,529.04	2,016.14	11,875.90	16,421.08 ✓		16,421.08	
ϕ	Allied Devices			15,938.89 ↖	27,901.11 ↖	43,840.00 ✓		43,840.00	C1
ϕ	Brown Construction	1,088.92 ↖	743.12 ↖	3,176.22 ↖	8,993.01 ↖	14,001.27 ✓		14,001.27	C2
ϕ	Balpreet Plumbing	501.10 ↖	7,309.50 ↖	30,948.01 ↖	24,441.25 ↖	63,199.86 ✓		63,199.86	C3
	Cermetrics Ltd.			3,813.76	8,617.30	12,431.06 ✓		12,431.06	
ϕ	Columbia Components				4,321.18 ↖	4,321.18 ✓		4,321.18	
	Drake Manufacturing			739.57	2,953.88	3,693.45 ✓		3,693.45	
	EMC		1,261.01	1,048.23	16,194.76	18,504.00 ✓		18,504.00	
ϕ	Graham Framing		7,799.36 ↖	20,006.63 ↖	89,017.15 ↖	116,823.14 ✓		116,823.14	C4
	Harvey Industries		1,709.16	6,111.25	18,247.31	26,067.72 ✓		26,067.72	
ϕ	Jed Ltd.	2,615.87 ↖	12,098.00 ↖	15,434.46 ↖	56,536.88 ↖	86,685.21 ✓	(9,416.96)	77,268.25	C5
	Jericho Electric		1,198.72	13,123.14		14,321.86 ✓		14,321.86	
	–	–	–	–	–	–	–	–	
	–	–	–	–	–	–	–	–	
	–	–	–	–	–	–	–	–	
	Rocko's Roofing		1,904.65 ↖	2,166.78 ↖	28,389.69	32,461.12		32,461.12	C60
	Yancey Ltd.	814.98	2,861.05	9,874.13	13,561.80	27,111.96		27,111.96	
		10,157.46	56,705.59	160,537.28	392,136.41	619,536.74	(9,416.96)	610,119.78	
		✓	✓	✓	✓	✓	✓	✓	
						B	B	B	

✓ Added or cross-added

ϕ Customer name and balance per books checked against subsidiary ledger

↖ Aging verified by examining transaction dates of related unpaid sales invoices in subsidiary ledger

C Account selected for confirmation—see W/P B–2

FIGURE 10.3 **Aged trial balance working paper**

seek an explanation from management and corroborate that explanation, usually by performing more tests of details. For accounts receivable and sales, analytical procedures can provide evidence relating to the existence or occurrence, completeness, and accuracy, valuation, and allocation assertions.

10.5.3 Tests of Details of Transactions

Where balances result from the effects of numerous transactions, it is normally more efficient to concentrate substantive procedures on tests of details of balances, and not tests of details of transactions. The latter are not unimportant, but serve to corroborate tests of details of balances. Often tests of transactions will be performed during the interim audit, commonly in the form of dual purpose tests. The cut-off tests described in later sections are always performed as part of year-end work and, although they are tests of transactions, serve to verify the recorded balance at the end of the reporting period.

Vouching Recorded Accounts Receivable to Supporting Transactions

This procedure involves vouching a sample of debits in customers' accounts to supporting sales invoices, and matching documents to provide evidence relevant to the existence, rights and obligations, and accuracy, valuation, and allocation assertions. It also involves vouching a sample of credits to remittance advices and sales adjustment authorizations to provide evidence relevant to the completeness assertion for accounts receivable that reductions in customer balances are legitimate.

Performing Sales Cut-Off Test

The **sales cut-off test** is designed to obtain reasonable assurance that:

- Sales and accounts receivable are recorded in the accounting period in which the transactions occurred.
- The corresponding entries for inventories and cost of sales are made in the same period.

sales cut-off test a substantive procedure designed to obtain reasonable assurance that sales and accounts receivable are recorded in the accounting period in which the transactions occurred, and that the corresponding entries for inventories and cost of sales are made in the same period

The sales cut-off test is made as at the end of the reporting period. Given the greater risk of overstatement, the emphasis is on verifying the occurrence of recorded sales before the year end. The auditor usually records the number of the last issued shipping document during attendance at the inventory count and compares it with the cut-off established for inventory purposes. For sales of goods from inventory, the procedure involves comparing a sample of recorded sales from the last few days of the current period with shipping documents numbered before the cut-off number to determine that the transactions occurred before the end of the reporting period. A smaller number of sales recorded after the end of the reporting period are vouched to shipping documents numbered after the cut-off, to ensure that none were delivered before the end of the reporting period.

The **sales return cut-off test** is similar and is particularly directed toward the possibility that returns made before year end are not recorded until after year end, resulting in the overstatement of accounts receivable and sales. The auditor can determine the correct cut-off by examining dated receiving reports for returned merchandise and correspondence with customers. The auditor should also be alert to the possibility that an unusually heavy volume of sales returns shortly after the year end could signal unauthorized shipments before year end to inflate recorded sales and accounts receivable.

sales return cut-off test a substantive procedure designed to obtain reasonable assurance that sales returns are accounted for in the period in which the original sales transactions took place

Performing Cash Receipts Cut-Off Test

The **cash receipts cut-off test** is designed to obtain reasonable assurance that cash receipts are recorded in the accounting period in which they are received. A proper cut-off at the end of the reporting period is essential to the correct presentation of both cash and accounts receivable. If present at the year-end date, the auditor can observe that all collections received before close of business are included in cash on hand or in deposits in transit, and are credited to accounts receivable. An alternative to personal observation is to review supporting documentation such as the daily cash summary and a validated deposit slip for the last day of the fiscal year. The objective of the review is to determine that the deposit slip total agrees with the receipts shown on the daily cash summary. In addition, the auditor should determine that the receipts were recorded on the closing date.

cash receipts cut-off test a substantive procedure designed to obtain reasonable assurance that cash receipts are recorded in the accounting period in which they are received

10.5.4 Tests of Details of Balances

As explained above, most of the audit effort on receivables is obtained through tests of details of balances, of which the most important is the confirmation of accounts receivable and related follow-up procedures. Confirmation provides evidence as to existence and rights. It does not provide evidence of completeness, because customers are unlikely to admit to owing more than their recorded balance. The other major test of details of balances is an evaluation of the adequacy of the allowance for doubtful accounts.

Cloud 9 Integrated Case

One of the substantive procedures selected and assigned to Josh is preparing the accounts receivable confirmations. As required by the audit program, Josh selected a stratified sample whereby clients with material account balances are selected for confirmation. Of the remaining accounts, a random sample is to be selected. Josh has given the confirmation list to Carla, the controller of Cloud 9, so she can have the confirmations prepared on the Cloud 9 letterhead. While he is waiting for the letters to be returned to him, he prepares a confirmation control working paper listing the customer accounts selected for confirmation. He knows he will need this list to follow up with customers who may not reply right away. He hopes to get a strong response rate, as it will reduce the need to perform alternative procedures over the existence of the accounts receivable.

Confirmation of accounts receivable involves direct written communication by the auditor with individual customers. The test is often referred to as an accounts receivable circularization. The confirmation of accounts receivable is a common audit procedure when they are material and it is reasonable to presume the accounts receivable customers will respond (CAS 505 *External Confirmations*). Confirmation is usually the most efficient procedure for gaining sufficient appropriate audit evidence to support the existence and rights assertions of accounts receivable. There are circumstances, however, in which the auditor concludes that confirmation is unlikely to be effective and that sufficient appropriate audit evidence can be achieved through the performance of alternative audit procedures. Based on the previous year's audit experience on that engagement, the auditor might expect, for example, that responses will be unreliable in the current year or that the response rates will be inadequate. Also, in some cases, customers may be unable to confirm balances if they use voucher systems that show the amount owed on individual transactions, but not the total amount owed to one creditor. The auditor may be able to overcome this problem by confirming individual transactions rather than balances.

As written evidence from third parties, responses to confirmation requests constitute highly reliable evidence. Against this, the following must be remembered:

- Because a customer agrees to owing a balance (existence), it does not mean they will have the cash on hand to settle the receivable when it is due (accuracy, valuation, and allocation).
- Some customers may not maintain adequate accounts payable records to provide a reliable response.
- Customers are unlikely to admit to owing more than is shown on the monthly statement, limiting the evidence to that of existence and rights.
- Many trivial differences are likely to be reported as a result of goods and cash in transit.
- The non-response rate may be high, resulting in the need to perform alternative procedures.

Given that dealings between the entity and its customers are confidential, the entity must authorize its customers to disclose details of the outstanding balance to its auditors. Occasionally, entities have prohibited auditors from confirming certain accounts receivable. The effect of prohibition should be evaluated on the basis of management's reasons, with the auditor determining whether sufficient evidence from other auditing procedures can be obtained. If the auditor regards management's reasons as unacceptable, then there is a limitation on the scope of the audit that might result in a modified auditor's report.

Form of Confirmation

There are two forms of confirmation request:

1. the positive form, which requires the customer to respond that the balance shown is correct or incorrect
2. the negative form, which requires the customer to respond only when the amount shown is incorrect

The positive form generally produces statistically valid evidence, providing that non-responses are verified by other means. With the negative form, it is impossible to determine whether a lack of response indicates agreement with the balance or simply a failure to reply. The positive form is used when detection risk is low or individual customer balances are relatively large. The negative form should be used only when the following conditions apply:

- Detection risk is moderate or high.
- There is a large number of small balances in the population.
- The auditor has no reason to believe that the respondents are unlikely to give the request due consideration.

Timing and Extent of Requests

When the acceptable level of detection risk is low, the auditor ordinarily confirms receivables as at the end of the reporting period. Otherwise, the confirmation date may be one or two months earlier. In such cases, the auditor must:

- perform analytical procedures on entries in the accounts receivable control account in the period between the date of confirmation and the end of the reporting period, and obtain a satisfactory explanation for any unexpected changes
- perform tests of controls in the intervening period to ensure that the assessment of control risk leading to a decision to accept a high level of detection risk continues to apply

Accounts receivable may be divided into distinct populations for sampling. For example, different categories of accounts receivable, such as wholesale and retail, may be subject to different information systems and control procedures and, thus, different control risks. Also, individually material balances are often confirmed directly and the remainder are subdivided into either overdue accounts or other, with a proportionately larger number of the former selected for confirmation as presenting a greater risk of misstatement. Sample size may be determined judgementally or with the aid of a statistical sampling plan. Apart from the exceptions noted, selection of accounts for confirmation should be effectively random.

Control of the Requests

The auditor must control every step in the confirmation process. This means:

- before selecting the sample for confirmation, performing the initial procedures described above to ensure the list of balances is complete and accurate
- drawing up a list of selected accounts and verifying that confirmation requests, prepared and signed by entity management at the auditor's request, are in complete agreement with that list
- ascertaining that the amount, name, and address on the confirmation agree with the corresponding data in the customer's account
- maintaining custody of the confirmations until they are mailed
- using the audit firm's own return address envelopes for the confirmations
- personally mailing the confirmation letters
- requiring that the replies be sent directly to the auditor

A working paper should list each account selected for confirmation and the results obtained from each request, cross-referenced to the actual confirmation response (which should also be filed with the working papers). A confirmation control working paper is illustrated in **figure 10.4**.

Disposition of Exceptions

Confirmation responses will inevitably contain some exceptions. Exceptions may be attributable to goods in transit from the entity to the customer, returned goods or payments in transit from the customer to the entity, items in dispute, or errors and irregularities. The auditor should investigate all exceptions and record their resolution in the working papers (as illustrated in figure 10.4).

Bates Ltd. Accounts receivable confirmation control **December 31, 2023**						W/P ref. B-2
				Prepared by: A.C.E		Date: 2/14/24
				Reviewed by: P.A.R		Date: 2/18/24
			Account no. 120			
Conf. no.	Customer	Book value	Confirmed value	Audited value	(Over)Under statement	Subsequent collections examined to 1/30/24
1	Allied Devices	43,840.00	43,840.00 ϕ	43,840.00		
2	Brown Construction	14,001.27	NR	14,001.27		14,001.27 ✓
3	Balpreet Plumbing	63,199.86	63,199.86 ϕ	63,199.86		
4	Graham Framing	116,823.14	116,823.14 ϕ	116,823.14		
5	Jed Ltd.	86,685.21	77,268.25 ϕ	77,268.25	(9,416.96) x1	
–	–	–	–	–	–	–
–	–	–	–	–	–	–
–	–	–	–	–	–	–
60	Rocko's Roofing	32,461.12	NR	32,461.12 ↖		4,071.43 ✓
	Totals	470,847.92	414,968.57	461,430.96	(9,416.96)	
Response recap:		No. of items				
Value of confirmations mailed		60	$470,847.92			
Value of confirmations received		58	$414,968.57			
		97%	88%			
Summary of results:						
Value of account total			$619,536.74			
Book value of confirmation sample			$470,847.92			
Coverage of book value			76%			
Audited value of sample			$461,430.96			
Ratio of audited value to book value of sample			98%			

ϕ Signed confirmation response attached for confirmed values

NR No response—alternative procedures performed

✓ Examined entries in cash receipts journal and related remittance advices for total collections indicated

↖ Examined supporting documentation for portion of book value remaining uncollected as at 1/30/24

x1 Credit memo issued 1/5/24 for merchandise returned 12/28/23. Adjusting entry:

Dr Sales Returns	9,416.96		See W/P B–1 and AE–1
Cr Accounts Receivable		9,416.96	

FIGURE 10.4 **Confirmation control working paper**

Computer Information Systems

Computer audit software assists the auditor in confirming receivables held on an accounts receivable master file. As explained in our discussion of initial procedures, the software can be programmed to test the completeness and accuracy of receivables listed on the master file. Software can also be used to select accounts on bases as previously discussed, print the letters for circularization, and prepare a working paper for recording responses.

Alternative Procedures for Dealing with Non-Responses

When no response has been received after the second (or third) positive confirmation request to a customer, the auditor should perform alternative procedures. The two main alternative procedures are examining subsequent receipts and vouching unpaid invoices and supporting documentation constituting customer balances.

The best evidence of existence and collectibility is the receipt of payment from the customer. Before the conclusion of the auditor's examination, the entity will receive payments from many customers on amounts owed at the confirmation date. The matching of such cash receipts to unpaid invoices at the confirmation date, substantiated by the remittance advice accompanying the cash receipt, establishes the existence and collectibility of the accounts.

Vouching open invoices constituting balances is a variation of step 3(a) in table 10.5. Preferably, the unpaid item should be traced to a shipping document signed by the customer acknowledging receipt of the goods, or to a written order from the customer.

Summary and Evaluation of the Results

The auditor's working papers should contain a summary of the results of confirming the accounts receivable. (The lower part of figure 10.4 illustrates how such data may be presented.) The auditor may use statistical or non-statistical procedures to project misstatements found in the sample to the population. Note though, for a sample test, that it is not sufficient merely to correct errors detected by the confirmation, but that the implications for the entire population of accounts receivable must also be considered.

The auditor evaluates evidence from the confirmations, alternative procedures performed on non-responses, and other tests of details and analytical procedures to determine whether there is sufficient evidence to support management's assertions about accounts receivable.

10.5.5 Evaluating Adequacy of the Allowance for Doubtful Accounts

Most entities determine the allowance for doubtful accounts by:

- making a general allowance, such as a percentage of balances overdue by more than a specified period
- making a specific allowance, by identifying customers who are known to be in financial difficulty or who are disputing payment

Common procedures performed regarding the allowance for doubtful accounts include:

- vouching amounts in aging categories to supporting documentation
- examining evidence of collectibility and discussing the collectibility of past due accounts with management
- reviewing the assumptions underlying the estimate and considering their reasonableness
- checking the calculations (such as the percentages applied to each overdue category) in determining the general allowance
- evaluating previous year's allowance

The allowance is an estimate that falls under CAS 540 *Auditing Accounting Estimates and Related Disclosures*. The auditor should examine evidence up to the audit report date, which may provide evidence regarding the estimation uncertainty of the allowance. To assess management's estimate, the auditor may examine correspondence with customers and outside collection agencies, review customers' credit reports and financial statements, and discuss the collectibility of the account with appropriate management personnel. This review includes a consideration of subsequent events, such as news of a customer's financial difficulties or payment of a disputed amount.

10.5.6 Disclosure

The auditor must be knowledgeable about the disclosure requirements for accounts receivable and sales. A review of the accounts receivable trial balance may indicate amounts due from employees, officers, other group entities, and related parties that should be specifically identified if material. The same source may reveal credit balances in customer accounts that may warrant classification as current liabilities. There should also be disclosure of the pledging, assigning, or factoring of accounts receivable. The auditor should be able to obtain evidence of such activities from a review of the minutes of board meetings and from inquiry of management. As one of the final steps in the audit, the auditor should obtain management's representations on these matters in writing in a representation letter. These procedures will ensure the classification and presentation assertions are met.

Cloud 9 Integrated Case

Josh is now happy to be completing his work on the accounts receivable and the sales cycle. He just finished following up on the accounts receivable confirmation requests, and overall he is pleased with the response rate. However, he still needs to perform subsequent receipts testing and vouch unpaid invoices and shipping documents for those accounts that did not send back confirmations. He knows he has to complete these procedures before he can conclude on the existence assertion for the accounts receivable.

In terms of valuation, he did discuss the adequacy of the allowance for doubtful accounts with Carla. His discussions focused on the balances that were over 90 days old and he is overall satisfied with the allowance for doubtful accounts recorded by Cloud 9. Josh has also decided to conduct an audit data analytic and compare the sales data with the accounts receivable and cash receipts data to verify cut-off.

With the substantive procedures almost completed, Josh is hoping to sign off on the accounts receivable procedures by the end of the day, as he is quite anxious to see what is next.

Before You Go On

10.5.1 What is the purpose of vouching recorded accounts receivable to supporting transactions?

10.5.2 What is the purpose of sales cut-off testing?

10.5.3 What are four reasons why accounts receivable confirmations may not provide reliable evidence?

Summary

1 Identify the audit objectives applicable to sales and receivables.

When auditing sales and receivables, the auditor's objective is to obtain sufficient appropriate evidence about each relevant assertion for the applicable classes of transactions and balances. Significant assertions for sales, cash receipts, and sales adjustments include occurrence, completeness, accuracy, cut-off, classification, and presentation. Relevant assertions for accounts receivable and allowance for doubtful accounts include existence; completeness; accuracy, valuation, and allocation; classification; and presentation. Evidence may be obtained by tests of controls or substantive testing depending on the audit strategy chosen.

2 Describe the functions and control procedures normally found in information systems for processing sales, cash receipts, and sales adjustment transactions.

The sales cycle includes processing credit sales, cash receipts, and sales adjustment transactions. A typical sales process for credit sales includes accepting customer orders, approving credit, filling and shipping sales orders, invoicing customers, and recording sales transactions. The cash receipts process includes receiving, depositing, and recording cash receipts, while sales adjustments include granting cash discounts, processing sales returns and allowances, and determining bad debts. Control procedures such as appropriate segregation of duties, authorizations, and use of documents and records should be interwoven into each process to reduce the risk of misstatement in the financial statements.

3 Outline audit strategy considerations including the risk of material misstatement and tests of controls for sales, cash receipts, and sales adjustment transactions.

To determine the appropriate audit strategy, the auditor starts with obtaining an understanding of the entity. This is necessary for the auditor to assess the inherent and control risks. For audit purposes, the most significant inherent risk is that of overstatement of sales transactions and receivables balances to boost reported profits and assets. For the entity, the greatest inherent risk is that of misappropriation of cash arising from sales transactions. The auditor assesses control risk by evaluating the design effectiveness of internal controls. The auditor drafts the audit program based on the preliminary assessment of control risk, identifying both tests of the operating effectiveness of controls and the reduced level of substantive procedures relevant to the control risk assessment. The auditor confirms the control risk assessment on completion of the tests of operating effectiveness.

4 Indicate the factors relevant to determining an acceptable level of detection risk for the audit of sales and receivables.

Before designing substantive procedures, the auditor must determine the acceptable level of detection risk for each significant related assertion. This level of detection risk will be used by the auditor to determine the nature, timing, and extent of substantive procedures that need to be performed.

5 Design a substantive audit program for sales and receivables.

It is usually cost-effective to perform substantive tests on the balance of receivables rather than the transactions making up that balance. The most important test of transactions is that of cut-off at the year end. The major test of balances is the confirmation of accounts receivable. Given that customers are third parties, such evidence is highly reliable. If no response is received, the auditor performs alternative procedures, such as examining subsequent collections and vouching unpaid invoices and supporting documentation constituting customer balances. The auditor must also verify the estimate of the allowance for doubtful accounts.

Key Terms

Self-Test Questions

Answers can be found in *WileyPlus*.

10.1 Use of an authorized price list in preparing the sales invoices will primarily meet the:

a. existence or occurrence assertion.

b. completeness assertion.

c. accuracy, valuation, and allocation assertion.

d. rights and obligations assertion.

10.2 Accounting for the numerical sequence of shipping documents used in tracing will primarily meet the:

a. existence or occurrence assertion.

b. completeness assertion.

c. accuracy, valuation, and allocation assertion.

d. rights and obligations assertion.

10.3 To enhance controls in the credit sales area, the warehouse should be instructed not to release goods until:

a. a faxed copy of the sales requisition is received.

b. a completed sales invoice is received.

c. an approved sales order is received.

d. the shipping department requests the goods.

10.4 A key control environment factor in reducing the risk of fraudulent financial reporting through the overstatement of sales and accounts receivable is:

(i) management's adoption of and adherence to high standards of integrity and ethical values

(ii) reducing the emphasis on sales targets

(iii) establishing an effective audit committee

a. (i) and (ii) only.

b. (ii) and (iii) only.

c. (i) and (iii) only.

d. (i), (ii), and (iii).

10.5 In most audits, the auditor is concerned about sales adjustment transactions because of:

a. the sheer number and value of these transactions.

b. the lack of proper authorization for these transactions.

c. the potential use of these transactions to conceal a theft of cash.

d. poor controls normally found over these transactions and the inherent lack of documentation.

10.6 In relation to materiality, the following statement is most accurate:

a. accounts receivable produced by credit sales transactions are material to the balance sheet for all businesses except those with primarily cash sales.

b. cash balances at the end of a particular reporting period will always be material.

c. the significance of sales adjustment transactions is consistent across entities.

d. bad debt expense is sometimes material to the profit and loss of entities that sell on credit.

10.7 Control risk assessments for accounts receivable assertions depend on the related control risk assessments for the class of transactions. The classes of transactions that do not relate to the accounts receivable balance are:

- **a.** credit sales.
- **b.** cash sales.
- **c.** sales adjustments.
- **d.** cash receipts.

10.8 When examining sales transactions, the following is not possible using generalized audit software:

- **a.** inquiring about segregation of duties for invoicing customers.
- **b.** selecting a sample of invoices for inspection.
- **c.** re-performing invoice pricing and reporting differences.
- **d.** ensuring the sales journal is correctly totalled.

10.9 The following is a cut-off test:

- **a.** selecting a sample of shipping documents around the year end and agreeing to sales invoices to ensure they are included in the appropriate period.
- **b.** selecting a sample of receivables balances outstanding at the year end and agreeing to cash received after the year end.
- **c.** selecting a sample of bad debts written off after the year end and agreeing to sales invoices dated before the year end.
- **d.** selecting a sample of receivables balances from the list of receivables and agreeing the build-up of the balance to sales invoices.

10.10 Confirming accounts receivable is required whenever:

- **a.** they are material in amount.
- **b.** it is reasonable to presume accounts receivable customers will respond.
- **c.** they are material and it is reasonable to presume accounts receivable customers will respond.
- **d.** a large number of small balances is involved.

Review Questions

10.1 Describe the inherent risks specific to sales and receivables the auditor needs to consider.

10.2 Why is the control risk assessment of the completeness of cash receipts and sales adjustment transactions associated with the control risk over the existence of the accounts receivable balance?

10.3 Why is the auditor likely to adopt a combined audit approach to accounts receivable wherever practicable? Why are substantive procedures more likely to be based on the accounts receivable balance than on sales, cash receipts, and sales adjustment transactions?

10.4 Outline the procedures involved in performing accounts receivable confirmations.

10.5 If the auditor does not receive a response after sending a letter to confirm a customer's account balance, what alternative audit procedures may be performed?

10.6 Discuss situations in which sales adjustments may be necessary. Identify necessary controls to ensure that the accounting system recognizes only genuine adjustments.

10.7 Identify situations leading to an inherent risk that an entity may wish to (a) overstate sales revenue and (b) understate sales revenue.

10.8 Explain the kinds of fraud that could be expected in sales, cash receipts, and sales adjustment transactions in the absence of adequate internal control procedures. Consider the importance of the segregation of duties in preventing such frauds.

10.9 Explain what is meant by "cut-off" and why it is important to auditors in establishing the fairness of the financial statements.

10.10 CAS 530 *Audit Sampling* distinguishes between sampling and other selective testing procedures. Explain the application of the requirements of this standard to the selection of accounts receivable confirmations.

Professional Application Questions

Basic **Moderate** **Challenging**

10.1 Audit objectives over the sales cycle **Basic** **LO 1**

Required

For each of the following statements, identify the audit assertion that it relates to:

- **a.** Sales are made to customers that do not have approved credit.
- **b.** Goods not ordered by the customer are shipped.
- **c.** Unit prices on customer invoices are incorrect.
- **d.** Invoices are not posted to customer accounts.
- **e.** Goods are shipped but not invoiced.

f. Sales may be made to unauthorized customers.

g. Fictitious sales may be recorded.

10.2 Sales cycle documents **Basic** **LO 2**

Key documents are used throughout the sales process and each supports an internal control function.

Required

For each of the following documents, describe its purpose and how it contributes to internal control over the sales cycle:

a. Customer order

b. Sales order

c. Accounts receivable master file

d. Shipping document

e. Sales invoice

f. Monthly customer statement

g. Deposit slip

[1] **10.3** Control weaknesses **Challenging** **LO 1, 2, 3**

Namini Corp. sells its products to clients ranging from proprietorships to medium-sized entities. Namini is controlled by two family members, and most of the employees are casual staff employed during the busy seasons (November 1 through January 15, and May 1 to July 15). The company's managers feel that on-the-job training is adequate for their needs and that the labour savings from using temporary staff are reflected in the profits that Namini has earned for the family each year.

The company has made a niche in its market by guaranteeing excellent and quick customer service. When a customer order is received, either by phone or by fax, the customer service clerk (CSC) who takes the order checks that Namini has the goods in stock and the correct price by checking an online database of inventory on hand. If the goods are available, the clerk then personally phones the customer back to verify the order, including both quantity and price for each item, and then calculates the extended prices for the entire order. The clerk then prepares a sales invoice and faxes a copy to the customer. Namini's policy is for the sales invoice to show a shipping date of one day from the order date. The clerk then walks to the warehouse (adjacent to the sales office), selects the goods, and takes them to shipping.

The company has a shipping staff of four people, and the shipping department will not ship any goods without a sales invoice initialled by the CSC. The shipping department is determined to reduce the number of shipping errors. This year, only nine shipments have occurred in which there was no sales invoice initialled and attached to the shipping bill. One of these turned out to be an urgent shipment to a long-time customer, sent on the manager's verbal instructions. In that case, the shipping clerk noted that the manager provided a sales invoice within one day for the shipping records. Another shipment resulted in the CSC being fired for fraud when it was discovered that he had sent a shipment of goods to a friend at below cost. Therefore, only the other seven shipments were considered to be true errors.

If the sales invoice does not indicate who is to pay the shipping costs, then Namini sends the goods FOB shipping point. When a shipment is occasionally delivered to an incorrect address, it is the CSC's job to contact the customer and obtain the correct information. If the account is unpaid after the due date (30 days), the receptionist mails a reminder invoice to the customer. If the account remains unpaid after 60 days, the receptionist pulls the sales invoice and gives it to the CSC who made the sale. The CSC is then responsible for contacting the customer by phone to determine if there is a problem.

Required

Identify *five* different types of weaknesses in Namini's internal controls.

10.4 Cash sales system controls **Moderate** **LO 1, 2, 3**

As the internal auditor of the Sellanything Group of companies, you have been asked to investigate the cash sales system of Stationery Ltd., one of the subsidiaries. Stationery sells office supplies in the Halifax

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area. Its prices are highly competitive and it offers a same-day delivery service for orders telephoned before noon. Costs are kept down by requiring cash on delivery. Sales are made in the following way:

1. The customer phones through an order to the sales department, which raises a pre-numbered multi-copy sales order, two of which (the invoice copies) are priced and totalled.
2. The shipping department makes up the order and gives the goods to the driver with the invoice copies of the order.
3. The driver delivers the goods, collects the cash, and receipts the customer's copy of the invoice.
4. The driver returns and hands over the cash and the second copy of the invoice to the cashier.
5. The cashier records and deposits the cash.

Required

a. Identify any weaknesses in the cash sales system.

b. Describe any audit tests you would perform to ensure that there was no material error or fraud within the system.

10.5 Control strengths and weaknesses **Moderate** **LO 1, 2, 3**

Soak City Waterpark is a family-owned business just outside of Winnipeg. The waterpark is only open for business from May to September. During the winter, the waterpark undergoes repairs and maintenance upgrades.

The capital assets for Soak City are significant and the waterpark recently completed an expansion project, where additional fencing, a restaurant, and a POS system were installed and three additional slides were constructed.

The following are Soak City's accounting procedures for revenue, receivables, and receipts. This is strictly a cash business. Revenues consist primarily of admission fees, but other revenues include restaurant sales and locker rentals. There are six cash registers open at peak times, and each starts with a daily float of $200. When the park is closed, the cash tills are kept in a vault.

At the end of each day, each cashier counts out the float and places the remaining cash in an envelope and gives it to the admissions manager. The admissions manager counts the cash and prepares the bank deposit. The admissions manager also completes a sales summary report, which summarizes the cash sales. This report is forwarded to the accounting department and the sales are recorded in the general ledger based on this report. When completing this report, she calculates and compares the admission revenues recorded in the tills with the cash collected. This information is forwarded to the general manager, who compares the sales with the bank statements.

Required

a. Identify the control strengths at Soak City Waterpark.

b. Identify the control weaknesses at Soak City Waterpark. For each weakness, state the implication (the WCGW) of the weakness and make a recommendation to correct it.

10.6 Revenue cycle strengths and weaknesses **Moderate** **LO 1, 2, 3**

Venture Volunteers for Troubled Teens (VVTT) is a not-for-profit entity that provides counselling services to troubled teens and adolescents. While the majority of its funding comes from the government, the group also participates in a variety of fundraising activities. To manage the fundraising activities and administer the various programs, there is an executive director, a receptionist, two accounting staff, and several youth counsellors.

The mail is opened by the receptionist. The receptionist photocopies any cheques and then passes them on to Andrea, a member of the accounting staff. When Andrea receives the cheques, she prepares the bank deposit and gives it to Ling for review (which is denoted by an initial on the bank deposit). It is then placed in the safe until Friday, as deposits are made once a week.

Ling then enters the information provided by Andrea into the general ledger based on the photocopies of the cheques received. Andrea subsequently matches the general ledger journal entries to the bank deposit and they are filed by date. The bank reconciliation is performed by Andrea when time allows. The executive director reviews the bank reconciliation when it is complete.

When significant government funds are received in advance, Ling records the cash with the credit to deferred revenue. As the revenue is earned, Ling posts an additional entry recognizing the revenue as earned. This is reviewed by the executive director on a monthly basis.

Once a year, the entity runs a door-to-door canvass to collect donations from the general public. Volunteers knock on people's doors and ask for funds. Each canvasser is provided with a pre-numbered sequential receipt book and duplicate receipts are to be given to all donors for tax purposes. All funds collected are to be remitted to the receptionist with the accompanying receipt book and a summary worksheet of donations collected. The amount collected is counted by the receptionist and forwarded to Andrea. Andrea prepares the deposit and records the cash donations. The deposit runs are done more frequently while this program is running to reduce the amount of cash on hand.

Required

a. Identify the control strengths of the revenue process at VVTT.

b. Identify the control weaknesses of the revenue process at VVTT. For each weakness, identify the implication of the weakness and recommend how to improve it.

10.7 Computerized sales system—controls **Moderate** **LO 1, 2, 3**

Bestwood Ltd. is planning to replace its computerized sales accounting system. The managing director has asked for your advice on certain matters relating to the new system.

The existing system uses the computer to produce sales invoices from handwritten shipping documents, posts them to the accounts receivable ledger, records cash received, and produces an aged analysis of receivables. The main weaknesses of the existing system are that many documents are still handwritten or typed and it is possible to deliver goods to customers with poor credit ratings, thus creating excessive collection costs and a high level of bad debts.

The managing director suggests that the new system should:

1. produce the order confirmation
2. produce the shipping note when the goods are ready for delivery
3. produce the sales invoice at the same time as the shipping document, using information from the shipping document and prices from a master price list, and post the invoice to the accounts receivable ledger
4. record receipts of cash from customers in the accounts receivable ledger and in the cash book

Access to the system will be from terminals and controlled by the use of passwords and by restrictions on the tasks that can be performed from specific terminals.

In view of the large number of orders, the managing director wants the computer to perform credit checks on customers with minimum intervention by the credit manager. The credit checks by the computer will use data input into the system by the credit manager and information on the customer master file. When the programmed criteria decide that goods should not be sent to a particular customer, the credit manager may override the computer.

Required

a. Describe the controls the computer system should exercise before:

- **i.** confirming a customer's order
- **ii.** creating a shipping document authorizing the delivery of goods to the customer

b. Describe the controls that should be exercised over:

- **i.** changing customer details, including adding new customers, amending details of existing customers, and deleting customers
- **ii.** changing customer credit limits
- **iii.** changing selling prices of goods

c. Describe:

- **i.** the credit criteria that the computer system should use to authorize delivery of goods to customers
- **ii.** the manual procedures the credit manager should undertake when overriding the computer

Source: Adapted from ACCA Audit Framework, Paper 6, June 1996.

10.8 Tests of controls—sales transactions **Challenging** **LO 1, 2, 3**

You have been assigned to perform tests of controls on the sales system at EDB Ltd. as part of the December 31, 2023, audit. EDB is a wholesaler of bathroom supplies such as vanity units, toilets, taps, and sinks. During testing, you noted the following errors:

1. Invoice no. 51839 issued on January 12, 2023, was entered twice. The error was discovered when the customer phoned to complain about being charged double the agreed amount.
2. Invoice no. 54922 issued on March 25, 2023, contained incorrect prices. Three vanity units were charged at \$453 each instead of \$543, and five sinks were charged at \$231 each instead of \$321. The error was discovered when the salesperson complained about not receiving the full commission for the month.

3. No prices were entered on invoice no. 56329 issued on April 24, 2023, resulting in a zero dollar invoice being issued. The error was discovered when accounts receivable staff noticed the zero amount appearing on the accounts receivable ledger.
4. Invoice no. 59328 issued on July 18, 2023, matched the customer's order. However, the order was only partially filled because of a lack of inventory in the warehouse, meaning items that were never delivered were included in the invoice. The error was discovered when the customer phoned to complain about being overcharged.
5. Invoice no. 61348 issued on August 7, 2023, was sent to the wrong address. Apparently, the invoice had the correct address on it, but a typing error occurred on the envelope. The error was discovered when the customer phoned to complain about the overdue notice received, stating that the invoice had never been received in the first place.
6. Invoice no. 64875 issued on November 29, 2023, was not processed through the usual channels. The details were correct but certain procedures, such as a formal credit check, were not documented. The invoice was a special order for a large building project and amounted to around 10 times the value of EDB's average invoices. The sale was personally handled by one of the directors and the invoice was prepared by his assistant.

Required

Treating each of the listed errors independently:

a. Describe application controls (both manual and via the computer information system) that would have prevented or detected the error.
b. Describe further work you would perform in relation to each of the errors.
c. Explain the implications of the errors for your substantive testing of accounts receivable.

10.9 Computer-assisted substantive testing for accounts receivable Basic LO 3

Ally Bobyk is conducting the audit of a wholesale electrical goods distributor, Electra Ltd. Electra supplies appliances to hundreds of individual customers in the Toronto area. It maintains detailed accounts receivable records on a computer system. The customer account master file is updated at the end of each business day. Each customer record in the master file contains the following data:

- customer account number
- customer address
- open (unpaid) invoices at the beginning of the month, by invoice number and date
- sales during the current month, by invoice number and date
- individual cash receipts during the current month
- date of last sale
- date of last cash receipt

Ally is planning to confirm selected accounts receivable as at the end of the current month. She will have available a computer file of the data on the accounts receivable master file on the date on which the company sends monthly statements to its customers. Ally has a generalized software package to help her in this task.

Required

Detail how Ally will be able to use the computer software package and accounts receivable master file to help her in the audit of accounts receivable.

Source: Adapted from an AICPA Audit Framework paper.

10.10 Substantive audit program for accounts receivable Challenging LO 4, 5

Your client is BigC Ltd., a large private firm with offices in all major cities of Canada. BigC specializes in selling concentrated fruit juices to Canadian and overseas buyers. This is the first year your firm will perform the audit. You are currently completing the planning work for the audit of accounts receivable for the year ending June 30, 2023, and have gathered the following information:

1. The Vancouver office recently won a large contract to supply an overseas supermarket chain with concentrated orange juice.
2. For the month of January, the Toronto office ran a sales promotion that allowed new customers double the normal credit terms of 30 days. Several new large customers took advantage of this offer.

3. The Montreal office has been experiencing a higher than usual level of sales returns owing to mould growth in a batch of guava juice.

You have calculated the receivables turnover ratio and receivables to total assets ratio for each of the branch offices, as shown in the tables below.

Office	Receivables Turnover Ratio		
	8 Months to February 2023	12 Months to June 2022	12 Months to June 2021
Victoria	8.0	9.2	10.1
Vancouver	7.5	9.1	9.2
Calgary	5.2	6.0	7.1
Toronto	10.1	8.5	9.5
Ottawa	8.8	9.0	9.0
Montreal	8.5	7.9	7.1
Halifax	5.9	6.0	6.0

Office	Receivables to Total Assets Ratio		
	8 Months to February 2023	12 Months to June 2022	12 Months to June 2021
Victoria	0.25	0.12	0.10
Vancouver	0.15	0.15	0.15
Calgary	0.18	0.14	0.12
Toronto	0.15	0.16	0.17
Ottawa	0.23	0.16	0.20
Montreal	0.17	0.30	0.15
Halifax	0.19	0.25	0.22

Required

a. List the questions you would ask of management in relation to the accounts receivable of each of the branch offices.

b. Describe additional audit work you would perform to satisfy yourself that accounts receivable were fairly stated.

Source: Adapted from Professional Year Programme of the ICAA, 1997, Accounting 2 Module.

10.11 Substantive procedures for allowance for doubtful accounts **Moderate** **LO 4, 5**

It is common practice for companies to make two allowances for doubtful accounts:

1. The specific allowance is based on accounts the company has reason to suspect may not be paid.
2. The general allowance relates to accounts as yet unknown but that experience suggests may not be paid. The likelihood of a receivable account being unpaid is usually assumed to increase the longer it remains unpaid, and many companies determine a general allowance as a percentage of overdue receivables, with an increasing percentage being applied against the longest overdue accounts.

You are aware that CAS 540 *Auditing Accounting Estimates and Related Disclosures* is likely to be relevant to the audit of the allowance for doubtful accounts.

Required

Describe the procedures you would adopt in verifying:

a. a general allowance for doubtful accounts

b. a specific allowance for doubtful accounts

CLIENT: New Millennium Ecoproducts	E04 – ACCOUNTS RECEIVABLE CUT-OFF	W&S PARTNERS
Period-end: Dec. 31, 2023		Reference
Currency/unit: $		E04

1. *Comments relating to our review of sales before and after year end (client's analysis by week, day...)*

Reference of work done:	E04.1

Comments:

✓ No unusual transactions or peak in sales detected.

2. *Specific tests as per audit program*

Customer name	Invoice number	Date in AR ledger	Amount	TM/Ref	Delivery date	TM/Ref	Recorded in the proper period? Yes/No	Comments
Transactions recorded before year end								
Brighter Bobs	785 553	12/29/23	25,000	✓	12/29/23	✗	Yes	
etc....								
Transactions recorded after year end								
Grey Ghost	854 321	01/05/24	33,000	✓	01/04/24	✗	Yes	
etc...								

Key to audit tickmarks:

✓ Agrees to invoice

✗ Agrees to shipping document

Comments:

✓ No errors detected

3. *Analytical procedures*

Reference of work done:	E04.2

Comments:

✓ No unusual transactions or peak in sales detected.

FIGURE 10.5 Accounts receivable balances working paper

10.12 Accounts receivable cut-off **Basic** **LO 4, 5**

Figure 10.5 is a copy of the auditor's working paper for auditing accounts receivable balances for the client New Millennium Ecoproducts. It shows the details of the cut-off tests.

Required

a. Find the details of the transactions selected for cut-off tests. Why would these transactions be selected for testing?

b. Explain how the auditor has used documents to test the details of the transactions. Why are these documents relevant to the tests?

c. Have any errors or misstatements been revealed by the cut-off tests in this example? If so, describe the error.

10.13 Accounts receivable confirmations **Basic** **LO 5**

Your firm is the external auditor of Southwood Trading Ltd. and you are auditing the financial statements for the year ended June 30, 2023. Southwood Trading has sales of $25 million and the accounts receivable at June 30, 2023, were $5.2 million.

The engagement partner has asked you to consider the relative reliability of evidence from third parties and certain matters relating to an accounts receivable confirmation.

Required

a. Consider the relative reliability of third-party evidence in the form of accounts receivable confirmations for trade receivable balances.

b. Describe the audit work you would carry out in following up the responses to the accounts receivable confirmations where:

- **i.** the customer disputes the balance and provides a different balance
- **ii.** no reply to the confirmation has been received from the customer, and all attempts at obtaining a reply have failed

Source: Adapted from ACCA Audit Framework, Paper 6, December 1998.

10.14 Audit of sales and accounts receivable **Challenging** **LO 1, 4, 5**

You have been assigned to audit the sales and accounts receivable balances of Coppero Engineering Ltd. for the year ended September 30, 2023. Coppero Engineering is a major manufacturer of steel parts and fixtures for other manufacturers in the engineering field. The interim work was undertaken in June 2023 and tests indicated that internal controls over sales and accounts receivable are effective and that therefore control risks are acceptable.

You observe that credit sales are made to a group of 2,500 active customers, located mainly in Canada and the United States. Approximately 30 percent of the customers represent 70 percent of the balances, and although most of these customers are in Canada, a number are also based in the United States, England, and Ireland. The sales made into the United States are invoiced in Canadian dollars and you note that the value of the Canadian dollar has escalated by 10 percent in recent months. The total of the accounts receivable balances at September 30 is $95 million and the current allowance for doubtful accounts is $500,000.

Sales and receipts are recorded on the company's computerized accounting system, which simultaneously updates the accounts receivable balances and sales and cash receipts transactions journals on a daily basis. On a weekly basis, an aged trial balance is generated, which is reviewed by the credit manager for slow-paying accounts. Follow-up action is then taken as necessary. Sales returns and bad debt write offs are processed and summarized weekly and any write offs have to be approved by the chief financial officer, based on the recommendations of the credit manager. Documents to support these write offs are kept on file.

After the end of the reporting period, the rising Canadian dollar and a financial crisis in two of the major American markets have caused some concern for the credit manager, who has recently joined the client after a number of years in the retailing industry. Also, rising interest rates in Canada and a slowing economy have affected sales growth in the Canadian market.

Required

You are asked to prepare an audit program to test Coppero Engineering's year-end accounts receivable. You are required to include in your program specific audit objectives you can test using the audit firm's new generalized audit software package. Your manager is particularly worried about the possible negative effects on the collectibility of accounts receivable because of the American financial crisis, the rising dollar, and the slowing Canadian economy.

10.15 Assessing confirmations **Challenging** **LO 5**

James Bach is a CPA student working on the confirmations working paper for one of his clients, Dunstan Electric Co. He has so far summarized the results of his testing as shown in **figure 10.6**.

Required

Help James complete the working paper.

a. Calculate any differences between the general ledger balance and the confirmed balance.

b. For any balance calculated in part (a), determine what would be considered an audit error.

c. For the differences calculated in part (a), identify the additional audit procedures that James should perform.

d. Complete the response recap and determine any extrapolated error. For any error, propose an audit adjustment.

Accounts receivable confirmation Dunstan Electric Co. Dec. 31, 2023								
Conf. No.	**Customer**	**Balance per GL**	**Balance Confirmed**	**(a) Difference**	**Customer Response**	**Explanation**	**(b) Error**	**(c) Additional Procedures Required**
1.	Applied Devices	117,383	117,383					
2.	Barry Manufacturing	107,084	92,084		Sent cheque for $15,000 December 29	Timing difference		
3.	Brandt Electronics	401,500	401,500					
4.	Groton Electric	227,047	227,047					
5.	Jed Ltd.	58,650	53,000		Returned damaged goods December 30 for $5,650	Discussed with client, credit note processed Jan. 2, so cut-off issue.		
6.	W & M Manufacturing	199,996	178,920		Overcharged for several items based on selling price agreed with sales	Examined invoice pricing to master price list, recalculated the invoices and pricing extensions, determined there was an invoice pricing error.		
	Totals	1,111,660	1,069,934					

	No. of Items	Amt.
Response recap:		
Value of confirmations mailed		
Value of confirmations received		
Summary of results:		
Value of account total	10	1,300,000
Book value of confirmation sample		
Total representative errors		
Total representative sample		
Error percent		
Total population		1,300,000
Proposed adjustment:		

FIGURE 10.6 **Confirmations working paper**

[2] 10.16 Integrative Case Study—Harlan Venture

Harlan Venture Inc. (HV) operates a restaurant named Harlan's in Toronto. The shareholder, Stephen Painter, wants to know whether the system and controls in place at the restaurant are appropriate to monitor and control the operations of the restaurant and to make sure that employees don't steal. He provides the following information:

Restaurant operations

The restaurant manager's duties include looking after reservations, seating customers, and managing the restaurant's operations.

Servers take the customer orders and enter them into a system that uses off-the-shelf restaurant software that HV purchased. Each order is temporarily stored in the "orders placed file" and is transmitted to the kitchen staff, who receive a printed order. This order is the basis for preparing the meal. The kitchen staff throws out the order forms when the meals are picked up by the servers.

The server instructs the system to prepare the customer bill. The customers pay by cash or by credit card (HV accepts Visa, Mastercard, American Express, and Diners Club). The server is to enter the payment amount and method of payment into the system. The amount of the tip is to be entered as a separate item for both cash payments and credit card payments. The order in the "orders placed file" is transferred to the "orders completed file" only when the server enters the customer payment information.

At the end of the day, the restaurant manager prepares cash envelopes, which contain the tips for the servers and kitchen staff based on the amount of the tips recorded in the system. The cash in the tip envelopes is taken from the cash payments made by customers. He then clears the system of any orders that remain in the "orders placed file."

The system generates a daily report of revenue recorded by method of payment and HST collected. This report is used by the part-time accountant to make the entries in the general ledger.

The restaurant manager prepares the daily bank deposit, which includes the credit card vouchers and the cash to be deposited. A cash float of $250 is maintained in the sales register. He takes the deposit home and makes the bank deposit first thing the next morning.

HV receives monthly statements from the credit card entities that report the amount of the credit card sales processed by the entity and the fee charged to the entity. The bookkeeper enters these expenses in the general ledger.

The bartender is responsible for all sales of wine and liquor. He provides wine (by the glass or bottle) and drinks to the servers, who are not allowed access to these items. The on-site wine is stored behind the bar and, for expensive wines, in the basement wine cellar. He takes inventory of the wines and liquor weekly and places the appropriate purchase orders.

Catering services

HV provides both in-restaurant special function catering and out-of-restaurant special function catering (for example, at a private residence). The price of the function is based on the menu cost plus a markup of 60 percent.

The customer is billed in full for the function after it is completed and when the customer indicates satisfaction with HV's performance by sending in the "customer satisfaction form." Revenue is recognized at the time of billing. Discounts are authorized by the restaurant manager if the customer deems HV's performance to be less than satisfactory. The amount of discounts given to date has been minimal. Billings are often made as much as 60 days after the date of the function. As at May 31, 2023, 10 functions with a contract value of $50,000 have been completed and as yet not billed. Forty functions have been billed.

Required

Based on the above, identify *five* control weaknesses. For each weakness, state the implication and make an appropriate recommendation to improve the control weakness.

10.17 Integrative Case Study—Tinkerbell Toys Co.

Tinkerbell Toys Co. (Tinkerbell) is a manufacturer of children's building block toys. It has been in business for more than 35 years and it sells to a wide variety of customers including large and small toy retailers across the country. The company's year end is May 31.

The company has a large manufacturing plant, four large warehouses, and a head office. Upon manufacture, the toys are stored in one of the warehouses until they are shipped to customers. The company does not have an internal audit department.

[2] Adapted and reprinted with the permission of CPA Ontario. Any changes to the original material are the sole responsibility of the author (and/or the publisher) and have not been reviewed or endorsed by CPA Ontario.

Sales ordering, goods shipped, and invoicing

Each customer has a unique customer account number and this is used to enter sales orders when they are received in writing from customers. The orders are entered by an order clerk and the system automatically checks that the goods are available and that the order will not take the customer over their credit limit. For new customers, a sales manager completes a credit application; this is checked through a credit agency and a credit limit is entered into the system by the credit controller. The company has a price list, which is updated twice a year. Larger customers are entitled to a discount; this is agreed to by the sales director and set up within the customer master file.

Once the order is entered, an acceptance is automatically sent to the customer by email confirming the goods ordered and a likely shipping date. The order is then sorted by customer address. The warehouse closest to the customer receives the order electronically and a shipping list and sequentially numbered goods shipped report (GSR) are automatically generated. The warehouse team packs the goods from the shipping list and, before they are sent out, a second member of the team double-checks the shipping list to the GSR, which accompanies the goods.

Once shipped, a copy of the GSR is sent to the accounting team at head office and a sequentially numbered sales invoice is raised and compared with the GSR. Periodically, a computer sequence check is performed for any missing sales invoice numbers.

Fraud

During the year, a material fraud was uncovered. It involved cash/cheque receipts from customers being diverted into employees' personal accounts. In order to cover up the fraud, receipts from subsequent unrelated customers were then recorded against the earlier outstanding receivable balances and this cycle of fraud would continue.

The fraud occurred because two members of staff who were related colluded. One processed cash receipts and prepared the weekly bank reconciliation; the other employee recorded customer receipts in the sales ledger. An unrelated sales ledger clerk was supposed to send out monthly customer statements but this was not performed. The bank reconciliations each had a small unreconciled amount but no one reviewed the reconciliations after they were prepared. The fraud was only uncovered when the two employees went on holiday at the same time and it was discovered that cash receipts from different customers were being applied to older receivable balances to hide the earlier sums stolen.

Required

a. Recommend *six* tests of controls the auditor would normally carry out on the sales system of Tinkerbell, and explain the objective for each test.

b. Describe substantive procedures the auditor should perform to confirm Tinkerbell's year-end receivables balance.

c. Identify and explain controls Tinkerbell should implement to reduce the risk of fraud occurring again and, for each control, describe how it would mitigate the risk.

d. Describe substantive procedures the auditor should perform to confirm Tinkerbell's revenue.

Source: Adapted from ACCA Audit and Assurance (International), Paper F8, June 2011.

Case Study—Cloud 9

The worksheet you completed for the case study question in chapter 8 includes your estimates of the overall risk assessment (ORA) and the acceptable detection risk (DR) in the sales to cash receipts process.

Required

Based on your ORA and DR estimates, design substantive audit procedures for Cloud 9 that would address the DR for the accounts receivable and sales accounts.

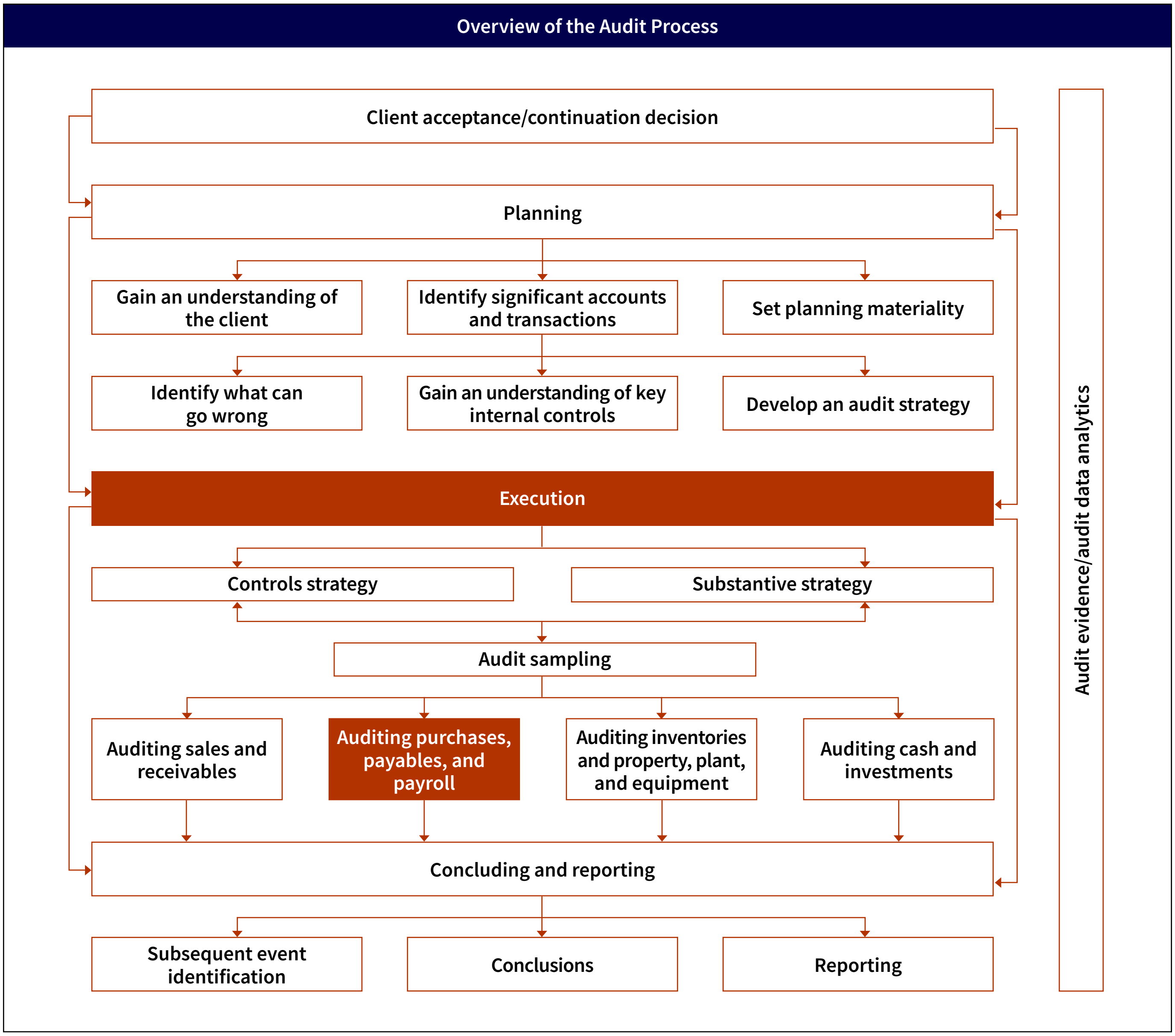
Research Question 10.1

In the early 2000s, several large corporations, such as Enron, WorldCom, and Nortel, collapsed because of corporate greed, bad business practices, and accounting irregularities. Others, such as Bristol-Myers Squibb, Xerox, and Harris Scarfe, were forced to restate their earnings, in some cases over a number of years, because of inflated sales and other accounting irregularities.

Required

Investigate *two* of the above companies in depth and determine how the irregularities were perpetrated and the reasons behind them. Also determine, to the extent possible, why these irregularities were not found by the auditors during their audits of sales revenue and receivables, and other related areas of the audit.

Auditing Purchases, Payables, and Payroll



LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
After studying this chapter you should be able to:		Standards addressed in each learning objective are as follows:
1 Identify the audit objectives applicable to purchases, payables, and payroll	**11.1** Audit Objectives	CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
2 Describe the functions and control procedures normally found in information systems for processing purchase, payment, and purchase adjustment transactions	**11.2** The Process for Purchase Transactions **11.2.1** Purchase transactions **11.2.2** Payment transactions	CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
3 Describe the functions and control procedures normally found in information systems for payroll transactions	**11.3** The Process for Payroll Transactions **11.3.1** Hiring employees **11.3.2** Authorizing payroll changes **11.3.3** Preparing attendance and timekeeping data **11.3.4** Preparing the payroll **11.3.5** Recording the payroll **11.3.6** Paying the payroll and protecting unclaimed wages	CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
4 Discuss considerations relevant to determining the audit strategy for purchases, payables, and payroll	**11.4** Audit Strategy **11.4.1** Understanding the entity and its environment **11.4.2** Analytical review **11.4.3** Inherent risk assessment **11.4.4** Internal controls **11.4.5** Final assessment	CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
5 Indicate the factors relevant to determining an acceptable level of detection risk for the audit of purchases, payables, and payroll	**11.5** Determining an Acceptable Level of Detection Risk	CAS 315 *Identifying and Assessing the Risks of Material Misstatement* CAS 330 *The Auditor's Responses to Assessed Risks*
6 Design a substantive audit program for purchases, payables, and payroll	**11.6** Designing Substantive Procedures **11.6.1** Initial procedures **11.6.2** Analytical procedures **11.6.3** Tests of details of transactions **11.6.4** Tests of details of balances **11.6.5** Disclosure	CAS 330 *The Auditor's Responses to Assessed Risks*

Cloud 9 Integrated Case

When Sharon Gallagher, the manager of the audit team, next meets with Josh Thomas, she explains that the audit team will now focus on the purchases, payables, and payroll cycles. These are significant cycles as they relate to the purchases and payments for the acquisition of goods and services from outside suppliers, and the payroll that relates to the acquisition of and payment for labour services from employees. Together, they represent the major expenditures of most entities and this holds true for Cloud 9. Sharon continues to explain that there are similarities between accounts payable and payroll in that both involve the acquisition of resources and payment to the suppliers. However, the nature of the employment contract between the entity and its employees is such that payroll transactions are processed separately, including the payment of salaries and wages.

Chapter Preview

The purpose of this chapter is to examine the audit of:

- the account balances of accounts payable and of accruals related to payroll
- the classes of transactions of purchases, payments, and payroll

Purchases and payments are for the acquisition of goods and services from outside suppliers, whereas payroll relates to the acquisition of and payment for labour services from employees. Together, they represent the major expenditures of most entities. There are similarities between the two, in that both involve the acquisition of resources and payment to the suppliers. However, the nature of the employment contract between the entity and its employees is such that payroll transactions are always processed separately, including the payment of salaries and wages.

This chapter begins with the identification of the audit objectives for each of the financial statement assertions that apply to purchases, payments, and payroll and to the accounts payable and accrued payroll liability balances. In the rest of the chapter, the focus is on the audit process—from obtaining an understanding of the internal control structure, through the assessment of the inherent risks and control risks, to the design and execution of substantive procedures for the purchases, payables, and payroll processes.

11.1 Audit Objectives

LEARNING OBJECTIVE 1

Identify the audit objectives applicable to purchases, payables, and payroll.

In the auditing of purchases, payables, and payroll, the key issues are to ensure the following:

- The purchases are all recorded and are not understated. (The relevant financial statement assertions are related to completeness and also accuracy and cut-off.)
- The payables that are derived from the purchases are all fully recorded in the accounts as a liability. (The relevant financial statement assertions are related to completeness and also accuracy, valuation, and allocation.)
- The payroll expense has been properly recorded and the associated deductions for income tax, employee benefits, and related liabilities are properly recorded as liabilities. (The relevant financial statement assertions are related to transactions of completeness, occurrence, and accuracy, as well as assertions related to balances of completeness, existence, and accuracy, valuation, and allocation.)

The audit objectives for purchases, payables, and payroll relate to obtaining sufficient appropriate evidence about each significant financial statement assertion for the applicable transactions and balances.

Table 11.1 lists the main objectives for each assertion that apply in most audits of these transactions and balances.

TABLE 11.1 Selected specific audit objectives for purchases, payables, and payroll

Transaction and Related Disclosure Objectives	
Occurrence (**OE**)	Recorded purchase transactions represent goods and services received during the period (**OE1**). Recorded payment transactions represent payments made during the period to suppliers and creditors (**OE2**). Recorded payroll expenses relate to employee services received during the period (**OE3**). Disclosed purchase and payroll events have occurred and pertain to the entity (**OE4**).
Completeness (**C**)	All purchase transactions that occurred during the period and that should have been recorded have been recorded (**C1**). All payments that occurred during the period and that should have been recorded have been recorded (**C2**). Recorded payroll expenses include all such expenses incurred during the period (**C3**).
Accuracy (**AV**)	Purchase, payment, and payroll transactions are properly (accurately) recorded (**AV1**). Purchase cycle and payroll information is disclosed accurately and at appropriate amounts (**AV2**).
Cut-off (**CO**)	Particularly relevant to transactions around the year end; all purchases, cash payments, purchase adjustments, and payroll transactions arising before the period end are recorded in the current period and those arising after the period end are included in the next accounting period (**CO1**).
Classification (**D**)	All purchases (**D1**), payments (**D2**), and payroll transactions (**D3**) are recorded in the correct accounts.
Presentation (**D**)	Purchase cycle and payroll transactions and events are appropriately aggregated or disaggregated, and related disclosures are clearly expressed, relevant, and understandable (**D4**).
Account Balance and Related Disclosure Objectives	
Existence (**OE**)	Recorded accounts payable represent amounts owed by the entity at the end of the reporting period (**OE5**). Accrued payroll liability balances represent amounts owed by the entity at the end of the reporting period (**OE6**).
Rights and obligations (**RO**)	Accounts payable (**RO1**) and accrued payroll liabilities (**RO2**) are liabilities of the entity at the end of the reporting period.
Completeness (**C**)	Accounts payable include all amounts owed by the entity to suppliers of goods and services at the end of the reporting period (**C4**). Accrued payroll liabilities include all amounts owed in respect of payroll and deductions at the end of the reporting period (**C5**). Accounts payable, accrued payroll liabilities, and related expenses are properly identified and included in the financial statements (**C6**). Disclosures pertaining to commitments, contingent liabilities, and related party creditors are adequate (**C7**).

(*continued*)

TABLE 11.1 **Selected specific audit objectives for purchases, payables, and payroll (*continued*)**

Account Balance and Related Disclosure Objectives	
Accuracy, valuation, and allocation (**AV**)	Accounts payable represent gross amounts due to suppliers and are stated at appropriate amounts (**AV3**). Accrued payroll liabilities are stated at the appropriate amounts (**AV4**). Related expense balances conform to applicable accounting standards (**AV5**).
Classification (**D**)	Payables, accrued payroll liabilities, and related expenses are recorded in the correct accounts (**D5**).
Presentation (**D**)	Payables, accrued payroll liabilities, and related expenses are appropriately aggregated and disaggregated, disclosures are clearly expressed, relevant, and understandable (**D6**).

To achieve each audit objective, the auditor uses a combination of tests of controls and substantive procedures (as determined by the audit strategy adopted).

Each audit objective is numbered (**OE1**, **OE2**, **C1**, **AV4**, and so on) in table 11.1. Using this numbering system, we can reference specific controls and audit procedures described in this chapter to the applicable audit objective. Some of the assertions for transactions are combined with account balance assertions in the numbering system: occurrence and existence (**OE**); completeness for transactions and completeness for balances (**C**); accuracy and accuracy, valuation, and allocation (**AV**); and classification and presentation that reflect disclosure assertions (**D**). These combinations reflect the fact that audit evidence obtained in relation to an assertion for transactions will also give some comfort for account balance assertions.

Note that table 11.1 summarizes assertions for both transactions audit objectives and account balance audit objectives.

Cloud 9 Integrated Case

During Josh's discussion with Sharon, he was surprised to learn that the assertions most at risk for the purchase and payable cycles are completeness and cut-off. He thought the audit team would perform procedures that would focus on the existence and occurrence assertions as they did for the revenue and receivables cycle. He thought that, because both cycles are significant, they would have the same audit focus. Sharon explained that the most significant risk with the payables and purchases at Cloud 9 is an understatement of these accounts, so the audit team will concentrate their audit work on what may be missing altogether or recorded in the next accounting period in error, therefore focusing on completeness and cut-off.

Not only is Josh surprised, he wonders how he will look for something that may be missing.

Before You Go On

11.1.1 What are three key issues auditors face when auditing the purchases and payables cycle?

11.1.2 What risk is of particular concern when auditing purchases and payables?

11.1.3 Define the audit objective of cut-off with respect to purchases and payables.

11.2 The Process for Purchase Transactions

LEARNING OBJECTIVE 2

Describe the functions and control procedures normally found in information systems for processing purchase, payment, and purchase adjustment transactions.

The following sections look at purchase and payment transactions in detail, including the related information systems and control procedures. CAS 315 requires the auditor to gain an understanding of this information system to understand how transactions flow through the entity. Where purchases are made on credit, the information system needs to maintain records of the accounts payable. The discussions here are designed to give an understanding of the purchasing system; in the later sections of this chapter, we consider how this affects the audit approach. The discussion in this section is based on a company buying goods; however, much of the commentary can easily be adapted to purchases of services.

11.2.1 Purchase Transactions

As illustrated in **figure 11.1**, the processing of purchase transactions involves the following functions, a number of which are done electronically:

- requisitioning goods and services
- preparing purchase orders
- receiving the goods
- storing goods received in inventory
- checking and approving the supplier's invoice
- recording the liability

When practicable, each of these functions should be assigned to a different individual or department for an appropriate segregation of duties. In such cases, the work of one employee or department can provide an independent check on the accuracy of the work of another.

Requisitioning Goods and Services

purchase requisition a form issued by authorized personnel detailing the goods and services required

Purchase requisitions (see figure 5A.5) may originate from the warehouse for inventory or from any department for other items. For inventory items, computerized inventory records are often programmed to issue requisitions automatically when predetermined reorder levels are reached. Where this is the case, controls should be in place to restrict access and adjustments to the reorder point. For purchases other than inventory replenishment, requisitioning authority is granted to specific people. This authority is usually restricted to the value and types of goods and services applicable to the person's function and level of authority. A stationery clerk may requisition sundry stationery supplies, for example, but only the office manager may requisition a photocopier service contract. Special procedures usually apply for requisitioning plant and equipment or for entering into lease contracts. Purchase requisition forms may be prepared manually but are normally generated electronically by authorized employees, or triggered by predetermined criteria programmed into an entity's computer system. The requisition normally indicates the general ledger account coding for the purchase, which the person making the requisition has budgetary responsibility over.

Purchase requisitions are usually pre-numbered within each originating department as a control over outstanding requisitions to ensure that goods requisitioned are duly ordered and received. The purchase requisition represents the start of the transaction trail of documentary evidence in support of management's assertion as to the occurrence of purchase transactions. Thus, it provides evidence that relates to the specific audit objective of occurrence (**OE1)** in table 11.1.

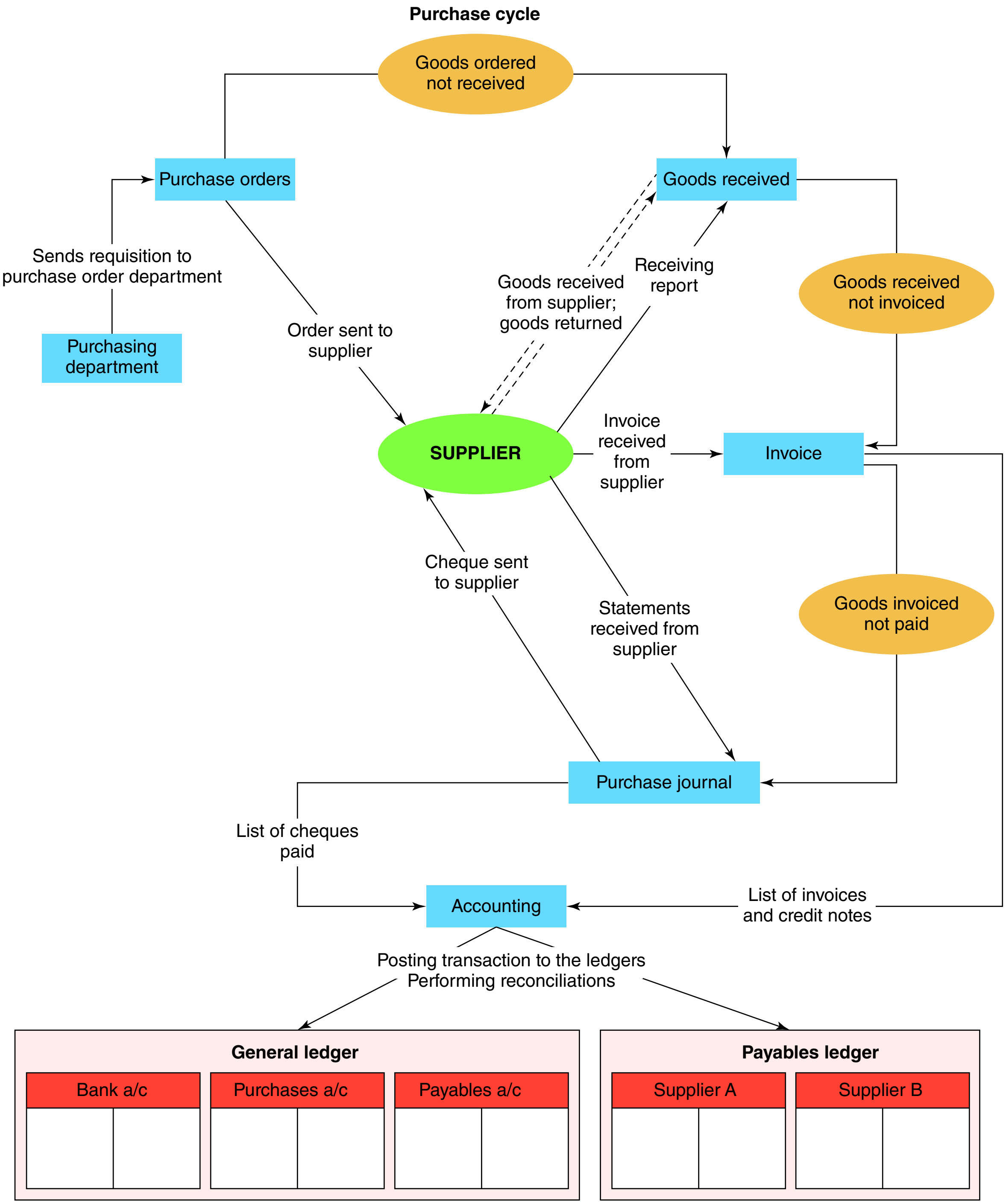


FIGURE 11.1 **Credit purchases cycle**

Preparing Purchase Orders

The purchasing department should issue **purchase orders** (see figure 5A.6) only on the receipt of requisitions properly approved by an employee who has appropriate requisitioning authority (except for programmed inventory replenishment). Before placing an order, purchasing department personnel should find the best source of supply and, for major items, obtain competitive bids.

purchase order a form showing the description of the goods, the quantity ordered, and other relevant data. This is signed by the purchasing officer as evidence of the approval of the purchase.

Separating requisitioning from ordering achieves two controls. It restricts the opportunity for those making requisitions to issue fraudulent orders, such as for goods for their own use. Purchasing department personnel are less likely to issue improper orders because they do not normally have access to goods delivered. The second control is improved efficiency through the centralization of purchasing in a specialized department. The purchasing department is better able to negotiate more favourable terms and prices and, by amalgamating orders, can obtain better volume discounts.

Purchase orders should contain a precise description of the goods and services required, quantities, price, delivery instructions, and the supplier's name and address. Purchase orders should be pre-numbered and signed or electronically approved by an authorized purchasing officer. The original is sent to the supplier and copies are distributed internally to the receiving department, the accounting department, and the requisitioner.

The purchase orders also become part of the transaction trail of documentary evidence that supports the occurrence assertion for purchase transactions (**OE1**). A file of unfilled purchase orders is generally maintained on the computer or as hard copy. A subsequent independent check on the disposition of purchase orders to determine that the goods and services were received and recorded relates to the completeness assertion for purchase transactions (**C1**).

Receiving the Goods

A valid purchase order represents the authorization for the receiving department to accept goods delivered by suppliers. The quantity ordered is sometimes not displayed to ensure that receiving clerks will make careful counts when the goods are received. Receiving department personnel should compare the goods received with the description of the goods on the purchase order, count the goods, and inspect them for damage. Deliveries of unordered goods should be refused.

The segregation of receiving from requisitioning and purchasing prevents those making requisitions from ordering goods directly from suppliers. It also prevents the purchasing department from gaining access to goods improperly ordered.

receiving report a form issued by the receiving department detailing the description and quantity of the goods delivered by the supplier

A pre-numbered **receiving report** (see figure 5A.7) should be prepared for each delivery. The receiving report (manual or electronic) is an important document in supporting the occurrence assertion for purchase transactions (**OE1**) because it provides evidence that the goods have been received. A copy of the receiving report is forwarded to the accounts payable department. A subsequent periodic independent check on the sequence of pre-numbered receiving reports (to determine that a supplier's invoice has been recorded for each) relates to the completeness assertion (**C1**).

Storing Goods Received in Inventory

On delivery of the goods to inventory or to the requisitioning department, the receiving clerks should have a copy of the receiving report signed to verify receipt of the goods, and this copy should be kept in the receiving department. This provides further evidence for the occurrence assertion for the purchase transaction (**OE1**). The signed receipt also establishes subsequent accountability for the purchased goods.

Checking and Approving the Supplier's Invoice

supplier's invoice a form issued by the supplier detailing the goods or services supplied and the amount owing

For goods and services supplied on credit, the supplier is usually instructed by the purchase order to send the invoice directly to the entity's accounting department. Before recording **suppliers' invoices** (see figure 5A.9), the department checks and approves them. Procedures applicable to this function include:

- numbering suppliers' invoices on receipt so that subsequent checks of numerical continuity can confirm that all invoices are recorded (**C1**)
- establishing the three-way match of the details of suppliers' invoices with the related receiving reports and purchase orders to ensure that all invoices relate to valid purchase transactions (**OE1**)
- determining the mathematical accuracy of the suppliers' invoices (**AV1**)
- coding the account distributions on the suppliers' invoices (that is, indicating the asset and expense accounts to be debited) (**AV1**, **D1**)
- approving invoices for payment by having an authorized person sign the invoices (**OE1**)
- preparing a daily prelist of suppliers' invoices approved for payment (**OE1**, **C1**, **AV1**)

A common practice is to stamp a grid on the supplier's invoice. The grid has boxes in which to record the serial numbers of purchase orders and receiving reports, the account codes, and the initials of the clerk performing the various checks. Details of the supplier's invoice and subsequent checks for accuracy and validity can all be processed electronically.

Other kinds of supporting documentation (such as copies of contracts) may be required when the invoice relates to certain types of services or to leased assets. In other cases, such as for monthly electricity bills, the supplier's invoice alone may suffice because there is no purchase order and receiving report. Other forms of verification will be required, such as a check of the reasonableness of electricity bills against previous charges.

Unpaid suppliers' invoices and supporting documentation are held in a file in the accounts payable department pending their subsequent payment. Properly approved suppliers' invoices provide the basis for recording purchase transactions. But note that scammers can use phony invoices to defraud a company, as described in Professional Environment 11.1.

Recording the Liability

Personnel in the accounts payable department either send approved suppliers' invoices in batches to the accounting department or enter the data directly via terminals. Programmed edit checks are made for such matters as valid suppliers and the reasonableness of amounts. When the data for a supplier's invoice are accepted by the computer system, the **accounts payable master file** for that supplier is updated and the invoice is added to the **purchase journal**. Additional controls over the accuracy of the data entry process may include the use of batch totals and exception reports (**OE1**, **C1**, **AV1**). The purchase journal is used to update the inventory and general ledger accounts. The update program produces printouts, if required, of the purchase journal and a general ledger summary showing the amounts posted to general ledger accounts.

accounts payable master file a computer file containing details of suppliers, transactions with suppliers, and the balance owing

purchase journal a computer file listing details of all purchase transactions

In the online systems most entities use, the invoice is entered immediately on receipt, automatically approved by reference to the purchase order and receiving report details, and coded by reference to information recorded on the order. The accounts payable, inventory, and general ledger files are immediately updated. Manual verification is required only if programmed application controls reject the invoice.

Monthly statements received from suppliers should be reconciled with recorded supplier balances. Periodic performance reviews by management—in the form of comparisons of asset, liability, and expense balances with budgeted amounts—can provide a means of both controlling expenditures and detecting misstatements in recorded purchase transactions. For very small purchases, authorized requisitions may be paid out of petty cash or with company-issued credit cards. Limits placed on such cards provide a sufficient safeguard against material loss.

11.1 Professional Environment — Be Wary of Fake Invoice Fraud

A business receives an invoice that looks genuine. A couple of days later the "supplier" follows up with a phone call for payment. Is it real or fraudulent?

Smaller enterprises are at the greatest risk from fraud. They're the least likely businesses to have dedicated security personnel, and the most likely to lack adequate internal systems and controls to prevent fraud. This makes them the target of scammers around the world, and one of the most common scams is fake invoice fraud.

But even large companies are at risk of invoice fraud. Financial services firm Citigroup announced that it paid $400 million in fake invoices over several years from a supplier to its Mexican subsidiary.

It is recommended that businesses take these measures to prevent fake invoice fraud:

- Scrutinize invoices carefully with a sceptical eye: fake invoices often look legitimate. Do not pay invoices until it is confirmed that the goods or services were ordered and received, and the payment details are verified.
- Check all paperwork closely, watching especially for invoices and cheques from unusual places.
- Scrutinize any solicitation that attempts to collect on products or services outside the scope of the normal routine.
- Confirm orders with the firm and/or with whoever authorized the purchase.
- Avoid payment until it is confirmed that the goods and/or services were ordered and/or received.
- If a cheque is payable to the organization, read and understand all of the terms listed on the back of the cheque before cashing it.
- Contact the relevant governmental authorities and the local Better Business Bureau to check out a suspicious company, invoice, or cheque.

The best defence against fake invoice fraud for any business is to institute strict purchasing and accounting controls. Document every purchase by issuing a signed purchase order to the supplier. The handling of invoices should be centralized and payment authorizations checked carefully before any payments are made. Businesses must protect themselves against scammers; once invoice fraudsters get their hands on a company's money, it's usually gone forever.

Q: What impact does new technology have on smaller enterprises with regards to theft and fraud?

Sources: Matt Levine, "Citi Paid $400 Million in Fake Invoices," *BloombergView*, February 28, 2014; "Be Wary of Fake Invoice Fraud," www.suite101.com, viewed December 17, 2010; "Fraud: Fake Invoices Targeted at Businesses," Office of the Minnesota Attorney General, www.ag.state.mn.us.

11.2.2 Payment Transactions

In this section, we consider the common documents and records, functions, and control procedures for payment transactions.

The two payment functions are:

- paying the liability
- recording the payment

The same department or individual should not perform both these functions.

Paying the Liability

The accounts payable department is responsible for ensuring that suppliers' invoices are processed for payment on their due dates. Payment is normally required within 30 days. Where early payment discounts are available, relevant invoices should be paid within the discount period.

cheque register a listing of all cheques issued

Payments are usually by cheque, or by electronic funds transfer for regular suppliers. The computer system can be programmed to extract the payments due from the accounts payable master file, produce the cheques and a **cheque register**, and update the accounts payable master file. Before being sent, the cheques are reviewed by the accounts payable department, and they are matched with the supporting documents before being forwarded for signing. This may now be done electronically; however, controls must be adequate. The signatory should maintain password control over the electronic signature and scrutinize the list of cheques to be signed. In such systems, cheques must be mailed directly from the computer department and not returned to the accounts payable department. With online banking, electronic funds transfer details may be electronically transmitted to the bank. Access controls should restrict this function to approved signatories.

Controls over the preparation and signing of cheques and electronic fund transfers and related specific audit objectives include the following:

- Authorized personnel in the finance department who otherwise have no responsibility for initiating or processing purchase transactions should be responsible for signing the cheques or controlling the use of electronic signatures (**OE2**).
- Authorized cheque signers should determine that each cheque or bank transfer is accompanied by properly approved suppliers' invoices, and that the name of the payee and amount on the payment agree with details on the invoice (**OE2**, **AV1**).
- The suppliers' invoices and supporting documents should be cancelled to prevent resubmission for duplicate payment (**OE2**).
- The cheque signer should control the mailing of the cheques or initiation of the bank transfers to reduce the risk of theft or alterations (**OE2**).
- Where cheques are used, none should be made payable to "cash" or "bearer" and no blank cheques should be issued (**OE2**).
- Pre-numbered cheques should be used (**C2**).
- Access to blank cheques and to electronic signatures should be limited to authorized personnel (**C2**).

remittance advice a form accompanying cash or cheques paid by a customer, indicating the customer's details and the items being paid

Cheques generally include a perforated attachment known as a **remittance advice** (see figure 5A.9), which identifies the serial numbers of the invoice(s) being paid. Alternatively, copies of the supplier's statement or remittance advice can be enclosed with the cheques mailed to suppliers, or other identifying details can be used where electronic funds transfers are made.

Recording the Payment

The cheque register in a computer system is created when cheques or electronic transfers are prepared. When updated, the program produces the cash payments journal and a general ledger summary, and also updates the master files.

Controls over the recording of payments include:

- an independent check by an accounting supervisor of the agreement of the amounts journalized and posted to the accounts payable ledger with the cheque register received from the treasurer (**OE2**, **C2**, **AV1**)
- independently prepared bank reconciliations (**OE2**, **C2**, **AV1**)

Cloud 9 Integrated Case

Josh has completed his interview with Carla and he feels he understands the purchasing and payables process at Cloud 9. Carla explained that at Cloud 9, the purchasing process starts when goods or services are needed and a purchase requisition is prepared by the manager of the department requesting the goods. The approved purchase requisition is sent to the purchaser, who must contact at least three different approved suppliers for price quotes, as it is the purchaser's job to secure the best possible quality of goods for the best price. Once the best price is secured and the order placed, a sequential pre-numbered purchase order is prepared, where the quantity ordered and the agreed-upon price are entered. A copy of this purchase order is sent to an open purchase order folder, which the accounts payable department has access to. This provides confirmation that the goods were approved for purchase.

When the goods are delivered to Cloud 9, the receiver counts and records the quantity of goods actually received on a pre-numbered sequential receiving report created by the system. Once the receiving report is completed, the receiving report is matched to the purchase order. This signals to the accounts payable department that Cloud 9 now has a liability that needs to get recorded in the books.

All supplier invoices are sent directly to the accounts payable department. The invoice must refer to the pre-numbered purchase order, which allows the accounts payable department to easily make the three-way match between the purchase order (indicates authorization), the receiving report (indicates the quantity of goods received), and the invoice details. If there is a three-way match, the invoice is posted to the general ledger and accounts payable sub-ledger.

At the end of each month, Cloud 9 asks each of its suppliers to send monthly statements highlighting any overdue or unpaid invoices. The suppliers' statements are then reconciled to the accounts payable sub-ledger and any discrepancies are followed up. Once such discrepancies are resolved, Cloud 9 prepares the cheques and the payment is processed and recorded.

Josh is in the middle of documenting this process, when he receives a call from Sharon. Sharon tells him they now have an appointment with Carla and Cloud 9's Human Resources Manager, Lorraine Murray, for 4 p.m. today. They need to meet to discuss the processes Cloud 9 has in place over its payroll, including the hiring of employees, the authorizing of payroll changes, and the timekeeping, preparing, recording, and processing of the payroll. Josh sighs, as he foresees this will be a late night.

Before You Go On

11.2.1 List the six steps involved in the purchasing and accounts payable cycle.

11.2.2 What is a purchase order?

11.2.3 What are three controls an entity should have in place over the preparation and signing of cheques and electronic funds transfers?

11.3 The Process for Payroll Transactions

LEARNING OBJECTIVE 3

Describe the functions and control procedures normally found in information systems for payroll transactions.

Payroll relates to payment for the services of employees. An entity's payroll transactions include salaries and hourly wages, commissions, bonuses, and employee benefits (for example, paid holidays, sick leave). In this section, we focus on employees paid hourly. Most entities have a detailed information system and related internal control procedures for recording labour services (typically in the form of hours worked) and ensuring that payment is made only to

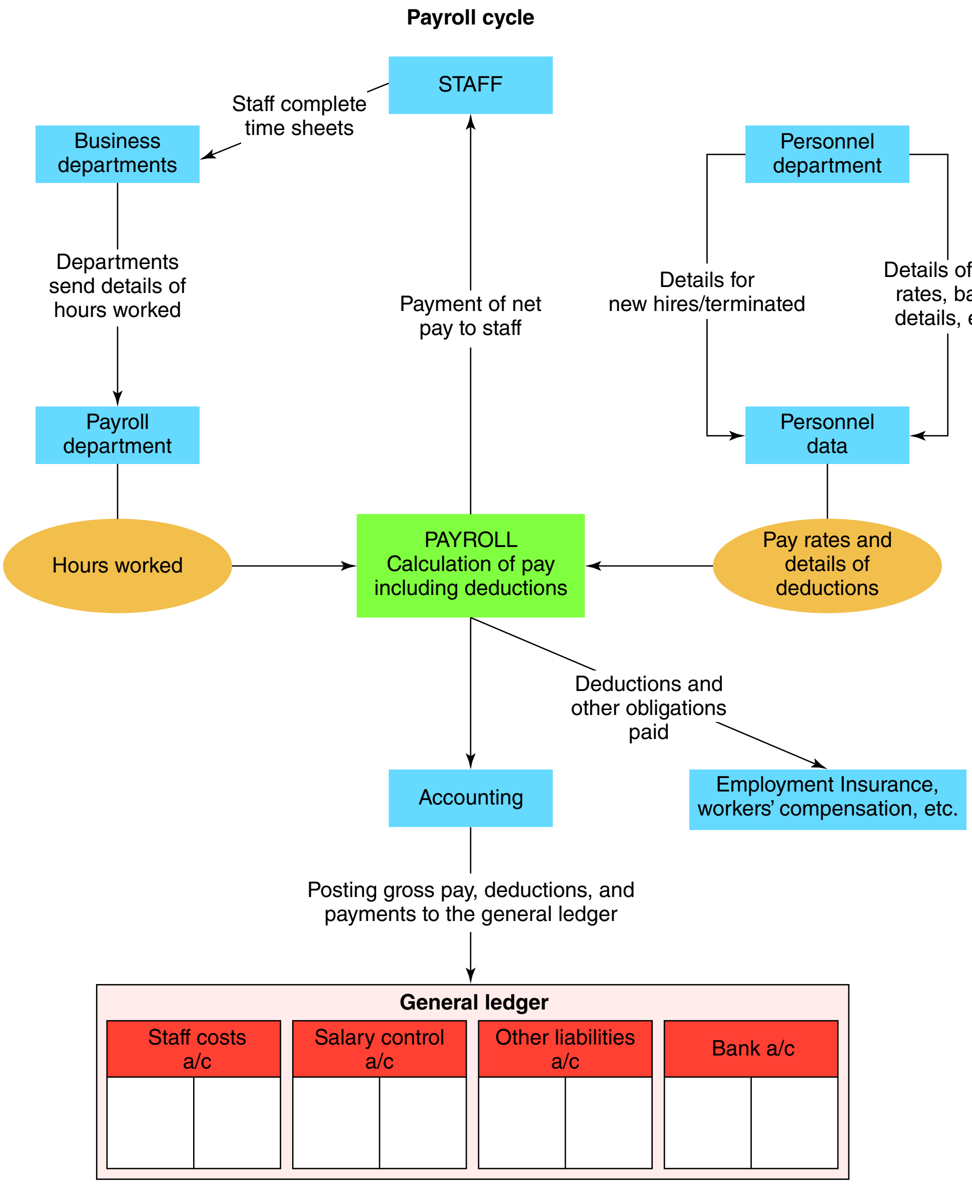


FIGURE 11.2 **Payroll cycle**

current employees in respect of labour services actually provided. The auditor is required to gain an understanding of this system. **Figure 11.2** gives an outline of the process, which will be discussed in detail below.

The relevant functions for payroll transactions are those of:

- hiring employees
- authorizing payroll changes
- preparing attendance and timekeeping data
- preparing the payroll
- recording the payroll
- paying the payroll and protecting unclaimed wages

Each function is explained below.

personnel authorization form a form issued by the personnel department indicating the job classification and wage rate for all approved positions

11.3.1 Hiring Employees

Employees are hired by the human resources department. All approved positions are documented on a **personnel authorization form**, which should indicate the job classification and the starting wage rate for all positions. In the system, data on new employees are entered in the **personnel master file**. Access to data entry to this file is restricted by password to authorized individuals in the personnel department. Periodically, a computer-generated log of all changes to the master file is printed and independently checked by a personnel manager not involved in entering the data into the computer. One copy of the personnel authorization form is placed in the employee's **personnel file** in the personnel department. Another copy is sent to the payroll department.

personnel master file a computer file containing details of employees, such as approved wage rate and date of hiring

personnel file a file maintained by the personnel department recording details of individual employees, such as the job classification, wage rate, and date of hiring

Segregating the functions of personnel and payroll reduces the risk of payments to fictitious employees because only the personnel department may add new employees to the personnel master file and only the payroll department may process the payment of wages (**OE3**, **RO2**). This segregation of functions is also an important control in the next function—authorizing payroll changes. Thus, personnel department employees cannot benefit from falsifying personnel records, and payroll department employees can process payroll only for employees listed in the personnel records and at the wage rates specified therein.

11.3.2 Authorizing Payroll Changes

An employee's supervisor may initiate the request for a change in job classification (or a wage rate change). However, all changes should be authorized in writing by the personnel department before being entered in the personnel master file. Other controls over entering the changes in the computer and distributing the change forms are the same as those for new employees. These controls over payroll changes help to ensure the accuracy of the payroll (**RO2**, **AV1**).

The personnel department should also issue a **termination notice** on completion of an individual's employment. It is vital that the payroll department be promptly notified of such terminations to prevent payment continuing to be made to employees after they have left (**OE3**).

termination notice a form issued by the personnel department to document the termination of an employee

11.3.3 Preparing Attendance and Timekeeping Data

In most organizations, each employee signs in for the purpose of recording hours of attendance at work by electronic means, where such recording is necessary. Other organizations employ things such as punch clocks, card swipes, or finger scans. These controls ensure that payments are made only for hours worked (**OE3**, **RO2**).

11.3.4 Preparing the Payroll

Time-recording details are manually or electronically entered into the payroll file from approved employee time records, which may be online or manually compiled. The resulting payroll data are then used in preparing the payroll.

The payroll transactions are subjected to supervisory review and approval, which include a check for a valid employee number and a limit or reasonableness check on the hours worked. The calculation of the payroll is performed and recorded in the **payroll transaction file**, which details the wage payments to employees.

payroll transaction file a file recording details of hours worked, wage rates, and wages paid per employee

11.3.5 Recording the Payroll

Using the calculated gross pay, deductions, and net pay for each employee, the data are used to update the employee payroll records and accumulate totals for the payroll journal entry that is generated and entered in the general ledger master file at the end of the run. A **payroll register** is also produced, which contains details of wages paid, withholding taxes, and a cumulative record of wages paid. The following printed outputs of this run can be produced if required for control purposes:

payroll register a document that contains details of wages paid, withholding taxes, and a cumulative record of wages paid per employee, per department, and in total

- an exceptions report
- a copy of the payroll register that is returned to the payroll department

- a second copy of the payroll register and pre-numbered payroll cheques or details of electronic direct bank transfers that are sent to the finance office (or pay slips and a cheque for total net pay if wages are paid in cash)
- a general ledger summary that is sent to accounting, showing the payroll entry generated by the payroll program

Proper review of each of these outputs by the appropriate personnel contributes to control over misstatements (**OE3**, **C3**, **AV1**).

It is common practice for a senior accounting officer to approve the payroll details before payroll cheques or bank transfers are prepared. In smaller entities, the authorizing officer could verify payroll by reconciling it with the previous period's payroll, allowing for hirings, terminations, or changes in hours worked. In any event, the payroll should be independently checked against personnel records at regular intervals.

11.3.6 Paying the Payroll and Protecting Unclaimed Wages

In the preceding section, we explained that the payroll cheques and a copy of the payroll register are sent to the finance office, where these functions are commonly performed. Applicable controls include the following:

- Finance office personnel should check the agreement of the names and amounts on cheques or bank transfers with payroll register entries (**OE3**, **C3**, **AV1**).
- Payroll cheques and bank transfers should be signed or authorized by finance office personnel not involved in preparing or recording the payroll.
- Payroll cheques, where used, should be distributed to employees by finance office personnel not involved in preparing or recording the payroll, who should require proper identification of employees (**OE3**, **AV1**).
- Any unclaimed payroll cheques should be stored in a safe or vault in the finance office (**OE3**, **C3**). Another important control over paying the payroll in many large entities is the use of an imprest payroll bank account on which all payroll cheques or electronic transfers are drawn. This account is funded with the amount of net pay. Any errors in preparing payroll cheques or electronic direct bank transfers or deliberate falsification would soon be detected because the amount paid out would exceed the account balance, causing the bank to refuse acceptance (**OE3**, **AV4**). It is now common practice for entities to pay wages by direct deposit to employee bank accounts, eliminating the need for cheques and the associated risks of their misuse.

Application of the controls described here and in the previous sections can help prevent the kind of fraud described in Professional Environment 11.2.

11.2 Professional Environment Employee Fraud: How You Can Avoid Getting Stung

In Australia, millions of dollars disappeared from the books of electrical goods retailer Clive Peeters. The "accounting discrepancies" mystery was solved when a payroll officer allegedly admitted to defrauding the company of around AUS$20 million.

The employee falsified entries in the company's payroll accounts, transferred cash from Clive Peeters' bank accounts to her own account, and used the money to buy real estate worth just under AUS$20 million. Legal action came just days after Clive Peeters suspended its shares from trade on the Australian Stock Exchange after warning it had discovered discrepancies in its payroll accounts.

You don't have to go as far as Australia, because similar frauds can be found here in Canada. For example, Adelle Sharpe, a payroll manager at a medium-sized manufacturing firm near Winnipeg, was accused of defrauding her employer of $750,000, to pay off her gambling losses. Ms. Sharpe, a decade-long employee, was described as hardworking, reliable, and loyal in her performance reviews. However perceived by her employer, Ms. Sharpe set up two fictitious employees in the company's payroll system and deposited the paycheques into a bank account near her home. This scheme went undetected because she was responsible for both processing and receiving the employee payroll without effective oversight. As the fraud went on undetected, Ms. Sharpe also began paying herself unauthorized overtime of 1,500 hours, as opposed to the 50 hours of overtime she actually did work. It was this excessive claim to overtime that eventually led to her being caught.

How can a company prevent and detect such frauds?

- Ensure an adequate segregation of duties. Payroll preparation, authorization, and distribution should be performed by different individuals.
- Regularly monitor payroll records for unusual "accounting" adjustments.
- Increase the use of direct deposit.
- Review the payroll records for duplicate names or incorrect or invalid social insurance numbers.
- Conduct surprise payroll audits to ensure all payees exist and have a payroll file.
- Perform analytics on payroll expenses, including month-to-month, quarter-to-quarter, and year-to-year variances.
- Limit changes to payroll master file data to only authorized personnel.
- Reconcile payroll expenses to the payroll records and the authorized amounts on a regular basis and follow up on any identified discrepancies.

Q: Often the opportunity for fraud exists because segregation of duties is not practicable due to the small size of an organization. What can these smaller organizations do to protect themselves from fraud or theft?

Sources: "Risk Spotlight: How to Detect and Prevent Employee Fraud," Marsh USA, February 4, 2013; Edward Nagel. "Padding the Payroll: How to Detect and Prevent Fraud," *Dialogue*, July/August 2010, www.payroll.ca; James Thomson, "Clive Peeters Hit by $20 Million Employee Fraud—How You Can Avoid Getting Stung," SmartCompany.com.au, August 12, 2009; Edward Nagel, "The Payroll Payoff," *CA Magazine*, May 2004.

Cloud 9 Integrated Case

After a late night the previous evening, Josh arrives at Cloud 9 ready to start documenting the payroll process. Now that he understands the processes over the purchases, payables, and payroll at Cloud 9, he is ready to assess the inherent risks and control risks and design the auditing procedures to address those risks.

Before You Go On

11.3.1 List the six steps involved in the payroll cycle.

11.3.2 What is a payroll register?

11.3.3 What are four controls over paying the payroll?

11.4 Audit Strategy

LEARNING OBJECTIVE 4

Discuss considerations relevant to determining the audit strategy for purchases, payables, and payroll.

The auditor must obtain an understanding of the entity and its environment to assess the inherent and control risks in order to determine the appropriate level of detection risk. This risk assessment will drive the development of the audit strategy, which will direct audit attention to significant risks through a mix of tests of controls and substantive procedures.

11.4.1 Understanding the Entity and Its Environment

As part of the audit planning procedures, it is important that the auditor be aware of the risk that misstatements may remain uncorrected in the financial statements. With regard to purchases, payroll, and payables, this will assist the auditor in:

- developing an understanding of cost of sales and gross margins by understanding the entity's products, its market share, and its competitive advantage

- developing an understanding of levels of various types of expenses, including staff costs
- developing an expectation of payables levels based on average payment periods for the client and the industry as a whole

The level of expenditure both for cost of goods sold and other costs will to some extent be affected by levels of revenue, and therefore an understanding of the sales cycle can lead to an understanding of an entity's expenditure cycles and help in assessing the possibility of misstatements in these areas. The auditor needs to carefully assess the extent to which costs are variable and therefore affected by sales and the extent to which they are fixed or affected by other drivers. Experience with the client entity or other companies in the same industry, through trade associations or reading newspaper or industry articles, will allow the auditor to understand the assertions at risk.

11.4.2 Analytical Review

Analytical techniques are used at various phases throughout the audit process. The objective of using these techniques during the risk assessment phase is to help identify high-risk areas for detailed audit testing. Where the auditor has a detailed knowledge of the entity, expectations can be created in relation to things such as income, expenses, and asset levels, against which the actual (draft) financial statements can be compared. Where the draft report is significantly different from the auditor's expectations, audit attention will be directed to that area of difference. If audit data analytics are performed, they can be performed on disaggregated data to provide more meaningful results. Furthermore, audit data analytics can be useful in uncovering fraud. An example is when employees are aware of expense approval levels, they may manipulate invoices and expense reports to fall under the approval thresholds to minimize scrutiny. An auditor can perform an audit data analytic to determine if there are significant invoices just under threshhold limits. To illustrate, if an entity requires manager approval for invoices over $2,500, an auditor could perform an audit data analytic to determine the number of invoices between $2,400 and $2,500. If a disproportionate number of invoices appear in this dollar range, further examination is required. Other examples of analytical procedures include investigations and comparisons of:

- gross margins and net margins—give indications of the reasonableness of cost of sales and expense levels
- expected staff costs based on average pay rates and average numbers of staff
- payables days (payables/credit purchases × 365)—consider any changes in payment terms

The audit strategy and the more detailed audit plan will be amended to address any significant risks identified through analytical procedures.

11.4.3 Inherent Risk Assessment

Purchase and payroll transactions account for the major expenses incurred by a business, and so are a major component in the determination of profit. They also relate to the acquisition of major classes of assets (notably, inventories and property, plant, and equipment). Moreover, the balance in the accounts payable produced by credit purchase transactions and the payroll expenses are nearly always material to the balance sheet. Because purchases, payables, and payroll are material for most businesses, the auditor assesses the risk of material misstatement relating to these transactions. This begins with the assessment of the inherent risk.

In assessing inherent risk by considering the likelihood and magnitude of a potential misstatement for purchase and payroll assertions, the auditor should consider factors that could motivate management to misstate expenditure. These may include:

- pressures to understate expenses in order to falsely report the achievement of announced profitability targets or industry norms
- pressures to understate payables in order to report a higher level of working capital in the face of liquidity problems or going concern doubts

These factors affect mainly the completeness assertion and reduce the acceptable detection risk, particularly in testing for understatement of liabilities. Other factors that may contribute to misstatements include:

- the high volume of transactions, which affects all assertions
- temptations for employees to make unauthorized purchases and payments, or to misappropriate purchased assets, which relate to the occurrence assertion
- contentious accounting issues such as whether a cost should be capitalized or expensed (such as the treatment of repairs and maintenance costs), which relate to the accuracy, valuation, and allocation assertion
- the complexity of payroll calculations for factory workers whose gross earnings may be based on time and/or productivity, affecting the accuracy of payroll costs

Payroll fraud is a major concern for the auditor. Employees involved in preparing and paying the payroll may process data for fictitious employees or for employees whose services have already been terminated, and then divert the wages for their own use. This affects the auditor's assessment of risk for the occurrence assertion for payroll.

The high volume of transactions, combined with the likely existence of effective control procedures over these transactions, means that it is normally appropriate to adopt a combined audit, particularly in respect to the occurrence and accuracy assertions. For other assertions, the audit strategy may vary with the preliminary assessment of control risk. The volume of transactions, however, means that a combined audit is preferred wherever the assessment of risk can support such a strategy.

Cloud 9 Integrated Case

Josh knows that the purchases, payables, and payroll transactions are material in terms of both volume of transactions and dollar amounts. Because of the large number of transactions processed during the year, he believes there is a high risk of errors simply happening. Therefore, he assesses the inherent risk for purchases, payables, and payroll as high for Cloud 9. He contemplates what the control risk assessment will be.

11.4.4 Internal Controls

In most well-established entities, management's own risk assessment procedures will have led it to adopt control procedures to reduce the risk of misstatements occurring in the processing and recording of transactions. However, the existence and effectiveness of controls relating to different transaction class assertions for purchases, payments, and payroll can vary considerably among entities and even among assertions for the same entity. Moreover, the auditor must remain mindful of the inherent limitations of internal control—including the possibility of management override, collusion, errors due to fatigue or misunderstanding, and failure to adapt the control structure to changed circumstances.

Factors relating to the control environment that the auditor needs to consider when assessing control risk for purchase, payment, and payroll transactions include those described below.

- Integrity and ethical values are important because there are numerous opportunities for employee fraud in processing purchase, payment, and payroll transactions, and for fraudulent financial reporting by management of expense account balances.
- Purchasing agents may be subjected to pressures from suppliers, such as offers of kickbacks for transacting more business with those suppliers.
- Management's commitment to competence should be reflected in the assignment and training of personnel involved in processing purchase, payment, and payroll transactions. In particular, people involved in payroll functions should be knowledgeable about employment laws and regulations and the applicable provisions of labour contracts.

- The entity's organizational structure and management's assignment of authority and responsibility over purchase, payment, and payroll transactions should be clearly communicated and provide clear lines of authority, responsibility, and reporting relationships. For example, purchasing, receiving, and inventory storage or warehousing activities may fall under the duties of the production manager; accounting may be the responsibility of the controller; and payments may be supervised by the treasurer.

Overall responsibility for personnel matters is often assigned to a director or manager of human resources. Officers' salaries and other forms of compensation are usually set by the board of directors.

Control Risk Assessment

Assessment of control risk is normally done in two phases. On obtaining an understanding of the internal control structure, the auditor forms a preliminary assessment of control risk.

Where the design effectiveness of control risk is assessed as low, tests of the operating effectiveness of controls are included in the audit program to confirm the preliminary assessment. Tests of controls for each of the three transaction classes are described in the following paragraphs.

Purchase Transactions

Table 11.2 contains a partial listing of "what can go wrongs," necessary controls, potential tests of the operating effectiveness of those controls, and the specific class of transactions audit objective for purchases to which each relates.

TABLE 11.2 Control risk assessment considerations—purchase transactions

Function	WCGW	Necessary Control	Possible Test of Operating Effectiveness	Relevant Class of Transactions Audit Objective (from Table 11.1)			
				OE1	C1	AV1	D1
Requisitioning goods and services	Goods may be requisitioned for unauthorized purposes.	General and specific authorization procedures	Inquire about procedures.	✓			
Preparing purchase orders	Purchases may be made for unauthorized purposes.	Approved purchase requisition for each order	Examine purchase orders for approved requisitions.	✓			
Receiving goods	Goods received may not have been ordered.	Approved purchase order for each shipment	Examine receiving report for matching purchase order.	✓			
	Incorrect quantities, damaged goods, or incorrect items may be received.	Receiving clerks to count, inspect, and compare goods received with purchase order	Observe the performance by receiving clerks.	✓			
Storing goods received for inventory	Inventory clerks may deny taking custody of purchased goods.	Signed receipt to be obtained on delivery of goods from receiving to inventory	Inspect signed receipts.	✓			
Approving the invoice	Invoices may be recorded for goods not ordered or received.	Matching of purchase order and receiving report with the supplier's invoice	Examine supporting documentation for invoices.*	✓	✓	✓	

(*continued*)

TABLE 11.2 **Control risk assessment considerations—purchase transactions (*continued*)**

Function	WCGW	Necessary Control	Possible Test of Operating Effectiveness	Relevant Class of Transactions Audit Objective (from Table 11.1)			
				OE1	C1	AV1	D1
Recording the liability	Invoices may be recorded incorrectly or not recorded.	Independent check of agreement of prelist with amounts recorded in purchase journal	Examine evidence of independent check; re-perform independent check.*	✓	✓	✓	✓
		Periodic accounting for pre-numbered receiving reports and purchase orders	Observe procedure; re-perform.		✓		
		Periodic performance reviews by management of reports, comparing actual asset, payable, and expense balances with budgeted amounts	Inquire of management about results of performance reviews; inspect reports.*	✓	✓	✓	✓

*Sometimes performed as a part of dual purpose tests.

Tests of Operating Effectiveness

The extent of tests of the operating effectiveness of controls will vary inversely with the auditor's preliminary assessment of control risk. Data analytics, statistical, or non-statistical attribute sampling procedures may be applicable to certain tests. Note that the direction of testing must be compatible with the specific audit objective to which the test relates—vouching for occurrence and tracing for completeness. Also, recall that some tests, particularly those pertaining to checking and approving suppliers' invoices and recording the liability, may be performed as dual purpose tests. In these tests (marked with an asterisk in table 11.2), evidence is obtained about the effects (measured in dollars) of processing errors on account balances, as well as about the frequency of deviations from controls. Based on the evidence obtained from procedures to obtain an understanding of the internal control structure and related tests of controls, the auditor makes a final assessment of control risk for each significant assertion related to purchase transactions.

A formal audit program that incorporates several of the tests from table 11.2 is presented in **figure 11.3**.

FIGURE 11.3 **Partial audit program for tests of controls—credit purchases**

Prepared by: ____________ Date: _________
Reviewed by: ____________ Date: _________

Cloud 9 Ltd.
Planned tests of controls — Credit purchases transactions
Year ending December 31, 2023

Assertion/Test of Controls	W/P Ref.	Auditor	Date
Occurrence 1. Observe procedures, including segregation of duties, for: • completing purchase orders from requisitions • receipt of goods • receipt of invoices • reconciliation of supplier statements			

(*continued*)

Assertion/Test of Controls	W/P Ref.	Auditor	Date
2. Select a sample of purchase transactions from the purchase journal and verify transaction dates, supplier names, and amounts by vouching entries to the following matching supporting documents: • purchase invoices • receiving reports • approved purchase orders • approved purchase requisitions			
Completeness			
3. Examine evidence of the use of and accounting for pre-numbered purchase requisitions, purchase orders, receiving reports, and sales invoices. Scan the sequence of sales invoice numbers in the sales journal.			
4. Select a sample of approved purchase requisitions and trace to matching: • approved purchase orders • receiving reports • purchase invoices • entries in the purchase journal			
Accuracy			
5. For the sample in step 2 above, examine evidence of: • an independent check on proper pricing of invoices • an independent check on the trade discounts received • an independent check on the mathematical accuracy of invoices			
6. For purchase invoices processed in batches, examine evidence of an independent check on the agreement of totals for purchase journal entries and amounts posted to supplier accounts with batch totals.			
Cut-off			
7. Obtain the number of the last receiving report for the last goods received for the year, select a sample of receiving reports before this number, and agree: • to purchase invoices dated in the current period • to entries in purchase journal before the period end			
8. Following on from step 7, select a sample of the receiving reports for the first goods received in the new fiscal period and agree: • to purchase invoices dated in the next accounting period • that the purchase is not recorded in the purchase journal until the following accounting period			

FIGURE 11.3 **Partial audit program for tests of controls—credit purchases (*continued*)**

The auditor normally uses the computer in performing tests of controls, using techniques similar to those used for sales transactions. In particular, tests of effectiveness must be performed for any controls that serve as the basis for a control risk assessment at a reduced level. This includes making inquiries and inspecting documentation concerning general controls over changes to programs and master files used in processing purchase transactions.

Tests of application controls may include the use of test data to determine whether expected results are produced by the entity's program for accepting and recording data for unpaid suppliers' invoices in circumstances such as the following:

- a missing or invalid supplier number
- a missing or invalid account classification code number
- a missing or unreasonable amount
- a missing due date or payment terms
- alphabetical characters in a numerical field

Examples of other possible computer-assisted audit tests are:

- using generalized audit software or a database program to perform sequence checks and print lists of purchase orders, receiving reports, or invoices whose numbers are missing in designated computer files
- designing, selecting, and evaluating a sample of receiving reports or unpaid invoices
- performing data analytics and visualizations to identify exceptions to the three-way match, missing authorizations, or other anomalies or outliers

Payment Transactions

Table 11.3 is a partial listing of potential misstatements, necessary controls, possible tests of the operating effectiveness of those controls, and the specific classes of transactions audit objectives

TABLE 11.3 Control risk assessment considerations—payment transactions

Function	WCGW	Necessary Control	Possible Test of Operating Effectiveness	Relevant Class of Transactions Audit Objective (from Table 11.1)			
				OE2	C2	AV1	D2
Paying the liability	Cheques may be issued for unauthorized purchases.	Cheque signers to review supporting documentation for completeness and approval	Observe cheque signers performing independent check of supporting documentation.	✓			
	An invoice may be paid twice.	"Paid" stamp to be placed on the invoice and supporting documents when a cheque is issued	Examine paid invoices for "paid" stamp.	✓			
	A cheque may be altered after being signed.	Cheque signers to mail cheques	Inquire about mailing procedures; observe mailing.		✓		
Recording the payment	A cheque may not be recorded.	Use of, and accounting for, pre-numbered cheques	Examine evidence of use of and accounting for pre-numbered cheques.			✓	
	Errors may be made in recording cheques.	Independent check of agreement of amounts journalized and posted with the cheque register	Observe procedure; re-perform.*	✓	✓	✓	
	Cheques may not be recorded promptly.	Periodic independent bank reconciliations	Examine bank reconciliations.*	✓	✓	✓	✓
		Independent check of dates on cheques with dates recorded	Re-perform independent check.	✓	✓		

*Sometimes performed as a part of dual purpose tests.

for payments to which each belongs. As explained for purchases, the potential misstatements and necessary controls are the basis of a checklist used to assess design effectiveness. Similarly, an audit program for tests of the operating effectiveness of controls for payment transactions can be prepared based on the potential tests of controls in table 11.3. Possible computer-assisted tests of controls are also similar to those for purchase transactions. Thus, for example, test data can be used to test programmed controls relating to the preparation and recording of cheques or electronic bank transfers to suppliers in payment of liabilities. Computer programs can also be used to design, select, and evaluate an attribute sample for payments. Where applicable, data analytics and visualizations may be used to test entire payment populations.

Payroll Transactions

The process of assessing the control risk for payroll transactions begins, as for purchases and payments, with identifying potential misstatements and necessary controls (shown in the second and third columns of table 11.4). Possible tests of controls are shown in the fourth column.

TABLE 11.4 Control risk assessment considerations—payroll transactions

Function	WCGW	Necessary Control	Possible Test of Operating Effectiveness	Relevant Class of Transactions Audit Objective (from Table 11.1)			
				OE3	C3	AV1	D3
Hiring employees	Fictitious employees may be added to the payroll.	Personnel department authorization for all hirings of new employees	Examine authorization forms for hirings of new employees.	✓			
Authorizing payroll changes	Employees may receive unauthorized rate increases.	Personnel department authorization for all rate changes	Inquire about procedures for authorizing rate changes.			✓	
	Terminated employees may remain on the payroll.	Personnel department notification to payroll department of all terminations	Examine termination notices in payroll department.	✓			
Preparing attendance and timekeeping data	Employees may be paid for hours not worked.	Use of time clock or electronic recording procedures and supervisory approval of time recorded	Observe time-recording procedures; examine supervisory approval procedures.	✓	✓	✓	✓
Preparing the payroll	Payroll data may be lost during submission to computer department.	Batch totals of hours worked prepared by payroll department and verified by data control	Examine evidence of the preparation and use of batch totals.		✓		
	Payroll transactions file may include incorrectly keyed or invalid data.	Edit checks of data on payroll transactions file	Observe data entry procedures; examine the exceptions and control report.*	✓	✓	✓	✓
Recording the payroll	Processing errors may occur in recording the payroll.	Exceptions and control report to be reviewed by data control	Inquire about the preparation and use of the exceptions and control report.*	✓	✓	✓	✓
	Unauthorized changes may be made to payroll data in computer department.	Payroll department comparison of payroll register with original batch transmittal data	Re-perform comparison.*	✓	✓	✓	✓
Paying the payroll and protecting unclaimed wages	Payroll cheques may be distributed to unauthorized recipients.	Employee identification on distribution	Witness distribution of payroll.	✓	✓	✓	✓

*Sometimes performed as a part of dual purpose tests.

In computer information systems, access controls over changes to personnel data are important. In the testing of controls, test data can be used to test programmed controls relating to the preparation and recording of payroll. Where time recording is computerized, test data can also be used in testing programmed controls over timekeeping.

The auditor knows that misstatements in payroll may result from unintentional errors or fraud. Of particular concern is the risk of overstatement of payroll through:

- payments to fictitious employees
- payments to actual employees for hours not worked
- payments to actual employees at higher than authorized rates

The first two risks relate to the occurrence assertion. The third risk relates to the accuracy assertion.

The risk of understatement (the completeness assertion) is of minimal concern because employees will complain when they see that they are unpaid for hours worked. Accordingly, many tests of payroll controls are directed at controls that prevent or detect overstatements. The direction of testing for these controls is from the recorded payroll data to source documents; for example, the auditor may vouch data for a sample of employees in a payroll register to approved clock card data and authorized pay rates and deductions.

Two tests of controls relating to the control risk for the occurrence assertion are the test for terminated employees and witnessing a payroll distribution. The former represents an exception to the normal direction of testing for payroll, in that the auditor selects a sample of termination notices and scans subsequent payroll registers to determine that the terminated employees did not continue to receive paycheques. In witnessing the distribution of payroll cheques or envelopes, the auditor observes that:

- segregation of duties exists between the preparation and payment of the payroll
- each employee is identified by a badge or employee identification card
- each employee receives only one cheque or pay envelope
- there is proper control and disposal of unclaimed wages

Such witnessing of payroll distribution is becoming less common as entities increasingly pay by electronic bank transfers. Recall from a previous chapter, possible test over electronic payments using audit data analytics is to compare payroll information and supplier information looking for matches, when no matches should exist. For example, the auditor could compare employee and supplier bank account numbers. Where matches are found, further investigation is needed because they could indicate fraud.

11.4.5 Final Assessment

Based on the evidence obtained from the procedures performed to obtain an understanding of the internal control structure and related tests of controls, the auditor makes a final assessment of inherent risk and control risk. For each significant audit objective where the assessment of risk is less than high, and this assessment is the basis for adopting a combined audit approach, the auditor must document reasons for this assessment. This assessment enables the auditor to plan the level of substantive procedures to be performed. The auditor must ensure that control deviations are properly identified and that their implications for the assessment of control risk are properly considered in deciding whether further substantive procedures need to be performed.

Cloud 9 Integrated Case

Josh has completed the purchase, payables, and payroll cycle documentation and his risk assessment by assertion and account. He has determined that the inherent risk for the completeness assertion over purchases and payables is high, while the control risk is low. This means Josh believes there is a high risk of misstatement in the purchases and payables accounts, but he believes there are controls in place that are effective in preventing and detecting such misstatements. Therefore, he is planning a combined audit, in that he is planning to test the controls over these transactions to confirm his original risk assessment.

He has also considered the risks over the payroll transactions. He has concluded the risk of completeness is low, as employees will generally complain if they are short-paid. However, he is not sure if the same holds true for any employees who are overpaid. Therefore, he has assessed the risk of the occurrence assertion as high. While he fears payments may be made to fictitious employees or actual employees may be paid for hours not worked, he believes there are controls in place that prevent this from happening. Therefore, he again suggests a combined audit approach for the payroll cycle.

He documents his conclusion and wonders if Sharon, the audit manager, will agree with him. He decides to confirm his assessment with her and the audit partner before continuing to plan any substantive work.

Before You Go On

11.4.1 List four inherent risks over the purchases and payables cycle.

11.4.2 What are three controls that should be in place over payment transactions?

11.4.3 What are three possible tests of controls over the payroll cycle?

11.5 Determining an Acceptable Level of Detection Risk

LEARNING OBJECTIVE 5

Indicate the factors relevant to determining an acceptable level of detection risk for the audit of purchases, payables, and payroll.

Accounts payable is usually the largest current liability in a balance sheet and a significant factor in the evaluation of an entity's short-term solvency. Like receivables, it is affected by a high volume of transactions and thus is susceptible to misstatements. However, whereas with receivables the auditor is usually concerned with overstatement, understatement is generally the greatest risk with payables. The reason is that management, if motivated to misrepresent payables, is likely to understate them in order to report a more favourable financial position. Compared with the audit of asset balances, the audit of payables places more emphasis on gathering evidence about the completeness assertion than about the existence assertion. This section focuses on accounts payable arising from purchase transactions and payroll liabilities arising from payroll transactions.

Accounts payable is affected by purchase transactions that increase the account balance and payment transactions that decrease the balance. Thus, detection risk for payables assertions is affected by the inherent and control risk factors related to both these transaction classes. The auditor considers the audit risk model or a risk matrix to determine the acceptable level of detection risk in planning the audit. The application of this process for accounts payable is summarized in **table 11.5**. The risk levels specified in this matrix are illustrative only and would vary based on the entity's circumstances. Furthermore, note that the acceptable detection risk levels shown in table 11.5 indicate the need for more persuasive evidence for the completeness assertion and the accuracy, valuation, and allocation assertion than for the other assertions.

Consider the following with regard to completeness assertions:

- Overall audit risk needs to be low to ensure there is a low risk of giving the wrong audit opinion in relation to completeness.
- The inherent risk has been assessed as higher on the spectrum of inherent risk. The auditor understands the entity and its environment and has concluded that there is a high likelihood that completeness errors will arise. (That is, there is a high risk that purchase transactions that actually occurred have been omitted or there are payable balances that exist that have been omitted.)

TABLE 11.5 **Correlation of risk components—accounts payable**

Risk Component	Existence or Occurrence	Completeness	Rights and Obligations	Accuracy, Valuation, and Allocation	Classification and Presentation
Audit risk	Low	Low	Low	Low	Low
Inherent risk	Moderate	High	Moderate	High	Low
Control risk—purchase transactions	Low	High	Moderate	High	Moderate
Control risk—payments	Moderate	Low	Low	Low	Low
Combined control risk*	Low	High	Moderate	High	Moderate
Acceptable detection risk**	High	Low	Moderate	Low	High

*This is the most conservative (highest) of transaction class control risk assessments used as the combined risk assessment.
**Based on the levels of audit risk, inherent risk, and combined control risk indicated above for each assertion category.

- The control risk is high, indicating that the auditor has obtained an understanding of the internal controls related to completeness and performed tests of controls on their effectiveness and has concluded that there is a high risk that any errors that do arise (and this is likely, given the high inherent risk identified above) will not be detected and corrected by the internal controls.
- The control risk for completeness is made up of the completeness control risk for purchase transactions (high) and the existence and occurrence control risk for cash payments (moderate). The logic for this is as follows (notice that both of the following lead to potential completeness problems in the balances):
  - A *completeness* problem with purchase transactions (a purchase has occurred but not been recorded in the accounts) leads to a *completeness* problem in the payables balance. (The purchase was not recorded, so the payable was also omitted.)
  - For cash payments, an *occurrence* problem (cash payments have been recorded but no payment was made) leads to a *completeness* problem in the payables balance. (The payable exists but a payment has been recorded to reduce the payable to zero even though no payment was made.)
- Having assessed inherent risk and control risk, the auditor will now determine the acceptable level of detection risk that will allow the overall audit risk for completeness and accuracy, valuation, and allocation to be low. Given that inherent risk is high and control risk is high, the auditor has determined that a low level of detection risk is appropriate to achieve the required audit risk. This level of detection risk will be used by the auditor to determine the nature, timing, and extent of substantive procedures that need to be performed. The level and detail of substantive procedures performed are a matter of professional judgement. Detection risk has been set low, so the auditor will be required to perform extensive substantive testing.

Before You Go On

11.5.1 What is the biggest risk with payables? Why?

11.5.2 Explain how accounts payable is affected by purchase and payment transactions.

11.5.3 Explain how the control risk for completeness is impacted by the control risk assessments for purchases and cash transactions.

11.6 Designing Substantive Procedures

LEARNING OBJECTIVE 6

Design a substantive audit program for purchases, payables, and payroll.

The general framework for developing audit programs for substantive procedures can be used in designing substantive procedures for payables and payroll liabilities. Table 11.6 lists possible substantive procedures in an audit program developed on this basis. Note that each test in the table is linked to one or more of the specific account balance audit objectives from table 11.1. Also note that multiple procedures are keyed to each account balance audit objective.

The procedures are explained in this section, together with comments on how some tests can be tailored based on the acceptable level of detection risk to be achieved.

TABLE 11.6 Possible substantive procedures for tests of payables assertions

		Account Balance Audit Objective (from Table 11.1)				
Category	**Substantive Procedure**	**OE5**	**C4**	**RO1**	**AV3**	**D5**
Initial procedures	1. Perform initial procedures on payables balances and records that will be subjected to further testing. (a) Trace the opening balance for payables to the previous year's working papers. (b) Review activity in the general ledger account for payables and investigate entries that appear unusual in amount or source. (c) Obtain a listing of accounts payable at the end of the reporting period and determine that it accurately represents the underlying accounting records by: • adding the listing and determining agreement with the total of the subsidiary ledger or the accounts payable master file and the general ledger control account balance • testing the agreement of suppliers and balances on the listing with those included in the underlying accounting records				✓	
Analytical procedures	2. Perform analytical procedures. (a) Determine expectations. (b) Compare current and previous year balances. (c) Calculate significant ratios such as: • gross profit • accounts payable turnover (d) Obtain explanations for unexpected changes. (e) Corroborate explanations.	✓	✓		✓	
Tests of details of transactions	3. Vouch a sample of recorded creditor transactions to supporting documentation. (a) Vouch credits to supporting suppliers' invoices, receiving reports, and purchase orders or other supporting documents. (b) Vouch debits to payments.	✓	✓	✓	✓	✓
	4. Perform purchases cut-off test. (a) Select a sample of recorded purchase transactions from several days before and after the year end and examine supporting vouchers, suppliers' invoices, and receiving reports to determine that purchases were recorded in the proper period.	✓	✓			

(*continued*)

TABLE 11.6 **Possible substantive procedures for tests of payables assertions (*continued*)**

Category	Substantive Procedure	Account Balance Audit Objective (from Table 11.1)				
		OE5	**C4**	**RO1**	**AV3**	**D5**
	(b) Observe the number of the last receiving report issued on the last business day of the audit period, and trace a sample of lower and higher numbered receiving reports to related purchase documents to determine whether transactions were recorded in the proper period.					
	(c) Examine subsequent payments between the end of the reporting period and the end of fieldwork and, when related documentation indicates the payment was for an obligation in existence at the end of the reporting period, trace to the accounts payable listing.					
	(d) Investigate unmatched purchase orders, receiving reports, and suppliers' invoices at the year end.	✓	✓			
	5. Perform cut-off test by tracing dates of cleared cheques on the subsequent period's bank statement to dates recorded.					
Tests of details of balances	6. Reconcile accounts payable to monthly statements received by the entity from suppliers.	✓	✓		✓	
	(a) Identify major suppliers by reviewing the accounts payable ledger or the accounts payable master file.					
	(b) Investigate and reconcile differences.					
	7. Confirm payables with major suppliers whose monthly statements are unavailable.	✓	✓	✓	✓	✓
	8. Perform a search for unrecorded liabilities.		✓			
	(a) Investigate differences identified by analytical procedures.					
	(b) Review agreements and long-term contracts requiring periodic payments for evidence of unrecorded liabilities.					
	9. Recalculate accrued payroll liabilities.				✓	
	10. Verify directors' and officers' remuneration.	✓	✓	✓	✓	✓
Classification and presentation	11. Compare financial statement presentation with applicable regulations and accounting standards.				✓	✓
	(a) Determine that payables are properly identified and classified as to type and expected period of payment.					
	(b) Determine whether there are debit balances that are significant in the aggregate and that should be reclassified.					

11.6.1 Initial Procedures

To begin verifying accounts payable:

- Trace the opening balance to the previous year's working papers, when applicable.
- Review activity in the general ledger account for any unusual entries.
- Obtain a listing of amounts owed at the end of the reporting period.

Usually the listing is prepared by the entity from the accounts payable records. The auditor must verify the mathematical accuracy of the listing by adding the total and verifying that it agrees with the underlying accounting records and the general ledger control account balance. In addition, the auditor selectively compares details of suppliers and amounts on the listing with the underlying records to determine that it is an accurate representation of the records from which the listing was prepared.

11.6.2 Analytical Procedures

Tests of details are usually planned on the basis that the analytical procedures confirm expectations. It is best to perform analytical procedures early in the final audit so the auditor can determine any changes needed to tests of details before starting that part of the audit. The first stage in applying analytical procedures is to review the understanding of the entity obtained during the planning phase as to whether any changes to payables balances are to be expected. The second stage is to identify absolute changes in amounts between the current year and previous years. This is normally done in the course of preparing the lead schedule for payables and payroll balances. The third stage involves the use of more sophisticated relationships, such as ratios and trends, including the gross profit ratio. If it is higher than expected, then one explanation could be an understatement of purchases (such as by a deliberate cut-off error) in order to boost revenues.

Analysis of expense accounts is also important. The auditor usually undertakes this analysis by comparing the ratio of each expense to sales in the current year with that in previous years. In this way, the effect of changes in the level of activity is largely eliminated. An unusually low expense account may indicate unrecorded liabilities through cut-off error; for example, if the final quarter's electricity account has not been paid or allowed for, then the current year's electricity expense will appear unusually low compared with that for the previous year. Wherever a change in relationships cannot be readily explained, the auditor must seek an explanation from management and corroborate it, usually by conducting additional tests of details.

Analytical procedures are significant in achieving the desired level of detection risk for payroll balances. Particularly useful ratios are those of the average wages per employee, which should not be dissimilar from previous years, subject only to known wage increases, and payroll expenses as a percentage of sales.

11.6.3 Tests of Details of Transactions

Balances affected by numerous transactions are more efficiently verified by tests of the closing balance and not by tests of the transactions making up that balance. When possible, the auditor performs the tests of details of transactions during the interim audit, commonly in the form of dual purpose tests. No substantive tests of details of payroll transactions are described here, because the tests of controls described earlier may also constitute the main sources of substantive evidence for payroll transactions. The cut-off tests now described are always performed as part of year-end work and, although they are tests of transactions, they serve to verify the recorded balance at the end of the reporting period.

Vouching Recorded Payables to Supporting Documentation

The emphasis of these tests is on vouching purchase transactions to supporting documentation in the entity's files (such as purchase orders, receiving reports, and suppliers' invoices) to verify their occurrence as legitimate transactions. It is equally important, however, to test the numerical continuity of purchase orders and receiving reports, and to trace them to suppliers' invoices and accounts payable to verify completeness.

Performing Purchases Cut-Off Test

The purchases cut-off test involves determining that purchase transactions occurring near the end of the reporting period are recorded in the proper period. Most entities hold their books open for a certain period to ensure that purchase transactions are recorded in the correct accounting period. When the books are closed, unmatched receiving reports and purchase orders are scrutinized and, if they relate to the current period, they are recorded by way of journal entry. Unlike receivables, it may take several weeks before all transactions occurring before the end of the reporting period are invoiced by the suppliers. Because cut-off is significant only at the end of the reporting period, most entities do not have effective controls to ensure an accurate distinction between the recording of transactions before and after that date. Acceptable detection risk is likely to be low, and extensive tests of details will be performed. The emphasis is on completeness, which is achieved by tracing receiving reports issued in the days immediately before the end of the reporting period to purchase journal entries or to the closing journal entry of purchase accruals. This procedure provides evidence that they are recorded in the current accounting period.

Because many purchases (such as services) do not result in the issue of a receiving report, purchases after the end of the reporting period are vouched to supporting documentation to ensure that they do not relate to goods or services received before the end of the reporting period.

Although the emphasis of the test is on completeness, the auditor also traces some receiving reports issued after the year end to suppliers' invoices, to ensure that they are recorded in the next period's purchase transactions file. In addition, the auditor vouches recorded purchases before the end of the reporting period to receiving reports dated before the end of the reporting period, to ensure that no transactions that occurred after the period are recorded before the end of the reporting period. This provides evidence as to the occurrence assertion. These tests usually cover a period of 5 to 10 business days before the end of the reporting period and as long after as appears necessary. In performing this test, the auditor should determine that a proper cut-off is achieved at the physical inventory count as well as in the recording of the purchase transactions. Where inventory is counted other than at the end of the reporting period, the auditor needs to check cut-off for purchases of inventory at the inventory count date as well as at the end of the reporting period.

Performing Payments Cut-Off Test

A proper cut-off of payment transactions at the year end is essential to the correct presentation of cash and accounts payable at the end of the reporting period. The usual method of verifying payments cut-off is to examine the date of presentation of cheques unpresented as at the end of the reporting period. This test is normally performed as part of the test of the bank reconciliation and the use of the next period's bank statement.

11.6.4 Tests of Details of Balances

The three tests included in this category for payables are:

1. reconciling payables with monthly statements received by the entity from suppliers
2. confirming accounts payable
3. searching for unrecorded liabilities

The two tests for payroll balances are:

1. recalculating payroll liabilities
2. verifying directors' and executive officers' remuneration

Reconciling Payables with Suppliers' Statements

In many cases, suppliers provide monthly statements that are available in entity files. As documentary evidence originating outside the entity, suppliers' statements provide reliable evidence as to suppliers' balances. However, because they are obtained from the entity, the auditor needs to be cautious that the statements have not been altered, and should not rely on photocopies and faxed statements. Where there is doubt, a copy should be requested directly from the supplier or the balance confirmed directly with the supplier.

In the selection of accounts for testing, the criterion should be the volume of business during the year, not the balance shown in the entity's accounts payable listing, because the main concern is that the recorded balance may be understated.

Discrepancies between suppliers' statements and the entity's accounts payable ledger need to be investigated. Most differences are likely to be due to goods and cash in transit and to disputed amounts. This procedure provides evidence as to the existence, completeness, and accuracy, valuation, and allocation assertions.

Confirming Accounts Payable

confirmation of accounts payable written inquiry of suppliers, requesting confirmation of the balance owed or a statement listing invoices owing at the confirmation date

Unlike the confirmation of receivables, the **confirmation of accounts payable** is performed less frequently because:

- confirmation offers limited assurance that unrecorded liabilities will be discovered
- external evidence in the form of invoices and suppliers' monthly statements should be available to substantiate the balances

Confirmation of accounts payable is recommended (1) when detection risk is low and (2) for suppliers with which the entity undertook a substantial level of business during the current or previous years and that do not issue monthly statements, and for suppliers for which the statement at the end of the reporting period is unexpectedly unavailable.

As in the case of confirming receivables, the auditor must control the preparation and mailing of the requests and should receive the responses directly from the supplier. The auditor should use the positive form in making the confirmation request, as illustrated in **figure 11.4**. Note that the confirmation does not specify the amount due. In confirming a balance, the auditor prefers to have the creditor indicate the amount due because that is the amount to be reconciled to the entity's records. Information is also requested regarding

PO Box 1777
Halifax, Nova Scotia

January 5, 2024
Supplier Limited
2001 Lakeview Drive
Halifax, Nova Scotia

Dear Sir or Madam:

Will you please send directly to our auditors, W&S Partners, an itemized statement of the amount owed to you by us at the close of business on December 31, 2023. Please also supply the following information:

Amount not yet due $...

Amount past due $..

Amount of purchase commitments $................................

Description of any collateral held ....

....

....

A business reply envelope addressed to our auditors is enclosed. A prompt reply will be very much appreciated.

Yours faithfully,

Controller

FIGURE 11.4 Accounts payable confirmation

purchase commitments of the entity and any collateral for the amount due. This test produces evidence for all assertions relating to payables. However, the evidence provided about the completeness assertion is limited, given the possible failure to identify and send confirmation requests to suppliers with which the entity has unrecorded obligations.

Searching for Unrecorded Liabilities

The major procedure for identifying unrecorded liabilities is the examination of the next period's purchase and payment transactions and the review of unpaid invoices as described earlier under cut-off tests. Analytical procedures may also identify unexpected differences between the current year's and the previous year's expense or liability balances, which could indicate the presence of unrecorded liabilities. An analysis of rent expense, for example, may indicate that only three quarterly payments have been made, suggesting that the fourth quarter's rent needs to be allowed for. Similarly, a comparison of accruals and prepayments may identify differences arising from the failure to make a closing entry in the current year.

An examination of contractual commitments may also alert the auditor to the existence of liabilities not yet provided for, such as progress payments on long-term contracts or amounts accrued but not yet due or invoiced under a franchise agreement. **Figure 11.5** shows a completed working paper documenting the search for unrecorded liabilities.

Other procedures known as the subsequent-events testing and the search for unrecorded liabilities include procedures to determine if there are undisclosed contingent liabilities or commitments.

Recalculating Payroll Liabilities

It is necessary for many entities to make a variety of accrual entries at the end of the reporting period for amounts owed to officers and employees for salaries and wages, commissions, bonuses, holiday pay, and so on, and for amounts owed to government agencies for income tax and other deductions. Although the auditor's main concern regarding payroll expenses for the year is with overstatement, the main concern regarding the year-end accruals is with understatement. Also of concern is consistency in the methods of calculating the accrued amounts from one period to the next. In obtaining evidence concerning the reasonableness of management's accruals, the auditor should review management's calculations or make independent calculations. Additional evidence can be obtained by examining subsequent payments made for the accruals before the completion of fieldwork. Evidence obtained from these procedures relates mainly to the accuracy, valuation, and allocation assertion.

Verifying Directors' and Executive Officers' Remuneration

Directors' and executive officers' remuneration is audit-sensitive because directors and executive officers may be able to override controls and receive salaries, bonuses, stock options, and other forms of compensation in excess of authorized amounts.

For these reasons, the auditor should compare the authorizations of the board of directors for directors' and executive officers' salaries and other forms of compensation with recorded amounts. This procedure relates to all assertions.

11.6.5 Disclosure

Each major class of creditors and borrowings must be disclosed. These are likely to include bank overdrafts, bank loans, accounts payable, related party liabilities, taxation, and employee benefits. In addition, disclosure must be made of the amount of each class of liability secured by a charge and the nature of the security. If accounts payable balances include material advance payments for future goods and services, such amounts should be reported as advances to suppliers and classified under current assets.

CLIENT: Sample Client Ltd. Period-end: 12/31/2023 Currency/Unit: $	N04 - SEARCH FOR UNRECORDED LIABILITIES	W&S PARTNERS Reference N04

Prepared by: LH
Date: 03/2024
Reviewed by: ___________________
Date: ___________

Section 1: Review of subsequent disbursements

Disbursement type (disbursements after year end)	Disbursement reference	Disbursement		Invoice details				TM/ Ref	Delivery Date/Date of service provided	TM/ Ref	Accrued at year end?	TM/ Ref	Comments
		Date	Amount	Recipient	Date	Amount	Description						
Wire transfer	123 456	Jan. 31, 2024	(700)	ABC	Jan. 12, 2024	(500)	Electricity bill 12/23		2023	✓	Yes		
Wire transfer	654 293	Jan. 31, 2024	(1,500)	DEF	Jan. 13, 2024	(1,000)	Lawyer's invoices 12/23		2023	✓	Yes		
Cheque	754 633	Jan. 31, 2024	(2,001)	GHI	Jan. 13, 2024	(2,001)	Flight to Las Vegas in FY24		2024	✓	N/A	N/A	
etc...													

Section 2: Review of invoices received after year end

Invoice details			TM/ Ref	Delivery date/ date of service provided	TM/ Ref	Accrued at year end?	TM/Ref	Comments
Date	Amount	Description						
Jan. 5, 2024	(900)	Raw material		2024	✓	N/A	N/A	
Jan. 3, 2024	(1,000)	Lawyer's invoices 12/23		2023	✓	Yes		
Jan. 4, 2024	(1,500)	Temporary workers Dec. 2023		2023	✓	Yes		
Jan. 4, 2024	etc...							

Key to audit tickmarks:

Agrees to invoice details
✓ Agrees to delivery note/details of service provided
Agrees to details of accrued liabilities

Comments: No errors detected (in addition to the one detected during our cut-off procedures)

FIGURE 11.5 **Completed working paper (search for unrecorded liabilities)**

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Josh is now happy to be completing his work on the accounts payable, purchases, and payroll. He has completed most of the substantive testing.

The bank confirmations will provide additional evidence about the completeness assertion for liabilities (by potentially revealing information about other loans), and communication with Cloud 9's lawyers will provide evidence about any other undisclosed liabilities, including contingencies. The audit manager will read the company's significant contracts, and the audit senior will review the board meeting minutes for information that could relate to other obligations. Tests relating to warranty, loyalty program, and other estimates are already in the plan.

Suzie and Ian include a final step in the substantive testing program for a senior member of the audit team to review the liabilities as a whole for any other issues, including significant disclosures required by the accounting standards.

Before You Go On

11.6.1 What is the purpose of payables cut-off testing?

11.6.2 What are three tests of details for accounts payable?

11.6.3 The confirmation of accounts payable is performed less frequently than the confirmation of receivables. Why?

Summary

1 Identify the audit objectives applicable to purchases, payables, and payroll.

In the auditing of purchases, the key issue is often to ensure that the purchases are all recorded and are not understated; therefore, the focus is on completeness, accuracy, and cut-off assertions. For payables that are derived from the purchases, the key issue is to ensure they are all fully recorded in the accounts as liabilities; therefore, the focus is on the completeness and accuracy, valuation, and allocation assertions. Lastly, the focus of the payroll expense is to ensure the expense has been properly recorded and the associated deductions for income tax, employee benefits, and related liabilities are properly recorded as liabilities. This means the focus is on the completeness, occurrence, and accuracy assertions as well as assertions related to balances of completeness, existence, and accuracy, valuation, and allocation.

2 Describe the functions and control procedures normally found in information systems for processing purchase, payment, and purchase adjustment transactions.

The processing of purchase transactions involves the following functions: requisitioning goods and services, preparing purchase orders, receiving the goods, storing goods received in inventory, checking and approving the supplier's invoice, and recording the liability. Control procedures such as using pre-numbered cheques, approval of purchases by authorized personnel, and segregation of duties should be interwoven into each process to reduce the risk of material misstatement.

3 Describe the functions and control procedures normally found in information systems for payroll transactions.

The processing of payroll transactions involves the following functions: hiring employees, authorizing payroll changes, preparing attendance and timekeeping data, preparing the payroll, recording the payroll, paying the payroll, and protecting unclaimed wages. Control procedures such as limiting access to payroll records, independently reviewing the payroll, and making payments by direct deposit should be included in each process to reduce the risk of material misstatements.

4 Discuss considerations relevant to determining the audit strategy for purchases, payables, and payroll.

The audit process starts with obtaining an understanding of the purchases, payables, and payroll systems to help assess the inherent and control risks. For audit purposes, the most significant inherent risk is usually that of understatement of purchase transactions and accounts payable balances in order to boost reported profits and enhance liquidity. For the entity, the greatest inherent risk is that of improper purchasing and payments to fictitious employees. Next, the auditor assesses the control risk. Based on the effectiveness of the internal controls, the auditor then drafts the audit program based on the preliminary assessment of control risk. The assessed level of control risk is confirmed on completion of the tests of operating effectiveness, which leads to the final determination of an audit strategy. For purchases and payroll, the audit strategy is likely to be one based on a combined approach.

5 Indicate the factors relevant to determining an acceptable level of detection risk for the audit of purchases, payables, and payroll.

Once the auditor assesses the inherent and control risks, detection risk is set to achieve the required audit risk. This detection risk will be used by the auditor to determine the nature, timing, and extent of substantive procedures that need to be performed. The level and detail of substantive procedures performed is a matter of professional judgement. If detection risk is set as low, the auditor will be required to perform extensive substantive testing. If the detection risk is set as high, the auditor may perform a combined audit.

6 Design a substantive audit program for purchases, payables, and payroll.

The final stage of the audit is the performance of substantive procedures. It is usually more cost-effective to test the balance of accounts payable than to test the transactions making up that balance. The most important test of transactions is that of cut-off at the year end. The major test of balances is the examination of suppliers' statements. Because these are documentary evidence received from third parties, they are moderately reliable; however, the auditor needs to be alert to the possibility that such statements may be forged or altered by the entity. Finally, the auditor must also verify directors' and officers' salaries.

Key Terms

Accounts payable master file 11-9
Cheque register 11-10
Confirmation of accounts payable 11-30
Payroll register 11-13
Payroll transaction file 11-13
Personnel authorization form 11-12
Personnel file 11-13
Personnel master file 11-13
Purchase journal 11-9
Purchase order 11-7
Purchase requisition 11-6
Receiving report 11-8
Remittance advice 11-10
Supplier's invoice 11-8
Termination notice 11-13

Self-Test Questions

Answers to the Self-Test Questions are available in *WileyPLUS*.

11.1 The specific audit objective "accounts payable are liabilities of the entity at the end of the reporting period" is derived from the:

- **a.** existence or occurrence assertion.
- **b.** completeness assertion.
- **c.** accuracy, valuation, and allocation assertion.
- **d.** rights and obligations assertion.

11.2 The receiving department should be instructed not to accept goods without having on file a properly authorized:

- **a.** purchase requisition.
- **b.** invoice.
- **c.** receiving report.
- **d.** purchase order.

11.3 The following is a test of control that would provide audit evidence for the management assertion of occurrence of credit purchases:

- **a.** selecting a sample of purchase invoices and ensuring there is evidence of a check that the discount given agrees with supplier agreement records.
- **b.** selecting a sample of authorized purchase orders and agreeing to receiving report and purchase invoice.
- **c.** selecting a sample of purchase invoices and verifying that there are appropriately authorized purchase orders.
- **d.** selecting a sample of purchases and ensuring that the items purchased are included either in sales or inventories.

11.4 Controls over the preparation and signing of cheques include all of the following *except*:

- **a.** authorized personnel in the finance department should be responsible for signing the cheques.
- **b.** the cheque requisition and supporting documents should be cancelled (stamped) when the cheque is signed.
- **c.** the signed cheque and the supporting documents should be returned to the accounts payable clerk for review and mailing.
- **d.** pre-numbered cheques should be used.

11.5 Controls over the recording of cash payments include:

- **a.** an independent check by the accounting supervisor of the agreement of the amounts journalized and posted to accounts payable with the cheque summary received from the accountant.
- **b.** an independent check of the agreement of the total of cheques issued with a batch total of the vouchers processed for payment.
- **c.** the cheque signer should control the mailing of the cheques.
- **d.** pre-numbered cheques should be used.

11.6 Segregation of the functions of payroll and personnel do all of the following *except*:

- **a.** reduce the risk of payments to fictitious employees.
- **b.** reduce the risk of payments to terminated employees.
- **c.** restrict the recording of new employee data to the payroll department.
- **d.** restrict the payment of wages to the payroll department.

11.7 All of the following are procedures for identifying unrecorded liabilities *except*:

a. examination of the subsequent period's purchase and payment transactions.

b. analytical procedures for expense and liability balances.

c. examination of contractual commitments.

d. confirmation of accounts payable balance to invoices.

11.8 Responsibility for updating the personnel data master file should rest with authorized employees in the:

a. personnel department.

b. payroll department.

c. controller's department.

d. employee's operating department.

11.9 Requiring a special supervisor's password in order to add a new employee to the personnel data master file relates to the:

a. existence or occurrence assertion.

b. completeness assertion.

c. rights and obligations assertion.

d. accuracy, valuation, and allocation assertion.

11.10 When test data may be used to test application controls over accepting and recording data for unpaid suppliers' invoices, the following conditions would *not* be relevant:

a. numerical characters in an alphanumeric field.

b. missing or invalid supplier numbers.

c. missing due date or payment terms.

d. alphabetical characters in a numerical field.

Review Questions

11.1 State the main audit objectives for: (a) purchases and payroll transactions and (b) accounts payable balances.

11.2 Explain the importance of segregating the personnel function from the payroll preparation.

11.3 Describe programmed application controls you would expect to find in a computerized payroll system. Explain the audit procedures for testing those controls.

11.4 Describe computer-assisted audit procedures that can be used in testing controls over purchasing.

11.5 Explain why the assessment of control risk for the occurrence of payment transactions affects the assessed level of control risk for the completeness of the accounts payable balance.

11.6 Describe the performance of the purchases cut-off test.

11.7 It is increasingly common for companies to program their computer information system to print and distribute cheques without further authorization. As an auditor, describe controls you would expect to find in place over such a system.

11.8 Explain why an unexpected change in the gross profit ratio leads the auditor to suspect a wide range of possible misstatements in recorded transactions and balances.

11.9 Cut-off procedures can be applied to receiving reports issued before the year end or to liabilities recorded after the year end. Consider the separate merits of each approach in assuring the completeness of recorded liabilities.

11.10 Explain why achieving an accurate cut-off of purchases and sales transactions is of critical importance in assuring the fairness of the financial statements. Illustrate your explanation with examples of the effect of cut-off errors.

Professional Application Questions

Basic Moderate Challenging

11.1 Audit objectives over purchases, payables, and payroll Basic LO 1

Required

For each of the following statements, identify the audit assertion that it relates to:

a. All purchases transactions that occurred during the period have been recorded.

b. Accrued payroll liabilities are liabilities of the entity at the end of the period.

c. Purchase invoices are properly recorded.

d. All cash payments are recorded in the correct period.

e. Utilities expenses are recorded in the correct accounts.

f. Invoices are received for goods not ordered.

g. Fictitious payable invoices may be recorded.

11.2 Purchases, payables, and payroll documents **Basic** **LO 2**

Key documents are used throughout the purchases, payables, and payroll process, and each supports an internal control function.

Required

For each of the following documents, describe its purpose and how it contributes to internal control over the purchases, payables, and payroll cycle.

a. purchase order

b. receiving report

c. accounts payable master file

d. suppliers' invoices

e. personnel master file

f. payroll register

11.3 Purchase controls **Moderate** **LO 1, 2**

Your firm is the external auditor of Bestwood Engineering Ltd., which manufactures components for motor vehicles and sells them to motor vehicle manufacturers and wholesalers. It has sales of $25 million and a profit before tax of $1 million. The company has a new financial controller, who has asked for your advice on controls in the company's purchasing system.

Bestwood has separate accounting, purchasing, and receiving departments. Most purchases are requisitioned by the production department, but other departments are able to raise requisitions for goods and services. The purchasing department is responsible for obtaining goods and services for the company at the lowest price that is consistent with the required delivery date and quality, and for ensuring their prompt delivery.

The accounting department is responsible for obtaining authorization of purchase invoices before they are input into the computer, which posts them to the accounts payable sub-ledger and the general ledger. The accounting records are kept on a computer and standard off-the-shelf accounting software is used. The accounting software maintains the accounts payable sub-ledger, accounts receivable sub-ledger, general ledger, and payroll. The company does not maintain inventory records because it believes the cost of maintaining these records outweighs the benefits.

The financial controller has explained that services include gas, electricity, telephone, repairs, and the short-term rentals of equipment and vehicles.

Required

a. Describe the procedures that should be incorporated in the purchasing department to control the purchase and receipt of goods.

b. Describe the controls the accounting department should exercise over obtaining authorization of purchase invoices before posting them to the accounts payable ledger.

c. Explain how controls over the purchase of services, from creating the purchase requisition to posting the invoice to the accounts payable sub-ledger, may differ from the procedures for the purchase of goods, as described in your answers to parts (a) and (b).

Source: Adapted from ACCA Audit Framework, Paper 6(U), December 1998.

11.4 Internal control evaluation—cash payments **Moderate** **LO 1, 2**

Management of Tarnawski Ltd. has requested a review of internal controls over cash payments for parts and supplies purchased at its various manufacturing plants. Cash payments are centrally processed at head office based on vouchers prepared and approved at the manufacturing plants. Each manufacturing plant purchases parts and supplies for its own production needs. In response to management's request, a thorough evaluation of internal controls over payments for plant purchases of parts and supplies is being planned. As a preliminary step in planning the engagement, the plant managers have been asked to provide a written description of their respective plants' procedures for processing payment vouchers for parts and supplies. The following are nine excerpts from one of the written descriptions.

1. The purchasing department acts on purchase requisitions issued by the stores department (which houses supplies).
2. Orders are placed on pre-numbered purchase order forms.
3. A complete purchase order copy is sent to the receiving department.

4. When goods are received, the receiving department records the receipt of the shipment by stamping "order received" on a copy of the purchase order and forwards the annotated order to the accounts payable department.
5. Purchase orders, purchase order copies that have been annotated by the receiving department, and supplier invoices are matched by the accounts payable department.
6. Clerical accuracy of supplier invoices is checked by the accounts payable department.
7. A pre-numbered payment voucher is prepared and forwarded, along with supporting documentation, to the plant controller, who reviews and approves the voucher.
8. Supporting documents are returned to the accounts payable department for filing and approved payment vouchers are forwarded to head office for payment.
9. A report listing cheques issued by head office is received and promptly filed by the accounts payable department.

Required

For each of the payment system procedures listed above, state whether it is consistent with good internal control and describe how it strengthens or weakens internal control.

[1]**11.5** Strengths and weaknesses of controls **Moderate** **LO 1, 2, 4**

GGG Electronics builds shortwave radios. Its manufacturing plant is also a warehouse. When parts are received, the receiver compares the type of goods and quantity with a copy of the purchase order available online. If the quantity received differs from the quantity on the purchase order, the receiver adjusts the purchase order amount online. When the goods are checked by the receiver, she sends an email to the accounting department, recording the type of goods, quantity, and date received. The accounting department uses the email to create a receiving report, and the purchase order is then printed and filed in the accounting department. The online system allows the company to reduce paper, because a hard copy is not needed until the goods are actually received. The company's order-entry and tracking system automatically assigns the next number in a series to the purchase order just before printing.

Inventory is physically moved to the warehousing area, which is located in a locked-up area at the end of the plant. There is a stores department in a separate area for supplies such as gloves, wire, and adhesives, all of which are used in significant quantities on a regular basis. When an assembly-line worker requires supplies, the supervisor fills out a serially pre-numbered requisition card, signs it, and gives it to the worker, who then takes it to the stores department to obtain the needed items. Each supervisor has a stock of requisition cards. When the supplier's invoice is received by the purchasing department, one of the purchasing department staff sends an email to the accounting department, noting the invoice amount, supplier name, date of shipment, and type of goods. The accounting department then matches this to the purchase order and receiving report, and prepares a cheque for the controller to sign.

The controller does not sign the cheque until she also receives an email from the accounting staff indicating that the purchase order, receiving report, and invoice have been matched.

Required

a. List *four* internal controls that appear to be effective in GGG's system.
b. List *three* examples of weak internal controls in GGG's system. Explain why each of your examples would be a weak control.

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11.6 Payroll—in-house payroll processing **Moderate** **LO 1, 3, 4**

Diamond Construction is an owner-managed entity with contracting revenues of $20 million in 2023. As construction is a labour-intensive industry, one of Diamond's largest expense accounts is labour and wages. You are a first-year auditor at Klein and Partners. You have been given the following information regarding the entity's payroll process for hourly employees at Diamond Construction:

1. The owner-manager is the only person who can authorize the hiring of a new employee.
2. When a new employee is hired, the payroll clerk prepares a new employee package that includes:
   - safety orientation
   - tax forms
   - benefits plan enrolment

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3. Only the payroll manager has the ability to update the employee master list. This can only be done once the tax forms, a void cheque with direct deposit information, and the owner's approval have been received. All forms need to be returned before the payroll manager will update the payroll master list and add any new employees.
4. Hourly employees are paid biweekly.
5. Hours worked are tracked on time cards. Supervisors fill in the time cards for each individual day and initial each of the time cards, noting the hours worked.
6. At the end of the pay period, time cards are provided to the payroll clerk, who compiles the total hours worked and codes the hours to the appropriate job number. Once compiled, the payroll clerk enters the hours worked per person in the payroll system.
7. The accounting system prepares the direct deposit information based on the rates of pay maintained in the payroll master list (listing of all authorized staff and approved wage rates). It also calculates the withholding taxes.
8. This information is transferred to the bank and a record of the transmission is printed and attached to the front of the payroll run.
9. The payroll module is integrated with the general ledger. The payroll clerk prepares and posts the journal entry to the payroll expense accounts.
10. Pay stubs with payroll details are given to the supervisors for distribution.
11. If an employee is terminated, Diamond just stops paying them as they no longer have time cards submitted.
12. When an employee has been promoted or their job classification has changed, the supervisor will verbally communicate this to the payroll manager, who will then update the payroll master file. Therefore, source documentation in employee files will only relate to an employee's original job classification. The rationale for this was that most job classification changes would only result in an additional dollar or two per hour paid to the employee.

Required

a. Identify the control strengths of the payroll process at Diamond Construction. For each strength, identify what the test of that control could be.

b. Identify the control weaknesses of the payroll process at Diamond Construction. For each weakness, identify the implications of the weakness and recommend how to improve it.

[2]11.7 Transaction-level controls over the payroll cycle **Moderate** LO 1, 3, 4

Trillite Ltd. has had strong growth over the past three years. The company is involved in mining in northern Canada. While revenues have been increasing, the costs of mining at its remote locations have increased as well. An investigation revealed that the controller had added a fictitious employee and had defrauded Trillite by collecting and cashing false payroll cheques. The CEO fired the controller and, instead, hired a new accountant with a mandate to cut costs. The accountant eliminated a number of administrative staff, because these employees do not contribute to the income-earning process. Under the new office structure, only the personnel manager can authorize the hiring of new employees and their pay rate, and only the accountant will prepare and distribute the payroll cheques.

Required

Does the new accountant's plan provide strong internal controls over payroll? Justify your answer by stating the strength(s) and weakness(es) of the new plan.

11.8 Segregation of duties and documentation **Moderate** LO 2, 4

Lise Couture is documenting the purchasing and cash payments processes at Hardies Wholesaling. Hardies Wholesaling imports garden and landscaping items, such as pots, furniture, fountains, mirrors, and sculpture, from suppliers in Southeast Asia. All items are non-perishable; are made from materials such as stone, concrete, metal, and wood; and are distributed to retailers throughout the country.

Purchases are denominated in U.S. dollars, which the company acquires under forward exchange contracts. The purchasing department initiates a purchase order when inventory levels reach reorder

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points or sales staff notify the department of large customer orders that need to be specially filled. The purchase order is approved and sent to suppliers selected from an approved supplier list. Goods are transported from Southeast Asia by ship and are delivered by truck to Hardies Wholesaling's central warehouse. A receiving report is generated by the receiving department and forwarded to the accounts payable department for matching with the copy of the original purchase order and the supplier's invoice. When the package of documents is completed, the purchase order and invoice are entered into the general ledger. The cash payments department initiates a voucher to request payment of the invoice according to the supplier's payment terms. The payment is approved and the cash payment is made.

Required

a. Create a flowchart to represent the flow of transactions from the initiation of a purchase order to cash payment.

b. Which duties in the above process should be segregated?

11.9 Computer information system controls—purchasing and cash payments **Challenging** **LO 1, 2, 4**

You are the auditor of Sofasellers Ltd., which buys furniture from manufacturers for sale to the public. You have been asked to audit certain aspects of the computerized purchasing and accounts payable system.

The company has a head office, a warehouse, and many stores throughout the country. Furniture from manufacturers may be delivered to the warehouse or directly to individual stores. Details of goods received are entered into computer terminals at the warehouse or store, which are online with the head office main computer.

The computerized purchasing system involves the following six processes:

1. The user department (store or warehouse) sends a purchase requisition to the purchasing department at head office.
2. The purchasing department issues a purchase order, which is sent to the supplier and recorded in the computer.
3. On delivery, the goods are checked by the receiving department in the warehouse and a receiving report is created, entered into the computer system, and allocated against the order.
4. On receipt of the invoice, the central accounting department forwards the invoice to the user department, which authorizes it and returns it to the accounting department. Invoice details are then recorded in the computer, which posts it to the accounts payable ledger.
5. The computer system allows payment only if the system has recorded:
   - the purchase order
   - receipt of the goods
6. When the purchase invoice is due for payment, the computer prints the cheque and remittance advice.

Cheques are automatically produced, so the partner in charge of the audit has asked you to identify controls over authorizing purchase invoices and changing suppliers' details on the computer's master file. He has explained that "application controls" comprise controls exercised by the company's staff and by the computer.

Required

a. Describe the application controls you would expect to find in operation from creating the purchase requisition to the computer accepting the purchase invoice.

b. Explain the controls that should be exercised over access to the main computer from terminals in the head office and at the retail locations.

c. Describe the application controls that should be exercised over changing supplier details in the supplier master file in the computer. You should consider:

   i. why such controls are important and how a fraud could be perpetrated in the absence of effective controls.

   ii. the controls you would expect to find over changing supplier details and ensuring that supplier details are correct. Your answer should include consideration of controls over access to the computer to perform these tasks.

Source: Adapted from ACCA Audit Framework, Paper 6, December 1994.

11.10 Payroll at a not-for-profit entity **Moderate** **LO 1, 3, 4**

Venture Volunteers for Troubled Teens is a not-for-profit entity that provides counselling services to troubled teens and adolescents. While the majority of its funding comes from the government, the group also participates in a variety of fundraising activities. To manage the fundraising activities and administer the various programs, there is an executive director, a receptionist, two accounting staff, and several youth counsellors. All staff are salaried and the payroll is processed biweekly. Employees are not paid overtime, but rather they use "flex" time to compensate for overtime. As a result, it is unusual for the payroll to change from pay period to pay period. All of the staff are on direct deposit, so no payroll cheques are issued. The responsibility for the payroll is split between the two accounting staff memhers, Maddie and Ricardo. Maddie is responsible for preparing and posting the payroll while Ricardo is responsible for processing infrequent items such as staff terminations and for administering the benefits program. The actual payroll processing is outsourced to a payroll service provider, Paystub Inc. Paystub processes the direct deposit payments to employees and the remittance of all withholding taxes.

Maddie maintains a spreadsheet listing the employees with the approved pay rates. This is maintained in Excel and is password-protected. The spreadsheet is sent to Paystub Inc., which processes the payroll. Only Maddie and Ricardo have access to the spreadsheet and only Ricardo can add or remove employees. Paystub provides Maddie with the payroll register that details the individual pay amounts and totals. Based on this report, Maddie prepares the journal entry for posting to the general ledger. This is reviewed by Ricardo for accuracy and, once signed as reviewed, the journal entry is posted. Ricardo also reviews the payroll register for unusual amounts and significant fluctuations. Every quarter, he prints a copy of the payroll master file and reviews it to ensure only actual employees are listed. He initials a copy of this master file to document this review.

When new staff are hired, they are provided with a new employee package. This package includes a signed offer letter, all tax and medical forms, a confidentiality package, an ethics statement, and a job description. These forms are maintained in an employee personnel file and stored in locked cabinets in the accounting area. Ricardo will update the employee master file when the employee begins work.

Maddie is notified of any staff terminations by the employee's manager. This is done via email. No change can be made to the employee payroll file unless it is provided in writing, and the organization deems emails adequate. There is a staff "leaving" checklist that needs to be completed, and one of the requirements is to remove the employee from the payroll. Once completed, this is filed in the employee's personnel file.

All salary changes are requested by the departmental managers and sent to the executive director for approval. Once approved, an official letter is signed by the executive director and maintained in the employee's personnel file. Ricardo is provided with a copy so he can update the employee's salary in the master file.

Required

Identify *eight* strengths of the payroll process at Venture Volunteers. For each strength, identify what the test of that control could be.

11.11 Accounts payable documentation **Moderate** **LO 5, 6**

Figure 11.6 is a copy of the auditor's working paper for auditing accounts payable for the client New Millennium Ecoproducts.

Required

a. Explain the nature of the test being documented in the working paper.

b. Compare the information for the current year with the details for the prior year. Do you agree with the auditor's conclusion? Why?

11.12 Accounts payable—substantive testing **Moderate** **LO 5, 6**

You are the audit senior for the audit of Grosse Ltd. and have been given the audit file to review. The reporting date is December 31, 2023, and the materiality for the client has been set at $200,000. You obtained the information below from your review of the audit file.

1. The balance noted for accounts payable in the general ledger at December 31, 2023, is $158,000, which compares with a balance as at December 31, 2022, of $342,000.
2. The audit assistant noted in the file: "Because the accounts payable balance is immaterial in the current year, only limited work is necessary."

CLIENT: New Millennium Ecoproducts Period-end: 31/12/23 Currency/unit: $	**N – LEADS**	W&S PARTNERS **Reference** N – Leads		Prepared by: RMP Date: 03/2024 Reviewed by: ______________ Date: ________

Step 1: Enter general information.

CLIENT	New Millennium Ecoproducts
Period-end:	12/31/23
Currency/unit	$ 000

Step 2: Lead schedules.

Account No	Account Name	31/12/2023 Pre-adjusted	Adjustments	31/12/2023 Year		Interim	31/12/2022 Prior Year		Variance	Change %	TM/Ref
20100	Trade payables	−8000	—	−8000	**TB**		−6500	**PY**	−1500	23%	**NO1**
21100	Other payables	−1800	—	−1800	**TB**		−1600	**PY**	−200	13%	**NO1**
F-TOTAL	**TOTAL**	**−9800**	**—**	**−9800**		0	**−8100**		**−1700**	**21%**	

Step 3: Account details, ratios, and KPIs

		31/12/2023	31/12/2022
Average Payment Period	$= \dfrac{365 \text{ Days} \times \text{Average A/P}}{\text{Annual Purchases of Goods and Services}}$	31 days	30 days

Expectations about account balances, ratios, and KPIs:

✓ Due to the nature of the client's business and the stability of the primary markets in which it operates, we do not expect the accounts payable balance or average payment days to vary year on year.

Comments:

✓ Account details are consistent with previous period and in line with expectations.

FIGURE 11.6 Working paper for accounts payable

3. The only work performed by the audit assistant was to select the three largest payables from the client's detailed purchases ledger (which had been compared with the general ledger) and compare the balances with photocopies of supplier statements.

Required

a. Outline any queries you would raise with the audit assistant.

b. Describe the additional audit procedures you believe should be performed to ensure that the accounts payable balance is fairly stated.

Source: Adapted from Professional Year Programme of the ICAA, 1999, Accounting 2 Module.

11.13 Payroll control and substantive testing Moderate LO 3, 5, 6

You are reviewing the audit work for Online Ltd., a large Canadian company. Online uses a service bureau to process all wages. Time sheets are authorized by the appropriate supervisor, batched, and sent to the service bureau for processing. Detailed payroll reports, as well as the time sheets, are returned to the accountant, who reviews the reports for reasonableness and initials them as evidence of her review.

Your audit assistant performed a month-to-month comparison of wages and found no abnormal trends. The following conclusion was noted on the working paper: "I have checked that all payroll reports from the period were reviewed and initialled by the client. This, in conjunction with the results of analytical review, led me to conclude that the payroll expense is fairly stated."

Required

a. Outline any queries you would raise with the audit assistant.

b. Describe the additional audit procedures you believe should be performed to ensure that payroll is fairly stated.

Source: Adapted from ACCA Audit Framework, Paper 6Y, December 1997.

11.14 Payroll system—substantive testing Moderate LO 1, 3, 5, 6

MO Company has a high volume of casual staff who work during peak season to support the increase in workload in the following main areas:

1. distribution: warehouse staff to pack, store, and receive goods
2. drivers: to deliver goods to retail stores
3. sales and marketing: MO representatives to operate at the retail stores to sell the range of products and manage the inventory
4. administration: data operators and clerical staff to process the purchase orders and sales orders

Other relevant facts about MO's employee profile include the following:

1. The peak selling periods when casual staff are required represent approximately eight months of the year. For the past three years, the average number of casual staff has been 120 per year.
2. The turnover of permanent staff is approximately 15 per year. There are currently 75 permanent staff on the payroll. The numbers have risen by 20 percent in the past two years.
3. There are a variety of incentive awards that support the wage and salary conditions of MO staff, depending on whether they are casual or permanent and whether they work in the warehouse or in the office. Casual staff do not receive annual or long-service leave entitlements.

Required

Your team has identified payroll expense as a high-risk area, so for the payroll expense:

a. Identify two key assertions at risk with respect to the casual employees and provide a brief explanation as to why they are at risk.

b. For each assertion, describe a specific practical substantive test of detail that would be appropriate to address the risk.

c. Given the information above, do you consider the use of analytical review to be appropriate and effective in relation to MO's payroll expense? Justify your answer.

Source: Adapted from Professional Year Programme of the ICAA, 1997, Accounting 2 Module.

Cases

11.15 Payroll Case Study—Blake Co.

Blake Co. assembles specialist motor vehicles such as freight trucks, buses, and delivery trucks. The company owns four assembly plants where parts are delivered and assembled into the motor vehicles.

The motor vehicles are assembled using a mix of robot and manual production lines. The assembly-line workers normally work a standard eight-hour day, although this is supplemented by overtime on a regular basis as Blake has a full order book. There is one shift per day; mass production and around-the-clock working are not possible due to the specialist nature of the motor vehicles being assembled.

Wages system—shift workers

Shift workers arrive for work at about 7:00 a.m. and "clock in" using an electronic identification card. The card is scanned by the time-recording system and each production shift worker's identification number is read from their card by the scanner. The worker is then logged in as being at work. Shift workers are paid from the time of logging in. The logging-in process is not monitored because it is assumed that shift workers would not work without first logging in on the time-recording system.

Shift workers are split into groups of about 25 employees, with each group under the supervision of a shift supervisor.

Each day, each group of shift workers is allocated a specific vehicle to manufacture. At least 400 vehicles have to be manufactured each day. If necessary, overtime is worked to complete the day's quota of vehicles.

The shift supervisor is not required to monitor the extent of any overtime worked, although the supervisor does ensure workers are not taking unnecessary or prolonged breaks that would automatically increase the amount of overtime worked. Shift workers log off at the end of each shift by re-scanning their identification card.

Payment of wages

Details of hours worked each week are sent electronically to the payroll department, where hours worked are allocated by the computerized wages system to each employee's wages records. Staff in the payroll department compare hours worked from the time-recording system with the computerized wages system and enter a code word to confirm the accuracy of transfer. The code word also acts as authorization to calculate net wages. The code word is the name of a cat belonging to the department head and is therefore generally known around the department.

Each week the computerized wages system calculates:

1. gross wages, using the standard rate and overtime rates per hour for each employee
2. statutory deductions from wages
3. net pay

The list of net pay for each employee is sent over Blake's internal network to the accounting department. In the accounting department, an accounting clerk ensures that employee bank details are on file. The clerk then authorizes and makes payment to those employees using Blake's online banking systems. Every few weeks, the financial accountant reviews the total amount of wages paid to ensure that the management accounts are accurate.

Termination of employees

Occasionally, employees leave Blake. When this happens, the personnel department sends an email to the payroll department detailing the employee's termination date and any unclaimed holiday pay. The receipt of the email by the payroll department is not monitored by the personnel department.

Salaries system—shift managers

All shift managers are paid an annual salary; there are no overtime payments.

Salaries were increased in July by 3 percent and an annual bonus of 5 percent of salary was paid in November.

Required

a. List *four* control objectives of a payroll system.

b. As the external auditors of Blake Co., write a management letter to the directors regarding the shift workers' wages recording and payroll systems that:

i. identifies and explains *four* weaknesses in that system

ii. explains the possible effect of each weakness

iii. provides a recommendation to alleviate each weakness

c. List *three* substantive analytical procedures you should perform on the shift managers' salary process. For each procedure, state your expectation of the result of that procedure.

d. Audit evidence can be obtained using various audit procedures, such as inspection. Apart from this procedure, in respect of testing the accuracy of the time-recording system at Blake, explain *four* procedures used in collecting audit evidence and discuss whether the auditor will benefit from using each procedure.

Source: Adapted from ACCA Audit and Assurance (International), Paper F8, December 2008.

11.16 Purchases and Payables Case Study—Greystone Co.

Greystone Co. is a retailer of women's clothing and accessories. It operates in many countries around the world and has expanded steadily from its base in Canada. Its main market is 15- to 35-year-olds and its prices are mid to low range. The company's year end is September 30, 2023.

In the past, the company has bulk-ordered its clothing and accessories twice a year. However, if the goods failed to meet the key fashion trends, this resulted in significant inventory writedowns. As a result, the company has recently introduced a just-in-time ordering system. The fashion buyers make an assessment nine months in advance as to what the key trends are likely to be. These goods are sourced from Greystone's suppliers but only limited numbers are initially ordered.

Greystone has an internal audit department, but at present its only role is to perform regular inventory counts at the stores.

Ordering process

Each country has a purchasing manager who decides on the initial inventory levels for each store; this is not done in conjunction with store or sales managers. These quantities are communicated to the central buying department at the head office in Canada. An ordering clerk amalgamates all country orders by specified regions such as Central Europe and North America, and passes them to the purchasing director to review and authorize.

As the goods are sold, it is the store manager's responsibility to reorder the goods through the purchasing manager. The stores are prompted weekly to review inventory levels because, although the goods are just in time, it can still take up to four weeks for goods to be received in store.

It is not possible to order goods from other branches as all ordering must be undertaken through the purchasing manager. If a customer requests an item of clothing that is unavailable in a particular store, then the customer is provided with other branch telephone numbers or recommended to try the company website.

Goods received and invoicing

To speed up the ordering to receipt of goods cycle, the goods are delivered directly from the suppliers to the individual stores. On receipt of goods, the quantities received are checked by a sales assistant against the supplier's delivery note, and then the assistant produces a receiving report. This is done at quiet times of the day so as to maximize sales. The checked receiving reports are sent to head office for matching with purchase invoices.

As purchase invoices are received, they are manually matched to receiving reports from the stores. This can be a very time-consuming process as some suppliers may have delivered to over 500 stores. Once the invoice has been agreed, it is sent to the purchasing director for authorization. It is at this stage that the invoice is entered onto the purchase journal.

Required

a. As the external auditors of Greystone Co., write a report to management in respect of the purchasing system that:

i. identifies and explains *four* deficiencies in that system

ii. explains the possible implications of each deficiency

iii. provides a recommendation to address each deficiency

A covering letter is required.

b. Describe substantive procedures the auditor should perform on the year-end trade payables of Greystone Co.

Source: Adapted from ACCA Audit and Assurance (International), Paper F8, December 2010.

11.17 Accounts Payable Reconciliation Case Study—Blackburn Ltd.

You are the audit senior in charge of the audit of Blackburn Ltd., and you are auditing the company's trade payables at December 31, 2023. A junior member of the audit team has been checking suppliers' statements against the balances in the accounts payable sub-ledger. He is unable to reconcile a material balance relating to Whitebone Ltd., and has asked for your help and suggestions on the audit work that should be carried out on the differences. The balance of Whitebone in Blackburn's sub-ledger is shown below.

Supplier: Whitebone Ltd.

Date	Type	Reference	Status	Dr	Cr	Balance
April 10	Invoice	6004	Paid 1		2,130	
April 18	Invoice	6042	Paid 1		1,525	
April 23	Invoice	6057	Paid 1		2,634	
May 4	Invoice	6080	Paid 2		3,572	
May 15	Invoice	6107	Paid 2		1,632	
May 26	Invoice	6154	Paid 2		924	
May 31	Payment	Cheque	Alloc. 1	6,163		
	Discount		Alloc. 1	126		
June 14	Invoice	6285			2,156	
June 21	Invoice	6328			3,824	
June 30	Payment	Cheque	Alloc. 2	6,005		
	Discount		Alloc. 2	123		
June 30	Balance					5,980

Below are the details on Whitebone's suppliers' statement.

Customer: Blackburn Ltd.

Date	Type	Reference	Status	Dr	Cr	Balance
April 7	Invoice	6004	Paid 1	2,130		
April 16	Invoice	6042	Paid 1	1,525		
April 22	Invoice	6057	Paid 1	2,634		
May 2	Invoice	6080	Paid 2	3,752		
May 13	Invoice	6107	Paid 2	1,632		
May 22	Invoice	6154	Paid 2	924		
June 10	Receipt	Cheque	Alloc. 1		6,163	
June 4	Invoice	6210	Alloc. 1	4,735		
June 12	Invoice	6285		2,156		
June 18	Invoice	6328	Alloc. 2	3,824		
June 28	Invoice	6355	Alloc. 2	6,298		
June 30	Balance					23,447

Whitebone's terms of trade with Blackburn allow a 2-percent cash discount on invoices where Whitebone receives a cheque from the customer by the end of the month following the date of the invoice (that is, a 2-percent discount will be given on November invoices paid by December 31).

On Blackburn's sub-ledger, under "Status," the cash and discount marked "Alloc. 1" pay invoices marked "Paid 1" (similarly for "Alloc. 2" and "Paid 2"). Blackburn's receiving department checks the goods when they arrive and issues a receiving report. A copy of the report is sent to the accounts payable department.

Required

a. Prepare a reconciliation of the balance on Blackburn's payable sub-ledger to the balance on Whitebone's supplier's statement. (*Hint:* Look for errors and omissions.)

b. Describe the audit work you will carry out on each of the reconciling items you have determined in your answer to part (a) to determine the balance that should be included in the financial statements.

c. In relation to verifying trade creditors:

  i. Consider the basis you will use for selecting suppliers' statements to check against the balances on the purchase ledger.

  ii. Describe what action you will take if you find there is no supplier's statement for a material balance on the purchase ledger.

Source: Adapted from ACCA Audit Framework, Paper 6, June 1996.

[3]**11.18** Integrative Case Study—Integrated Measurement Systems Inc.

Integrated Measurement Systems Inc. (IMS) is a Canadian public company that manufactures high-end measuring devices used primarily in the oil and natural gas industries.

Ted Pollock, IMS's CEO, is a proponent of strong corporate governance. He has spent the past year strengthening IMS's internal control environment. He believes that organizations that demonstrate good corporate governance practices will be perceived favourably by the markets.

Ted has some concerns regarding the purchasing process. He has provided you with a description of the purchasing process in **figure 11.7**.

FIGURE 11.7 IMS's purchasing process

Control objectives that relate to the purchasing process

1. Proper approval of all transactions
2. Safeguarding of company assets
3. Prevention and detection of errors and irregularities
4. Accuracy and completeness of books and records
5. Appropriate use of information

Purchasing process documentation

The purchasing process has four major components, namely:

1. Vendor prequalification
2. Purchase of goods and/or services
3. Receipt of goods
4. Settlement

Process description

The purchasing process begins when there is a requirement for goods or services. A manually completed purchase request form is sent from the operating department (for example, sales, marketing, manufacturing) to the purchasing department. The purchasing clerk numbers these documents and reviews each purchase request form to verify that a signature is present. Purchase request forms must be authorized by the signature of a person with the appropriate level of authority. The amount of the expenditure determines the level of authority required, and the expenditure authorization levels are organized in tiers. Because there are so many possible combinations of departments and authorization levels, the operating departments are responsible for ensuring that their purchase request forms are signed by individuals with the appropriate level of authority. This requirement eliminates the need for the purchasing clerk to check the specifics of the signatures.

The purchasing clerk sends the purchase requests to the purchasing manager for review and approval.

(*continued*)

[3] Adapted with permission of the Chartered Professional Accountants of Canada, Toronto, Canada. Any changes to the original material are the sole responsibility of the publisher and have not been reviewed or endorsed by the Chartered Professional Accountants of Canada.

The approved purchase request is then sent to the buyer, who sources the purchase. If the amount is below $5,000, selection of the vendor is left up to the buyer. For purchases from $5,000 to $25,000, a vendor from the prequalification listing is selected, again at the discretion of the buyer. For purchases of $25,000 or more, a formal bidding process is performed. However, at the discretion of the buyer, the bid process can be waived if deemed to be cost inefficient.

Upon selection of the vendor, the buyer inputs the purchase request information into a purchase order form. The purchase order is forwarded to the purchasing manager for review and a photocopy is made and filed, in numerical order, with the appropriate photocopy of the purchase request. The original purchase order is then sent back to the buyer, who delivers it to the vendor.

All goods are received in the warehouse. All employees have access to the warehouse. The goods are checked against the packing slip and are examined for damage, amounts, and so on. If the goods are acceptable, the bill of lading is signed off by the receiver. A copy of the signed bill of lading is then forwarded to the purchasing clerk, who matches it to the file copy of the purchase request and purchase order. If there are differences in the details (over/under-shipment, wrong product, etc.), the bill of lading is forwarded to the buyer for resolution with the vendor. If no problems are noted, copies of the three documents are sent to the payables group for settlement.

The receiver, John Sang-hun (who was hired six months ago), sends the goods to the user department that made the original purchase request along with a photocopy of the bill of lading. The user department agrees the quantities noted by the receiver and files the bill of lading. User departments have noted that, recently, there has been an increasing number of manual adjustments to the quantities shipped versus received. Any unmatched purchase requests and purchase orders that remain outstanding for over 90 days are returned by the purchasing clerk to the user department that originally ordered the goods on the assumption that the goods have been received. It is then the responsibility of the user department to follow up and forward the paperwork to the payables group for settlement.

If a signed bill of lading is forwarded to the purchasing clerk for which there is no source documentation (that is, no purchase request or purchase order exists), the purchasing clerk follows up with the buyer to understand the nature of the receipt. At the same time, a copy of the bill of lading is also sent to the payables group.

FIGURE 11.7 **IMS's purchasing process (*continued*)**

Required

a. Identify the existing key internal controls within the purchasing process and relate each to the appropriate control objective.

b. Identify the internal control weaknesses within the purchasing process and recommend improvements.

c. To further strengthen the control environment, Ted Pollock is considering creating an internal audit department. Outline the kinds of things this group could be involved in.

Source: UFE 2004 Paper III, Simulation 1.

Case Study—Cloud 9

Answer the following question based on the information presented for Cloud 9 in Appendix A and in the current and earlier chapters. You should also consider your answers to the Cloud 9 case study questions in earlier chapters.

Required

Prepare common-size statements for Cloud 9. Use total assets as the basis for the balance sheet, and revenue as the basis for the income statement. Comment on any audit implications revealed by your statements.

Research Question 11.1

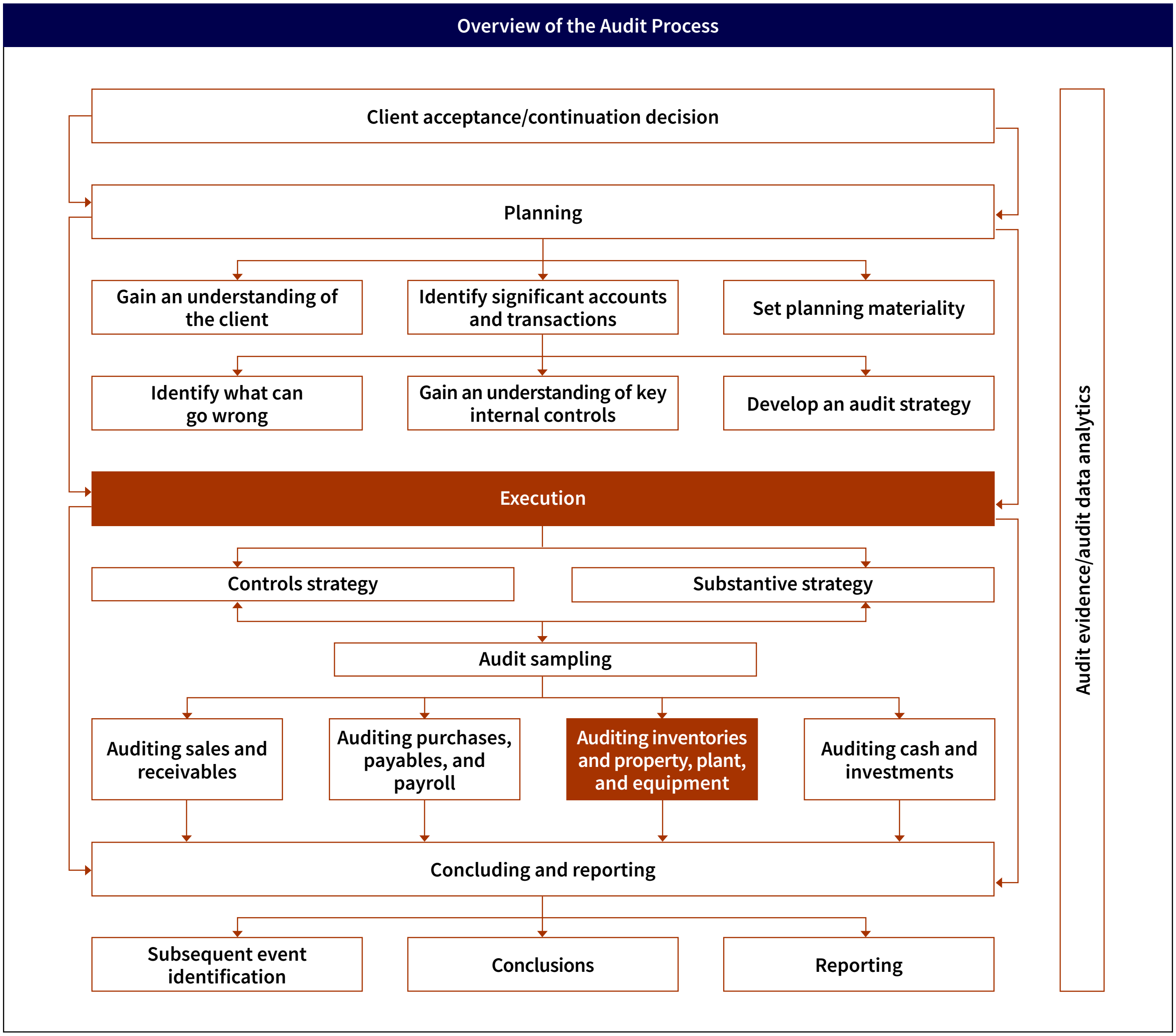
A generally accepted definition of earnings management is the planned timing of revenues, expenses, gains, and losses to smooth out earnings over a number of accounting periods. Generally speaking, earnings management is used to increase income in the current year at the expense of income in future years by, for example, prematurely recognizing sales before they are complete in order to boost profits. However, earnings management can also be used to decrease current earnings, so as to increase income in the future, a practice often referred to as “cookie jar” accounting. For example, WorldCom Inc., which later became one of the greatest U.S. corporate bankruptcies, used so-called cookie jar accounting to inflate provisions for expected expenses and later reversed them to boost earnings.

Required

Consider the issues that lead to earnings management and, in particular, the reasons for companies adopting cookie jar accounting practices. How might auditors overcome such practices? In your discussion, refer to widely publicized corporate collapses such as WorldCom, which have used earnings management techniques.

CHAPTER 12

Auditing Inventories and Property, Plant, and Equipment



LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
After studying this chapter you should be able to:		Standards addressed in each learning objective are as follows:
1 Identify the audit objectives applicable to inventories	**12.1** Audit Objectives: Inventory	CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
2 Describe the functions and control procedures normally found for the custody of inventory and maintenance of inventory records	**12.2** Custody of Inventory and Maintenance of Inventory Records **12.2.1** Maintaining inventory records **12.2.2** Physical comparison of inventory with inventory records **12.2.3** Determining and recording inventory costs	CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
3 Discuss considerations relevant to determining the audit strategy for inventories	**12.3** Audit Strategy: Inventory **12.3.1** Inherent risk assessment **12.3.2** Control risk assessment	CAS 315 *Identifying and Assessing the Risks of Material Misstatement* CAS 330 *The Auditor's Responses to Assessed Risks* CAS 501 *Audit Evidence—Specific Considerations for Selected Items* CAS 620 *Using the Work of an Auditor's Expert*
4 Design a substantive audit program for inventory	**12.4** Substantive Procedures for Inventories **12.4.1** Initial procedures **12.4.2** Analytical procedures **12.4.3** Tests of details of transactions **12.4.4** Tests of details of balances **12.4.5** Testing inventory pricing **12.4.6** Confirming inventories at locations outside the entity **12.4.7** Examining consignment agreements and contracts **12.4.8** Disclosure	CAS 330 *The Auditor's Responses to Assessed Risks* CAS 510 *Initial Audit Engagements—Opening Balances* CAS 540 *Auditing Accounting Estimates and Related Disclosures* CAS 600 *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* CAS 610 *Using the Work of Internal Auditors* CAS 620 *Using the Work of an Auditor's Expert* IAS 2 *Inventories*
5 Identify the audit objectives applicable to property, plant, and equipment	**12.5** Audit Objectives: Property, Plant, and Equipment	CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
6 Discuss considerations relevant to determining the audit strategy for property, plant, and equipment	**12.6** Audit Strategy	CAS 315 *Identifying and Assessing the Risks of Material Misstatement* CAS 330 *The Auditor's Responses to Assessed Risks*

LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
7 Design a substantive audit program for property, plant, and equipment	**12.7** Designing Substantive Procedures for Property, Plant, and Equipment **12.7.1** Initial procedures **12.7.2** Analytical procedures **12.7.3** Tests of details of transactions **12.7.4** Tests of details of balances **12.7.5** Disclosure	CAS 330 *The Auditor's Responses to Assessed Risks* IAS 16 *Property, Plant and Equipment*

Cloud 9 Integrated Case

Josh is now looking forward to focusing on the inventory of Cloud 9. He knows W&S Partners has a wide range of audit clients, including a department store, a chain of small retail shops, a construction company, a manufacturer of electronic goods, a farm, a jeweller, a mining company, a hotel, a chain of restaurants, and a car dealership. For each of these businesses, inventory is likely to be a significant asset.

Some of these companies, including Cloud 9, will have a perpetual inventory system where the receipt and shipping of goods are recorded as they happen. Regular inventory counts act as a check against the inventory recorded in the perpetual system and any discrepancies due to theft or other events will be adjusted for. While some businesses have very specialized products where specific expertise is required to understand the product and its worth, the running shoes at Cloud 9 are a relatively simple product to value. Regardless, for most clients, including Cloud 9, a significant amount of audit attention will be devoted to this area.

Chapter Preview

The purpose of this chapter is to examine the audit of inventories and property, plant, and equipment. The internal controls over the classes of transactions affecting both the inventory and property, plant, and equipment balances have already been considered. We have considered the purchase cycle, including the acquisition of inventories and property, plant, and equipment assets, and the selling of inventory as part of the sales cycle. In this chapter, there is no separate section describing the functions and control procedures for inventory or property, plant, and equipment transactions. However, for inventory, there is a section describing functions and control procedures associated with the custody of inventory and the maintenance of inventory records. In the section on developing the audit plan, the significance of assessing the effectiveness of controls over inventory records is discussed in the context of determining the audit strategy.

For property, plant, and equipment, the auditor usually adopts a substantive approach. The nature of such records is described in the section on developing the audit plan, but there is rarely an assessment of controls. The explanation of the audit of property, plant, and equipment is followed by the design and execution of substantive audit procedures. Given the complex nature of intangible non-current assets, their audit is not addressed in this text.

For both inventory and property, plant, and equipment, the inherent risk is primarily over their existence and valuation. Thus, verification of the existence and accuracy, valuation, and allocation assertions for these assets receives special consideration.

12.1 Audit Objectives: Inventory

LEARNING OBJECTIVE 1

Identify the audit objectives applicable to inventories.

The key issue in auditing inventories is to ensure the inventories actually exist, are owned, and are properly valued. **Table 12.1** lists the main audit objectives for each assertion, including references to be used later for referencing them to specific controls and audit procedures. More detail about assertions specific to the classes of transactions and account balances can be found in CAS 315 *Identifying and Assessing the Risks of Material Misstatement*.

Note that, for occurrence and completeness, transfer transactions apply only to multi-location entities and manufacturing entities that distinguish between raw materials, work in process, and finished goods.

TABLE 12.1 Selected specific audit objectives for inventory

Transaction and Related Disclosure Objectives	
Occurrence (**OE**)	Recorded purchase transactions represent inventories acquired during the period (**OE1**). Recorded transfers represent inventories transferred between locations or categories during the period (**OE2**). Recorded sale transactions represent inventories sold during the period (**OE3**). Disclosed inventories have occurred and pertain to the entity (**OE4**).
Completeness (**C**)	All inventory receipts during the period have been recorded as purchases (**C1**). All transfers of inventories between locations or categories during the period have been recorded (**C2**). All inventory shipped during the period has been recorded as sales (**C3**).
Accuracy (**AV**)	Inventory transactions are properly (accurately) recorded (**AV1**).
Cut-off (**CO**)	Inventories received before the period end are recorded as purchases in the current period and those received after the period end are included in the next accounting period (**CO1**). Inventories shipped before the period end are recorded as sales in the current period and those shipped after the period end are included in the next accounting period (**CO2**).
Classification (**D**)	Inventory transactions are recorded in the correct accounts (**D1**).
Presentation (**D**)	Purchase and inventory transactions and events are appropriatly aggregated or disaggregated, clearly described, and the related disclosures are relevant and understandable (**D2**).
Account Balance and Related Disclosure Objectives	
Existence (**OE**)	Inventories recorded represent items on hand at the end of the reporting period (**OE5**).
Rights and obligations (**RO**)	The entity has rights to the inventories included in the balance sheet (**RO1**).

(*continued*)

TABLE 12.1 **Selected specific audit objectives for inventory (*continued*)**

Account Balance and Related Disclosure Objectives	
Completeness (**C**)	Inventories include all materials, products, and supplies on hand at the end of the reporting period (**C4**). All inventory disclosures that should have been included in the financial statements have been included (**C5**).
Accuracy, valuation, and allocation (**AV**)	Inventories are properly stated at the lower of cost and net realizable value, determined in accordance with applicable accounting standards (**AV2**). Inventories are disclosed accurately and at appropriate amounts (**AV3**).
Classification (**D**)	Inventories are properly identified and classified in the financial statements (**D3**).
Presentation (**D**)	Inventories are appropriately aggregated or disaggregated, clearly described, and the related disclosures are relevant and understandable (**D4**).

Cloud 9 Integrated Case

Because the same processes are used for the purchase and sale of all products and services, including inventory, Josh realizes that the audit team has already gathered some evidence about the inventory when they did the testing over the purchases and sales cycles. Josh can see from the audit file documentation that Weijing Fei, a first-year auditor with W&S, attended the inventory count at year end at Cloud 9's main warehouse. He is not sure if anyone was present for the inventory count at the retail location. He makes a note to ask Sharon about this.

Because W&S attended the count, he believes the audit team will plan a substantive approach in obtaining evidence for the existence and completeness assertions of the inventory. He is uncertain what audit strategy they will use for the accuracy, valuation, and allocation assertion.

Before You Go On

12.1.1 What are two key issues auditors face when auditing inventory?

12.1.2 What is completeness with respect to inventory?

12.1.3 Define the audit objective of cut-off with respect to inventory.

12.2 Custody of Inventory and Maintenance of Inventory Records

LEARNING OBJECTIVE 2

Describe the functions and control procedures normally found for the custody of inventory and maintenance of inventory records.

In a merchandising entity, inventory consists of goods acquired for resale. In a manufacturing entity, inventory can be in one of three stages:

1. **raw materials** awaiting processing
2. partly manufactured items known as **work in process**
3. **finished goods** awaiting sale

raw materials materials purchased from suppliers to be used in the manufacture of finished goods

work in process partly manufactured products consisting of materials, direct labour, and overhead applied to the stage of completion

finished goods manufactured inventory that is available for sale

Smaller entities, particularly those not engaged in manufacturing, may not maintain inventory records. Instead, inventory is determined at or near the end of the reporting period by a physical inventory count. The main audit procedure in such cases is observation of the count. At the other extreme, large manufacturing entities maintain comprehensive inventory records, with subsidiary inventory ledgers integrated with the general ledger. These records may be used as the basis for determining both the quantity and value of inventory at the end of the reporting period. To obtain sufficient audit evidence in such cases, the auditor must perform extensive tests of controls over the recording of inventory transactions and the maintenance of inventory records.

Obtaining evidence of the existence of inventory through observation is a required audit procedure. The auditor may meet this requirement by observing a number of cyclical counts that the entity undertakes during the year as part of its control procedures over the maintenance of inventory records. Alternatively, if the entity performs an inventory count at or close to year end, the auditor meets the requirement by attending that count.

Verifying the accuracy, valuation, and allocation assertion for inventory is also an important audit procedure. This involves verifying both cost and net realizable value and management's judgement of which basis is relevant for each item of inventory.

12.2.1 Maintaining Inventory Records

perpetual inventory records records of the movement of inventory items and the quantity on hand

inventory master file a file containing details of inventory items, their movement, and the quantity on hand

The use of computer information systems has made it much easier for entities to maintain **perpetual inventory records**, and systems can maintain inventory records by quantity and value, which are fully integrated with the accounting records in an **inventory master file**. For merchandising entities, a single inventory record is required, although this may be subdivided by location. Manufacturing entities need to record separate inventories of raw materials, work in process, and finished goods, and to establish procedures for recording the movement of goods through production.

An important control over maintaining inventory records is the segregation of this function from the physical custody of the inventory. The custodian then has no opportunity to conceal an inventory shortage by manipulating the inventory records.

The separate functions are:

- recording the movement of goods into inventory
- recording the movement of goods from inventory
- recording transfers of inventory
- physically comparing inventory with inventory records

Movement of Goods into Inventory

In all cases, the initial entry into inventory is through the purchasing system. The receiving clerk acknowledges receipt of the goods by initialling a copy of the receiving report. The receiving report then provides the source of the quantity and cost entries on the appropriate inventory record. These procedures relate mainly to the occurrence and completeness assertions (**OE1**, **C1**).

Movement of Goods from Inventory

When merchandise inventories or finished goods are sold, the shipping document serves as the basis for authorization of the release of the goods from inventory, and for the entry in inventory records reducing the quantity on hand. In retail stores, bar codes or security tags scanned at the cash register provide data for reducing recorded inventory. Control procedures over the occurrence and completeness of sale transactions also relate to the occurrence and completeness of recorded inventory movements (**OE3**, **C3**).

inventory transfer requisition a document authorizing the requisitioning of materials and labour for the purpose of manufacturing

Transfers of Inventory

Further procedures are necessary when goods are transferred from one inventory location to another. In manufacturing entities, **inventory transfer requisitions** control the movement of goods from raw materials through work in process to finished goods. These pre-numbered documents are issued by production control and represent authorization to issue raw materials and to apply direct labour to process materials to produce the finished goods. Each transfer requisition consists of tickets identifying the specific material and labour requirements for the goods to be produced. Initialled copies of tickets represent acknowledgement, by inventory custodians, of the receipt of goods, or evidence of their proper delivery. They also provide the basis for accounting entries, relieving one inventory location and charging the other. Similar procedures, on a less elaborate scale, are required in retailing entities to record and control internal transfers. These procedures relate to the occurrence and completeness assertions for internal inventory movements (**OE2**, **C2**).

12.2.2 Physical Comparison of Inventory with Inventory Records

Perpetual inventory records need to be compared with actual inventory at regular intervals. The two functions involved are:

- an inventory count
- a comparison of the actual items on hand with the inventory records

Inventory Count

Procedures for an inventory count are similar whether the purpose is to determine inventory at the end of the reporting period or to compare inventory with inventory records at an intermediate date. This section describes procedures applicable to a full inventory count. Procedures for **cyclical inventory counts** may be less thorough and involve counting only a portion of inventory items. Such counts are usually performed where a perpetual inventory system is in place and the cyclical counts act as a control. The sample selected for counting may be organized systematically, through different sections of the warehouse or different types of inventory, or by random sampling. Another approach is to count items at the reorder point when inventory levels are low, thus reducing both the cost of the count and the likelihood of count errors.

cyclical inventory counts periodic inventory counts that count, over a year, all or most inventory items

The procedures for an inventory count involve:

- assigning and communicating responsibility
- preparing
- identifying
- counting
- checking
- clearing
- recording
- cut-off

These procedures are described as follows:

- *Assigning and communicating responsibility*. Overall responsibility for the count should be assigned to a person who has no responsibility for either the custody of inventory or the maintenance of inventory records. People involved in the count should also be suitably independent, although warehouse staff may be involved if supervised. The area containing inventory should be subdivided, with count teams assigned to specific sections. Instructions should be drawn up and responsibilities clearly explained to each person involved.
- *Preparing*. Before the count, areas such as the warehouse and shop floor should be tidied, with inventory neatly stacked and items not to be counted (such as scrap or goods held for third parties) removed or clearly marked. Arrangements need to be made to cease

production, if possible, and receiving and shipping departments need to be alerted so as to avoid movement of goods to or from those departments during the count. In this way, cut-off errors can be avoided. If an accurate cut-off is not achieved, the physical count may include, for example, goods for which the purchase or production cost is not recorded by the information system until after the count. This could result in an overstatement of inventory.

- *Identifying*. Inventory to be counted must be properly identified. This is a particular problem with specialized items or work in process. With work in process, the problem is with identifying the stage of completion, which determines the costs accumulated against the items. Either the goods must be tagged in advance or count teams knowledgeable of the inventory must be assigned to the count in appropriate sections.
- *Counting*. Count teams usually work in pairs where any lifting or moving of items is necessary to ascertain the quantity. Forklift trucks and weighing scales may also need to be available. Instructions should ensure that count teams understand the unit of measurement (e.g., 25-kilogram bags). The degree of thoroughness also needs to be considered, such as whether cartons need to be opened at random or weighed to verify that they are full and the contents are as described.
- *Checking*. Sometimes all counts are double-checked and all discrepancies are re-counted. Where errors are unlikely, only spot checks need to be performed and only counts by those count teams making errors need to be double-checked.
- *Clearing*. As each item is counted, the count team should leave a mark to avoid duplicating the count. On completion of a section, a supervisor should tour the area to ensure no items appear to be uncounted.
- *Recording*. Control over count sheets is particularly important. Three systems are commonly used. First, where inventory items are standardized, pre-printed **inventory count sheets** containing descriptions are issued to the count teams, who then complete the sheets by entering the quantity. Another system is to issue blank, pre-numbered count sheets. The serial numbers issued to each count team must be noted and checked on completion to ensure that no sheets are missing. Half-filled sheets should be ruled off, and unused sheets should be identified as such to prevent items being added after the count. The third method involves attaching pre-numbered, three-part **inventory tags** to each inventory item before the count. The count team enters the description and quantity on the first part of the tag and removes it. The checkers do likewise with the second part, which is compared with the first part. The third part, the stub of the tag, remains attached to the item to enable the supervisor to verify the completeness of the count. Again, serial numbers should be fully accounted for. In each case, counters and checkers should be required to sign or initial each count sheet or tag.

inventory count sheets prepared (usually pre-numbered) sheets for recording inventory description and quantity as counted

inventory tags three-part, tie-on tags for recording the inventory count of each item

- *Cut-off*. Serial numbers of the last pre-numbered receiving reports, shipping documents, and inventory transfer requisitions issued before the inventory count need to be recorded to ensure that the count is compared with inventory records based on the same documents.

Comparison with Records

Comparison with the inventory records is of greater importance for cyclical counts, where the aim is to ensure the reliability of the inventory records and to establish the effectiveness of the procedures designed to ensure accountability for the custodianship and record-keeping of the inventory. With counts undertaken at or near the end of the reporting period, comparison with the records helps identify any major errors in quantities discovered by the count.

Procedures should require a re-count of material differences. If the difference remains, further investigation is required to ascertain whether the inventory records are in error and why. A record should be maintained of differences and the causes (if known), and the inventory records should be adjusted to agree with the count. This list of errors provides evidence of the reliability of the records and the possibility of reliance on inventory records in determining inventory at year end, without the need for a further count.

These procedures relate mainly to the existence assertion (**OE5**) but also contribute to the completeness assertion (**C4**).

12.2.3 Determining and Recording Inventory Costs

For merchandise inventory, procedures relating to measurement in the recording of purchase transactions ensure that proper costs are recorded in inventory records. On sales, the cost of sales should be determined in accordance with the appropriate cost flow assumption, which would normally be either first-in, first-out or weighted average. Entities recording cost of sales on a continuing basis will usually rely on computer information systems, which should be programmed to determine the appropriate cost.

Costing of manufactured inventory is far more complex. Procedures are required to:

- determine the cost of materials entered into raw materials
- determine the cost of raw materials transferred to work in process at first-in, first-out or weighted average cost
- record costs of direct labour applied to work in process
- identify abnormal waste or spoilage in the production process
- identify manufacturing overhead costs and apportion costs to production departments
- assign overhead costs to work in process using an appropriate absorption rate
- apportion costs to by-products
- relieve work in process and charge finished goods on completion of manufacturing, based on costing procedures such as batch or process costing
- relieve finished goods with the cost of sales at first-in, first-out or weighted average

Some entities record inventory at standard cost and identify differences between standard and actual costs as variances.

In obtaining the understanding of the accounting system, the auditor needs to identify the entity's accounting policy and ascertain the procedures for ensuring that costs are recorded in accordance with that policy. It is also necessary for the auditor to ensure that the policy is consistent with the requirements of the accounting standards for inventories. These procedures relate to the accuracy (**AV1**) and accuracy, valuation, and allocation assertions (**AV2**), and contribute to the presentation assertion (**D4**).

Cloud 9 Integrated Case

Josh is glad that Sharon had already arranged for Weijing to attend the physical inventory count at Cloud 9's warehouse at year end. He reviews Weijing's memo to file indicating there was no shipping or receiving at the warehouse the day of the count. The count was performed by count pairs who were assigned a specific area of the warehouse to count. Count tags and sequentially numbered count sheets were assigned and the warehouse was neat and tidy. The running shoes were neatly organized and stacked by item type. As items were counted, the count tags were ticked to prevent any double counting. Weijing noted that all count sheets were submitted at the end of the count. She also noted that Carla and the warehouse manager were present and supervised the count.

Before You Go On

12.2.1 What four functions should be segregated with respect to inventory?

12.2.2 Describe the eight procedures applicable to a full inventory count.

12.2.3 List the procedures required to cost manufactured inventory.

12.3 Audit Strategy: Inventory

LEARNING OBJECTIVE 3

Discuss considerations relevant to determining the audit strategy for inventories.

The selected approach to the audit of inventory depends on the availability and reliability of inventory records. Consideration of the internal control structure relating to inventory records, described in the previous section, is necessary only where such records exist. In all audits, it is important to consider the determination of cost records.

12.3.1 Inherent Risk Assessment

In many industries, particularly retail and manufacturing, inventories and cost of sales are usually significant to both the entity's financial position and the results of its operations. Moreover, numerous factors contribute to the risk of misstatements in the assertions for these accounts, including the following:

- The volume of purchase, manufacturing, and sale transactions that affect these accounts is generally high, increasing the opportunities for misstatements to occur.
- In manufacturing environments, there are often contentious accuracy, valuation, and allocation issues, such as:
  - the identification, measurement, and allocation of indirect materials, labour, and manufacturing overhead
  - joint product costs
  - the disposition of cost variances
  - accounting for scrap and wastage
- Special procedures are sometimes required to determine inventory quantity or value, such as geometric volume measurements of stockpiles using aerial photography, and estimation of value by experts.
- Inventories are often stored at multiple sites, leading to difficulties in maintaining physical control over theft and damage, and in accounting for goods in transit between sites.
- Inventories are vulnerable to spoilage, obsolescence, and general economic conditions that may affect demand and saleability, and thus their valuation.
- Inventories may be returned by the customer.

In planning the audit, the auditor will be aware that the relevant assertions are the existence assertion and the accuracy, valuation, and allocation assertion, because these assertions tend to fall higher on the spectrum of inherent risk. Management typically has a greater incentive to overstate inventory, being an asset, than to understate it. It may do so by either inflating the quantity or overstating its value. There are numerous instances of such frauds discovered (and not discovered) by auditors. A lack of third-party evidence means it is also often easier to overstate inventories than assets such as cash or accounts receivable. Further, inventory is subject to theft both by employees and by outsiders. The depletion of inventory as a consequence of shoplifting is well known.

In verifying the existence (and completeness) assertion, the auditor has the choice of three audit strategies—a choice that depends on the entity's own policy for determining inventory quantity. The options are:

- Determine inventory quantity by perpetual inventory records where the entity does not intend to count inventory at or close to the end of the reporting period. This audit strategy requires assessing the control risk over inventory records as being low.

- Determine inventory quantities by a physical count near the end of the reporting period, adjusted to balance sheet quantities by reference to perpetual inventory records. This strategy requires assessing the control risk over inventory records, or of purchases and sales, as being less than high.
- Determine inventory quantities by a physical count at or within a few days of the end of the reporting period. This is a substantive approach in which the auditor does not test controls over inventory records, which may not even exist.

The auditor may use all three methods for a single entity with different categories of inventory or for inventory at different locations. A manufacturing entity may, for example, determine the quantities of raw materials and finished goods at a year-end inventory count, but rely on perpetual records in determining the work-in-process inventory.

In developing the audit plan, the auditor needs to discuss the approach management intends to take. If management intends to rely solely on inventory records, then more extensive tests of controls will be necessary to confirm the required assessment of control risk. Moreover, this assessment must be completed before the end of the reporting period in the event that tests of controls fail to confirm the assessment of control risk as being low, and the auditor is required to advise management to undertake an inventory count at or near the end of the reporting period.

Specialized inventories may require the assistance of experts in determining either the quantity (as in the case of aerial measurement of stockpiles) or value (as in the case of antiques). In accordance with CAS 620 *Using the Work of an Auditor's Expert*, the type of expertise required will vary with different circumstances, so the nature and scope of the work need to be clearly agreed between the expert and the auditor. The auditor must also ensure that they obtain sufficient understanding of the field of expertise to be able to evaluate the adequacy of the work performed; this includes an assessment of the expert's capabilities and objectivity.

For merchandise inventory, a substantive approach is usually more efficient in verifying the accuracy, valuation, and allocation assertion. For manufacturing entities, it is usually necessary for the auditor to have assessed control risk over the maintenance of costing records (used as the basis for costing closing inventory) as being less than high. This is an area that sometimes receives insufficient audit attention owing to a reluctance to unravel the complexities of the costing system. Yet close attention is crucial, because inventories are particularly vulnerable to fraud, as Professional Environment 12.1 points out.

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Josh understands that, for the inventory account, the relevant assertions are existence and accuracy, valuation, and allocation. This is because management has an incentive to overstate the quantity and/or value of inventories, athletic shoes are susceptible to theft, and the valuation of the shoes involves judgement and estimation by Cloud 9 management. He believes the substantive work performed on the inventory count provides sufficient and appropriate evidence over the existence assertion.

12.1 Professional Environment Inventory frauds

Inventory is an easy fraud target. For retailers, inventory is usually their biggest asset, while for manufacturers, inventory is a significant portion of their assets. Even service businesses have supplies on hand.

The most common type of inventory fraud is theft. Inventory items can be small and numerous, easily accessible, of small value, and not easily missed. Having few, large-value inventory items (like cars in a car dealership) is no guarantee of protection from such frauds. The loss is from the theft of business assets.

How is the fraud done?

Both employees and non-employees can easily steal inventory items. Many physical assets are not locked up, and many are freely available to employees without authorization or requisition, such as goods available to retail salespeople or materials needed by factory employees.

For smaller items or a one-time theft, employees will usually not bother to hide the theft, since it will probably go undetected in the business records or at the next inventory count. But for recurring inventory thefts, the employee will need to hide them in the business records.

In order to hide the inventory loss at the next inventory count, an employee would need to alter the accounting records, using one of four methods:

- False write-off schemes involve writing off the stolen inventory as scrap or similar.
- False inventory counts involve falsifying the recorded stock count with the amount of inventory actually on hand.

- Perpetual record schemes involve falsifying the amount of inventory in the perpetual record when the inventory is stolen, so that the amount will match the inventory count later.
- False receiving documentation involves falsifying the amount of inventory received from suppliers in the records, to hide the actual amounts on hand and stolen.

How to reduce inventory fraud

There are several ways to reduce the risk of inventory fraud, including the following.

- Use physical security to secure inventory during and after business hours.
- Limit employee access to the business premises, especially the storeroom, after hours. This reduces the risk of them stealing things and also accessing records to alter and hide their theft.
- Require authorized employees to use passwords to access business records.
- Require independent authorization to write off inventory losses.
- Segregate duties regarding inventory, such as ordering, receiving, and invoicing.
- Conduct proper, verified inventory counts. Employees have even been known to stack empty boxes to try to fool auditors into thinking inventory is there when it isn't.

Q: When physically inspecting inventory, what are some of the possible indications of obsolescence?

Sources: "Detecting and Deterring Business Asset Misappropriation by Employees," *Business Owner's Toolkit*, March 19, 2012, www.bizfilings.com; "Stock Fraud—Inventory Record Frauds: Description of Inventory Record Frauds," Worrells Solvency & Forensic Accountants, May 8, 2006, www.worrells.net.au; "Important Fraud Prevention Tips for Your Parts Department," The Mercadien Group, www.mercadien.com.

12.3.2 Control Risk Assessment

Assessment of control risk over inventory records is important where the entity does not intend to perform a full inventory count at or close to year end. In this case, a satisfactory assessment is vital. Assessment of control risk over the cost of inventory is always important for manufacturing entities.

Control Risk over Inventory Records

Table 12.2 contains a partial listing of potential misstatements (WCGW), necessary controls, possible tests of the operating effectiveness of those controls, and the specific audit objective to which each belongs. As explained previously, the auditor assesses control risk over perpetual inventory records only where they are used in determining inventory at the end of the reporting period. If the preliminary assessment based on the design effectiveness of controls is that control risk is likely to be high, then the auditor would advise management not to rely on the records in determining inventory at the end of the reporting period.

If the preliminary assessment supports management's intended reliance on inventory records, then the auditor would draw up an audit program incorporating possible tests of the operating effectiveness of controls such as those identified in table 12.2.

TABLE 12.2 Control risk assessment considerations—inventory transaction

Function	WCGW	Necessary Control	Possible Test of Operating Effectiveness	Relevant Audit Objective (from Table 12.1) OE No.	C No.	AV No.	D No.
Recording movement of goods into inventory	Failure to record goods	Use of pre-numbered receiving reports and inventory transfer requisitions	Re-perform test of numerical continuity.		✓1, 2		
		Independent reconciliation of inventory records with control account in general ledger	Re-perform.*	✓1, 2, 3	✓1, 2, 3	✓1	

(*continued*)

TABLE 12.2 **Control risk assessment considerations—inventory transaction (*continued*)**

Function	WCGW	Necessary Control	Possible Test of Operating Effectiveness	Relevant Audit Objective (from Table 12.1)			
				OE No.	C No.	AV No.	D No.
Recording movement of goods from inventory	Unauthorized removal of goods	Custodian at receiving location required to acknowledge responsibility for receipt of goods into inventory	Inspect receiving reports and inventory transfer requisitions for custodian's initials.	✓1, 2			
		Custodian required to obtain receipt for all requests to move inventory out of storage	Vouch recorded removals with properly authorized shipping documents and inventory transfer requisitions.*	✓2, 3			
		Physical comparison of inventory with inventory records	Observe. Re-perform.*	✓1, 2, 3	✓1, 2, 3		
Physical comparison of inventory with inventory records	Unreliable count procedures	Responsibility independent from maintenance of inventory records and custodianship of inventory	Observe.	✓5	✓4		
		Adequate instructions properly issued and followed	Observe. Re-perform.*	✓5	✓4		
	Inadequate investigation and correction	Proper record maintained of differences and their correction	Inspect. Re-perform.*	✓5	✓4		
	Insufficient extent of comparison	Prescribed procedures for systematic counts	Inspect.	✓5	✓4		
Determining inventory costs	Inappropriate basis	Approved by controller	Inquire. Compare with accounting standards.			✓1, 2	✓1, 3
	Improper calculation	Consistent with engineering specification	Inspect.			✓1, 2	
			Re-perform.*			✓1, 2	
		Program controls	Use test data.*				

* Usually performed as part of dual-purpose tests.

Many of these tests are in the form of dual-purpose tests. It is important to remember that CAS 501 *Audit Evidence—Specific Considerations for Selected Items* requires the auditor, where reliance is placed entirely on perpetual inventory records in determining inventory at the end of the reporting period, to perform procedures to ensure that changes in inventory between a count date and the period end are properly recorded. This includes procedures to ensure that:

- the design, implementation, and maintenance of internal controls over the recording of changes in inventory are effective
- significant differences between the physical count and the perpetual inventory records are properly adjusted

Close to the end of the reporting period, the auditor needs to consider the extent of test counts relative to total inventory, and to review the recorded differences between test counts and inventory records over the year and the explanations of those differences. If the auditor is not satisfied that results of test counts support an assessment of control risk as low, then the auditor must discuss with management the need for a complete inventory count.

Control Risk over Inventory Cost

In a manufacturing entity, assessment of the reliability of the costing system to provide accurate costs of production that are correctly determined in accordance with acceptable accounting standards can constitute a substantial component of the interim audit.

Manufacturing costs are nearly always determined through the computer information system, and test data can be used to test the accuracy of processing and recording cost information. Where standard costs are intended to be used as the basis for valuing inventories, the tests must extend to the procedures used in developing standards from the engineering specifications as to the:

- quantities of labour and material required
- determination of standard prices for labour and materials

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Josh can see that the most important test of controls is the comparison of the results of the test counts to the accounting records. The extent and results of such test counts performed by the entity are important to the assessment of control risk. Where perpetual inventory records are used to determine inventory at the end of the reporting period, the auditor needs to obtain an understanding of the internal control structure and perform tests of controls. He knows this is not necessary for Cloud 9 because W&S Partners has planned a substantive audit strategy over the inventory.

Before You Go On

12.3.1 Describe some of the inherent risks for inventory.

12.3.2 In verifying the existence (and completeness) assertions, the auditor has the choice of which three audit strategies?

12.3.3 Is it possible for the auditor to rely on tests of controls for inventory?

12.4 Substantive Procedures for Inventories

LEARNING OBJECTIVE 4

Design a substantive audit program for inventory.

Except where perpetual records are used as the basis for determining inventory at the end of the reporting period, and for costing records in manufacturing entities, the audit for inventories is based mainly on substantive procedures applied to the account balance at the end of the reporting period.

The emphasis is on the relevant assertions of existence and accuracy, valuation, and allocation, because the inherent risk of their misstatement is usually high. Acceptable detection risk for these two assertions is usually assessed as low, with detection risk for other assertions being low to moderate.

Table 12.3 lists possible substantive procedures to be included in the audit program, with each test referenced to the audit objectives shown in table 12.1.

TABLE 12.3 **Possible substantive procedures for tests of inventory assertions**

		Account Balance Audit Objective (from Table 12.1)				
Category	**Substantive Procedures**	**OE5**	**RO1**	**C4**	**AV2**	**D No.**
Initial procedures	1. Perform initial procedures on inventory balances and records that will be subjected to further testing. (a) Trace opening inventory balances to the previous year's working papers. (b) Review activity in inventory accounts and investigate entries that appear unusual in amount or source. (c) Verify totals of perpetual inventory records and their agreement with closing general ledger balances.				✓	
Analytical procedures	2. Perform analytical procedures. (a) Review industry and entity trends. (b) Examine an analysis of inventory turnover and gross profit. (c) Review relationships of inventory balances to recent purchasing, production, and sales activities.	✓		✓	✓	
Tests of details of transactions	3. Test entries in inventory records to and from supporting documentation.	✓	✓	✓	✓	
	4. Test the cut-off of purchases, inventory transfers, and sales.	✓		✓		
Tests of details of balances	5. Observe the entity's physical inventory count. (a) Evaluate the adequacy of the entity's inventory-count plans. (b) Observe physical inventory count and test compliance with prescribed procedures. (c) Make test counts. (d) Look for indications of slow-moving, damaged, or obsolete inventory. (e) Account for all inventory tags and count sheets used in the physical count. (f) Record cut-off data.	✓	✓	✓	✓	
	6. Test the clerical accuracy of inventory listings. (a) Recalculate totals and extensions of quantities times unit prices. (b) Trace test counts (from item 5(c)) to listings. (c) Vouch items on listings to and from count sheets and inventory tags. (d) Compare physical counts with perpetual inventory records. (e) Verify the adjustment of amounts for movements between the date of the physical count and the end of the reporting period.	✓		✓	✓	
	7. Test inventory pricing. (a) Examine suppliers' invoices for purchased inventories. (b) Examine the propriety of costing information, standard costs, and the disposition of variances relating to manufactured inventories. (c) Perform a lower of cost and net realizable value test.				✓	

(continued)

TABLE 12.3 Possible substantive procedures for tests of inventory assertions (*continued*)

Category	Substantive Procedures	Account Balance Audit Objective (from Table 12.1)				
		OE5	RO1	C4	AV2	D No.
	8. Confirm inventories at locations outside the entity.	✓	✓	✓		
	9. Examine consignment agreements and contracts.		✓			
Disclosure	10. Compare statement presentation with applicable accounting standards. (a) Confirm agreements for assignment and pledging of inventories. (b) Review disclosures for inventories in drafts of the financial statements and determine conformity with applicable accounting standards.					✓2, 4, 5

12.4.1 Initial Procedures

In tracing opening inventory balances to working papers for the previous year, the auditor should make certain that any audit adjustments agreed on in the previous year were recorded. In addition, where perpetual inventory records are maintained, entries in the control accounts in the general ledger should be scanned to identify any postings that are unusual in amount or nature and thus require special investigation. Where perpetual inventory records are to be used as the basis for determining inventory at the end of the reporting period, the inventory listing must be test-checked to and from the records, added, and compared with the balance in the control account. Additional work on inventory listings is discussed in a later section on the tests of details of balances.

12.4.2 Analytical Procedures

The application of analytical procedures to inventories is often extensive. A review of industry and company trends may be essential in developing expectations to be used in evaluating analytical data for the entity. Knowledge of an industry-wide fall in inventory turnover, for example, will enable the auditor to expect a fall in the entity's inventory turnover ratio. If the ratio does not show the expected fall, then the auditor may suspect errors in the existence or occurrence of the inventory balance, or in the completeness of the balance used in calculating the ratio. A review of relationships of inventory balances with recent purchasing, production, and sales activities should also help the auditor understand changes in inventory levels. An increase in the reported level of finished goods inventory when purchasing, production, and sales levels have remained steady, for example, could indicate misstatements relating to the existence or valuation of the finished goods inventory.

Important ratios are those of inventory turnover and gross profit. We previously explained the use of the gross profit ratio with respect to the audits of sales and purchases. An unexpectedly high inventory turnover ratio, or an unexpectedly low gross profit ratio, might be caused by an overstatement of cost of sales and a corresponding understatement of inventories. Conversely, conformity of these ratios with expectations provides assurance of the fairness of the data used in the calculations. When performing inventory turnover ratios, where the data are available and reliable, the auditor may use audit data analytics to calculate inventory turnover by product or stock-keeping unit (SKU) to identify slow-moving items. Inventory movements can also be examined by location to identify items that may be of particular concern.

Where the physical inventory count is other than at the year end, the auditor should analyze totals of transactions in the intervening period for reasonableness.

12.4.3 Tests of Details of Transactions

With the exception of cut-off tests, tests of details of transactions are performed only where inventory at the end of the reporting period is determined wholly or partly from perpetual inventory records.

Testing Entries in Inventory Records

Where inventory at the end of the reporting period is determined wholly by reference to perpetual inventory records, the tests of details of inventory transactions will be those described in table 12.2 as dual-purpose tests. Where inventory at the end of the reporting period is determined by a count other than at the year end and adjusted by reference to inventory records in the intervening period, such tests of details of transactions may be confined to the period between the date of the physical count and year end.

Testing Cut-Off of Purchase, Manufacturing, and Sale Transactions

The purpose and nature of sales and purchases cut-off tests were previously explained in connection with the audit of accounts receivable and accounts payable balances. Both sales and purchases cut-off tests are important in establishing that transactions occurring near the end of the year are recorded in the correct accounting period. Purchases in transit at year end, for example, should be excluded from inventory and payables, and inventory in transit to customers at year end should be included in sales and excluded from inventory. In a manufacturing entity, it must also be determined that entries are recorded in the proper period for the allocation of labour and overhead costs to work in process, and for goods moved between raw materials, work in process, and finished goods.

In each case, the auditor must ascertain, through inspection of documents and observation, that the paperwork cut-off and the cut-off for the physical inventory count are coordinated. If it is determined, for example, that an entry has reported the transfer of the cost of the final completed batch of the period to finished goods, then the auditor should determine that the goods, even if in transit, were included in the physical count of finished goods only; that is, that they were neither counted as part of work in process, nor double-counted, nor missed altogether. When attending the count, the auditor should note details of documentation relating to the movement of goods at the date of the count. Where the count is at a date other than at the end of the reporting period, the auditor must also check cut-off at the date of the count to ensure that movements between that date and the end of the reporting period exclude transactions before the count. Evidence from these cut-off tests relates to the occurrence, completeness, and accuracy, valuation, and allocation assertions for inventory balances.

12.4.4 Tests of Details of Balances

As previously explained, the auditor reduces audit risk to the desired level mainly through the performance of substantive tests of details of balances.

In observing the inventory count, the auditor is not responsible for supervising the process. From this procedure, the auditor obtains direct knowledge of the reliability of management's inventory-counting procedures and, thus, the reliance that may be placed on management's assertions as to the quantities and physical condition of the inventories. In some cases, the entity may hire outside inventory specialists to do the count. Where the outside inventory specialists have no particular expertise in the type of inventory being counted, the auditor must be present to observe their counts, too, because, from an auditing standpoint, they are basically the same as entity employees. Where the specialists are experts in the particular type of inventory (such as precious stones), the auditor may be in a position to place a degree of reliance on the work of the expert in accordance with CAS 620 *Using the Work of an Auditor's Expert*.

As has been explained, the timing of the inventory count is negotiated with management in accordance with the entity's inventory system and the assessment of control risk. Except where reliance is placed wholly on perpetual inventory records, quantities are determined by physical count as at a specific date. The date should be at or near the end of the reporting period, and the auditor should be present on the specific date. For a multi-site entity, the auditor may vary locations attended each year, so long as the sample of inventory observed each year is of sufficient size. In such cases, the auditor may consider relying on internal audit for attendance at locations not visited, subject to the requirements of CAS 610 *Using the Work of Internal Auditors*. Such reliance, however, does not replace the requirement for the auditor to undertake sufficient personal observation of inventory counts. Other firms of auditors may also be engaged to observe an inventory count; for example, where another auditor is responsible for the audit of a subsidiary in a group, subject to the requirements of CAS 600 *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*.

Attendance at an inventory count involves performing tests of controls over entity procedures and substantive procedures applied directly by the auditor. Both procedures are performed simultaneously. Moreover, because there is no alternative audit strategy if the entity's inventory count procedures are found to be inadequate, the auditor should review and evaluate the entity's inventory count plans well in advance of the counting date. With ample lead time, the entity should be able to respond favourably to suggested modifications in the plans before the count begins. It is common for the auditor to help design a count plan that will facilitate both taking and observing the count.

Procedures are the same as for test counts in respect of perpetual inventory records (see section 12.2.2), except that the count is of all inventory, not just a sample.

In observing the inventory count to ensure prescribed procedures are being properly followed, the auditor should:

- observe entity employees performing their prescribed procedures
- determine that pre-numbered count sheets or inventory tags are properly controlled
- be alert to the possible existence of empty containers and hollow squares (empty spaces) when goods are stacked in solid formations
- observe that cut-off procedures are being followed and that the movement of goods, if any, is properly controlled
- see that all goods are marked as having been counted

In addition, the auditor should perform substantive procedures, including:

- making test counts and comparing quantities with the entity's count
- recording details of serial numbers of count sheets or tags used and unused (or taking copies of all used count sheets)
- appraising the general condition of the inventory, noting damaged, obsolete, and slow-moving items
- ensuring that partly used count sheets are ruled off to prevent additional entries being made
- identifying and noting the last receiving, production, and shipping documents used, and determining that goods received during the count are properly segregated

The extent of the auditor's test counts partly depends on the nature and composition of the inventory. Before the inventory count, the auditor may identify high-value items for test counting in addition to counting a representative sample of other items. In making test counts, the auditor should record the count and give a complete and accurate description of the item (identification number, unit of measurement, location, and so on) in the working papers, as shown in **figure 12.1**. Such data are essential for the auditor's comparison of the test counts with the entity's counts, and for the subsequent tracing of the counts to inventory summary sheets and perpetual inventory records.

On conclusion of the observation procedure, a designated member of the audit team should prepare a working paper detailing such matters as those listed below before reaching a conclusion as to the reliability of the count:

- departures from the entity's inventory count
- the extent of test counts and any material discrepancies resulting therefrom
- conclusions on the accuracy of the counts
- the general condition of the inventory

Cloud 9 Ltd.						**Prepared by: L.R.S.**
Inventory test counts						**Date: 4/7/2024**
12/31/2023						**Reviewed by: B.E.M.**
						Date: 4/10/2024
Tag no.	Inventory sheet no.	Inventory		Count		
		Number	Description	Company	Auditor	Difference
6531	15	1-42-003	Olympic—Women's	125✓	125	
8340	18	1-83-012	Heavenly 456—Women's	93✓	93	
1483	24	2-11-004	Maximum Speed—Men's	1,321✓	1,325	4
4486	26	2-28-811	White Laces	220✓	220	
3334	48	4-26-204	Thunder 75—Men's	424✓	424	

Each difference was corrected by the company and the net effect of the corrections was to increase inventory by $840.

Total inventory values for which test counts were made and traced to inventory summaries without exception = $210,460 or 22% of the total. In my opinion, errors were immaterial.

✓ = Traced to company's inventory summary sheets (F–4), noting corrections for all differences.

FIGURE 12.1 **Inventory test counts working paper**

In the initial audit of an established entity, it is clearly impracticable for the auditor to have observed the physical inventory at the previous year end that established the opening inventory. CAS 510 *Initial Audit Engagements—Opening Balances* permits the auditor to verify the inventories by other auditing procedures. When the entity was audited by another firm of auditors in the previous period, the auditor may review working papers of the predecessor audit firm and consider its competence and independence. If the entity has not been audited previously, the auditor may be able to obtain audit satisfaction by testing transactions from the previous period, reviewing the records of previous counts, or applying analytical procedures.

When sufficient evidence has not been obtained as to the existence of opening inventories, or when the auditor is unable to observe the taking of closing inventory counts or to obtain sufficient evidence from alternative procedures, the auditor cannot issue an unmodified auditor's report. Like the confirmation of accounts receivable, the observation of the entity's inventory count applies to many assertions. This procedure is the main source of evidence that the inventory exists. In addition, this procedure relates to the assertions detailed in **table 12.4**.

TABLE 12.4 **Assertions for which attendance at an inventory count provides evidence**

Assertion	Application
Completeness	Procedures provide assurance that no items were omitted from the count.
Accuracy, valuation, and allocation	Observation of the condition of goods as being damaged, obsolete, or apparently slow-moving provides evidence of goods that may need to be valued at net realizable value.
Rights and obligations	Possession of goods on entity premises provides some evidence as to ownership.

After the inventory count, the entity uses the count sheets or inventory tags to prepare a listing of all items counted. The inventory items are then priced to arrive at the total value of the inventory. Because this listing serves as the basis for the recorded inventory balance, the auditor must perform procedures to ensure that the listing is clerically accurate and that it accurately represents the results of the physical count.

To determine that the list accurately represents the results of the count, the auditor:

- compares their own test counts with the inventory listings
- identifies count sheets or tags used in the count according to records made by the auditor at the time of attendance, and tests items on those count sheets or tags to and from the listings
- compares the count, on a test basis, with amounts per perpetual records, when applicable, and inquires into any differences noted
- tests the clerical accuracy by recalculating the extensions of quantities times unit prices on a test basis, as well as the totals shown on the inventory listings

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Josh is reading the memo to file prepared by Weijing regarding the inventory count. She documented the item and serial numbers for all items included in her sample test count. Weijing noted that she vouched items from the count sheet to the inventory items to test for existence and traced items from the shelves back to the count sheets to test for completeness. Based on what he is reading, Josh believes the inventory count produced reliable results over the existence and completeness assertions. He can see that work on the accuracy, valuation, and allocation assertion must now be performed.

12.4.5 Testing Inventory Pricing

This procedure involves verifying the cost of inventory and the net realizable value of those items that management has determined need to be written down. It also involves considering whether other items, whose net realizable value may be below cost, need to be written down. Thus, it relates to the accuracy, valuation, and allocation assertion.

Inventory at Cost

For merchandise inventory and raw materials valued on a first-in, first-out basis, this test involves examining suppliers' invoices covering the quantity in inventory.

For work-in-process and finished goods inventories, the auditor must test cost against costing records. The entity's costing system should have been evaluated during the interim audit, and controls over the determination of product cost assessed. Dual-purpose tests (table 12.2), serving as both tests of controls and substantive procedures, should provide sufficient evidence as to the reliability of product cost data. The auditor then vouches the costs that are applied to inventory to the costing records.

Where inventory is costed at standard cost, variances for the year need to be analyzed. When a variance account has a large balance, the auditor must consider whether fair presentation requires a pro rata allocation of the variance to inventories and to cost of sales, instead of charging the entire variance to cost of sales. A large adverse material price variance, for example, may indicate that the true cost of inventory is greater than the standard cost. If the variance is written off, then the cost of inventory is understated.

Inventory at Net Realizable Value

Accounting standards require inventory to be written down to net realizable value where below cost. The writedown constitutes an accounting estimate and the auditor must follow the procedures in CAS 540 *Auditing Accounting Estimates, and Related Disclosures.*

Recall that auditing estimates requires the auditor to perform one or more of the following: review and test the process used by management, develop an independent estimate, and review subsequent events.

For items priced at net realizable value, the auditor must verify the basis for arriving at that value. In some cases, it will be the actual, current, or contracted selling price less an estimate of costs to be incurred in completion and selling. In other cases, a formula may be used, taking into account the age, past movement, and expected future movement of the inventory items. The auditor may examine the data and assumptions on which the estimates are based, check the calculations, consider consistency of assumptions with prior periods, and assess judgements for signs of management bias.

In view of the inherent risk of understatement of the required writedown, the auditor should also carry out substantive procedures to identify the need for further writedowns. For example, IAS 2 *Inventories* specifically identifies the following situations in which a writedown may be necessary:

- a fall in selling price
- physical deterioration of inventories
- obsolescence
- a decision to sell at a loss
- purchasing or production errors

Specific procedures normally adopted by the auditor include:

- review of sales after the end of the reporting period
- observation of deterioration or obsolescence during the auditor's attendance at the physical count
- analysis of inventory holdings relative to recent or future budgeted turnover to identify excessive holdings; this is often performed with the use of generalized audit software
- inquiry of management and of sales and production personnel
- review of the minutes of the board of directors and executive committees

Use of an Expert

When entity assertions about the value of the inventory relate to highly technical matters, the auditor may require the assistance of an outside expert. This may occur, for example, in an oil company with different grades of gasoline and motor oil, or in a jewellery shop with diamonds of varying quality. The auditor may use the work of an expert as an auditing procedure to obtain sufficient appropriate audit evidence when the auditor is satisfied with the expert's qualifications and independence.

12.4.6 Confirming Inventories at Locations Outside the Entity

When inventories are stored in public warehouses or with other third parties, the auditor should obtain evidence as to the existence of the inventory by direct communication with the custodian. This type of evidence is deemed sufficient except when the amounts involved represent a significant proportion of current or total assets. When this is the case, the auditor should apply procedures that include:

- considering the integrity and independence of the third party
- observing (or arranging for another auditor to observe) physical counts of the goods
- obtaining another auditor's report on the warehouse's control procedures relevant to physical counting and to custody of goods

Confirmation of inventories at outside locations also provides evidence about the rights and obligations assertion. In addition, it results in evidence as to the completeness assertion if the custodian confirms more goods on hand than stated in the confirmation request. It does not provide any evidence about the value of the inventory because the custodian is not asked to report on the condition of the goods stored in the warehouse.

12.4.7 Examining Consignment Agreements and Contracts

Goods on hand may be held for customers, at their request, after a sale has occurred, and goods belonging to others may be held on consignment. A consignment "sale" is one made on a sale-or-return basis. Payment for the goods is required only on subsequent sale to a third party. For accounting purposes, such goods are included in the "seller's" inventory. Thus, management is requested to segregate goods not owned during the physical count. In addition, the auditor usually requests a written assertion on ownership of inventories in the representation letter.

The auditor should also inquire as to whether any of the entity's own goods are held on consignment and included in inventory. If so, the auditor should review the documentation or, if the goods are material, confirm the existence of such goods directly with the other party.

Goods may also be assigned or pledged, usually as security for loans. The auditor must inquire of management as to the existence of such agreements, and the appropriate disclosure should be checked in the financial statements.

Evidence obtained from this procedure relates to the rights and obligations assertion and the presentation assertion.

12.4.8 Disclosure

It is appropriate to identify the major inventory categories in the balance sheet. In addition, there should be disclosure of the inventory costing method(s) used, the pledging of inventories, and the existence of major purchase commitments.

Inquiry of management is used to determine the existence of binding contracts for future purchases of goods. When such commitments exist, the auditor should examine the terms of the contracts and evaluate the fairness of the entity's accounting and reporting. When material losses exist on purchase commitments, they should be recognized in the financial statements, together with a disclosure of the attendant circumstances.

The substantive procedures described above provide evidence regarding financial statement disclosure. Further evidence may be obtained, as needed, from a review of the minutes of board meetings and from inquiries of management. Based on the evidence, the auditor determines the fairness of the disclosures in accordance with the applicable accounting standards.

Cloud 9 Integrated Case

Cloud 9 discloses that its inventory is valued at the lower of cost and net realizable value, which relates to the accuracy, valuation, and allocation assertion. Josh plans to test the inventory costing by looking at the most recent selling prices compared with the invoice costs for a sample of inventory items. He also plans to identify any slow-moving items and, using the most recent purchase invoices, verify if any writedowns to net realizable value are needed.

Before You Go On

12.4.1 What three possible strategies are available to the auditor to determine inventory quantity?

12.4.2 What are four controls that should be in place over inventory?

12.4.3 What is the auditor's responsibility with respect to a client's inventory count?

12.5 Audit Objectives: Property, Plant, and Equipment

LEARNING OBJECTIVE 5

Identify the audit objectives applicable to property, plant, and equipment.

There are various classes of property, plant, and equipment but all are tangible, non-current assets that are held to be used by the entity or to be rented out to others. Property includes:

- land and buildings, which may be freehold or leasehold
- plant and equipment, which includes machinery, vehicles, furniture, and equipment and may include items held under lease

The key issues in auditing property, plant, and equipment are ensuring that the property, plant, and equipment actually exist, are owned, and are properly valued with adequate provision for depreciation. The relevant audit objectives are presented in table 12.5. Further details on these assertions are provided in CAS 315 *Identifying and Assessing the Risks of Material Misstatement*. A key focus in the audit of property, plant, and equipment relates to the transactions for purchasing new assets and disposing of old assets, including profits or losses on sale. In addition, the auditor must consider depreciation charges, the treatment of leased assets in accordance with the financial reporting framework, and asset revaluations.

TABLE 12.5 Selected specific audit objectives for property, plant, and equipment

Transaction and Related Disclosure Objectives	
Occurrence (**OE**)	Recorded additions represent property, plant, and equipment acquired during the period under audit (**OE1**). Recorded disposals represent property, plant, and equipment sold or scrapped during the period under audit (**OE2**). Disclosed property, plant, and equipment transactions have occurred and pertain to the entity (**OE3**).
Completeness (**C**)	All additions that occurred during the period have been recorded (**C1**). All disposals that occurred during the period have been recorded (**C2**). Disclosures as to: • cost or valuation • depreciation methods and useful lives of each major class • pledging as collateral • the major terms of lease contracts of property, plant, and equipment assets are adequate and complete (**C3**)
Accuracy (**AV**)	Additions are correctly journalized and posted (**AV1**). Disposals are correctly journalized and posted (**AV2**).

(continued)

TABLE 12.5 Selected specific audit objectives for property, plant, and equipment (*continued*)

Transaction and Related Disclosure Objectives	
	Property, plant, and equipment transactions are disclosed accurately and at appropriate amounts (**AV3**).
Classification (**D**)	Additions and disposals of property, plant, and equipment are recorded in the correct accounts (**D1**).
Presentation (**D**)	Property, plant, and equipment transactions and events are appropriately aggregated or disaggregated, clearly described, and the related disclosures are relevant and understandable (**D2**).
Account Balance and Related Disclosure Objectives	
Existence (**OE**)	Recorded property, plant, and equipment assets represent productive assets that are in use at the end of the reporting period (**OE4**).
Rights and obligations (**RO**)	The entity owns or has rights to all recorded property, plant, and equipment assets at the end of the reporting period (**RO1**).
Completeness (**C**)	Property, plant, and equipment balances include all applicable assets used in operations at the end of the reporting period (**C4**).
Accuracy, valuation, and allocation (**AV**)	Property, plant, and equipment are stated at cost or valuation less accumulated depreciation (**AV4**).
Classification (**D**)	The details of additions and disposals of property, plant, and equipment support their classification in the financial statements (**D3**).
Presentation (**D**)	Property, plant, and equipment are appropriately aggregated and disaggregated, clearly described, and the related disclosures are relevant and understandable (**D4**).

Cloud 9 Integrated Case

Josh sees that, for Cloud 9, property, plant, and equipment are material on the balance sheet and the expenses associated with property, plant, and equipment are material to the profit. He also notes that the property, plant, and equipment account balances are greater than last year's. He asks Sharon why this may be. She indicates that she believes this is due to the addition of the new retail store, and part of their audit work will be to verify these additions.

Before You Go On

12.5.1 What items are considered property?

12.5.2 What are the key issues in auditing property, plant, and equipment?

12.5.3 Explain the completeness assertion for property, plant, and equipment.

12.6 Audit Strategy

LEARNING OBJECTIVE 6

Discuss considerations relevant to determining the audit strategy for property, plant, and equipment.

Because transactions relating to property, plant, and equipment are usually few and individually material, assessment of control risk relating to these transactions is rarely necessary. Although the auditor rarely assesses controls over recording fixed asset transactions, the auditor generally uses a fixed asset continuity schedule as a source of evidence used in substantive procedures.

There may be significant variations in the inherent risk assessments for assertions relating to different property, plant, and equipment accounts. Inherent risk for the existence assertion may be lower on the spectrum of inherent risk in a merchandising entity, for example, because the plant and equipment are not normally vulnerable to theft. However, it may be moderate or high in a manufacturing entity because scrapped or retired machinery may not be written off the books, or small tools and equipment used in production may be stolen. Similarly, the inherent risk in the accuracy and in the accuracy, valuation, and allocation assertions may be lower on the spectrum of inherent risk when equipment items are purchased for cash, but higher when items are acquired under lease. In the same way, the inherent risk may be high for the rights and obligations assertion for plant and equipment acquired under lease.

Although material, the verification of property, plant, and equipment typically involves significantly less time and cost than the verification of current assets. Unlike receivables or cash balances, control risk assessments for non-current asset balances are usually less dependent on controls over major transaction classes.

The only transaction class with a significant effect on non-current asset balances is purchases. When expenditures for smaller items (such as furniture, fixtures, and equipment) are processed as routine purchase transactions, the auditor may elect to use a combined approach. In such cases, the auditor's tests of controls of purchase transactions should include a sample of such assets. In assessing control risk for the plant and equipment assertions, the control risk assessments for purchase transactions are applicable. Other expenditures for land, buildings, and major capital improvements tend to occur infrequently and are not subject to the routine purchasing controls. These transactions may be subject to separate controls, including capital budgeting and specific authorization by the board of directors. Because such transactions are often individually material, a substantive approach is often adopted for the property, plant, and equipment assets, resulting in the specification of low acceptable levels of detection risk.

In determining detection risk for the accuracy and the accuracy, valuation, and allocations assertions for depreciation expense and accumulated depreciation, note that inherent risk is affected by both the degree of difficulty in estimating useful lives and residual values, and the complexity of the depreciation methods used. Control risk may be affected by the effectiveness of any controls related to these estimates and calculations.

Entities often maintain a **capital asset sub-ledger** detailing individual items of plant and equipment. The file records the cost of each asset and of any additions or alterations, and the accumulated depreciation charged against it. Balances in the sub-ledger reconcile with the written-down value of the plant and equipment account in the general ledger. The file may also contain additional information, such as serial number, supplier or manufacturer, insurance coverage, maintenance records and location, as well as other information relevant to management of the portfolio of plant and equipment. From time to time, the entity may carry out a physical verification of plant and equipment, mainly to identify unrecorded disposals of fully depreciated items.

capital asset sub-ledger a file containing plant and equipment information such as description, supplier, serial number, and location, as well as cost and depreciation charges that reconcile with the control account in the general ledger

Control over maintenance of the sub-ledger is only of audit significance for assets that are vulnerable to misappropriation. Regular checking of such assets provides evidence of their existence, and the auditor may not need to inspect such assets physically at the end of the reporting period. Procedures for understanding the internal control structure and assessment of control risk are similar to those for perpetual inventory records described in the first part of this chapter. As Professional Environment 12.2 shows, it is important to make sure that existing assets are properly recorded and that recorded assets actually exist.

12.2 Professional Environment Ghost and Zombie Assets

When auditors determine the fair value of a company's assets, they need to locate and inspect them. Assets that can't be seen are what auditors call "ghost and zombie assets." Ghosts are assets that appear in the books but can't be found. Zombies are assets that do exist but don't appear in the books. Neither is acceptable, of course.

Some companies don't periodically reconcile their fixed asset ledger to the property, plant, and equipment assets they actually have. That means auditors really can't certify that the internal controls over property, plant, and equipment are functioning. So, by having ghost and zombie assets, an entity has a material weakness in internal controls. These controls could result in a missing computer (a ghost asset) or an item worth several million dollars that was unidentified in the books (a zombie asset).

The reasons for ghost assets include:

- unrecorded trade-ins
- parts of existing machines being used to repair other units
- factory rearrangement, with "unneeded" items scrapped
- not writing off old items when new items replace them

Q: What can a company do to avoid having ghost or zombie assets?

Sources: Alfred M. King, "Ghost and Zombie Assets—It's Midnight. Do You Know Where Your Assets Are?" *KnowledgeLeader* provided by Protiviti, 2009; "The Benefits of Exorcising Ghost Assets from Your Books," Bloomberg BNA Software, www.bnasoftware.com; "How Should We Handle Zombie Assets and Ghost Assets?" www.nacva.com.

Cloud 9 Integrated Case

On determining the audit strategy, Josh assesses the inherent risk for property, plant, and equipment as being moderate to high, and control risk has not been not assessed at all (and thus is taken as being high). Substantive procedures will, therefore, be designed and performed so as to achieve the desired low level of detection risk. This will help the audit team achieve the required reduction in the audit risk of misstatements in the property, plant, and equipment balances.

Before You Go On

12.6.1 Why is a control risk assessment rarely performed for property, plant, and equipment?

12.6.2 What audit approach is generally used for property, plant, and equipment? Why?

12.6.3 Explain the purpose of a capital asset sub-ledger.

12.7 Designing Substantive Procedures for Property, Plant, and Equipment

LEARNING OBJECTIVE 7

Design a substantive audit program for property, plant, and equipment.

In the first audit, evidence must be obtained as to the fairness of the opening balances and the ownership of the assets making up the balances. When the entity has previously been audited by another firm of auditors, this evidence may be obtained from a review of the predecessor auditor's working papers. If the entity has not previously been audited, the auditor must undertake an investigation of the opening balances. Information concerning opening balances obtained in the initial audit is usually recorded in the permanent audit file. This record is updated annually to record changes in the major assets, particularly property, including details of title deeds and registered charges such as mortgages.

In a recurring engagement, the auditor concentrates on the current year's transactions. The opening balances are verified through the preceding year's audit, and changes in the balance are usually few. This contrasts with the audit of current assets, which are subject to numerous transactions and for which the audit effort is concentrated on the closing balance. The auditor relies on the inspection of documentary evidence in verifying additions and disposals, and on mathematical evidence in verifying depreciation.

Possible substantive procedures for property, plant, and equipment balances, and the specific account balance audit objectives to which the tests relate, are shown in **table 12.6**. Risk considerations usually result in greater emphasis being placed on the existence or occurrence and the accuracy, valuation, and allocation assertions. We explain each substantive procedure in a later section.

TABLE 12.6 **Possible substantive procedures for property, plant, and equipment assertions**

		Account Balance Audit Objective (from Table 12.5)				
Category	**Substantive Procedure**	**OE4**	**C4**	**RO1**	**AV4**	**D No.**
Initial procedures	1. Perform initial procedures on property, plant, and equipment balances and records that will be subjected to further testing. (a) Trace opening balances for assets and related accumulated depreciation accounts to and from the previous year's working papers. (b) Review activity in the general ledger, accumulated depreciation, and depreciation expense accounts, and investigate entries that appear unusual in amount or source. (c) Obtain entity-prepared schedules of additions and disposals and determine that they accurately represent the underlying accounting records by: • adding and cross-adding the schedules and reconciling the totals with increases or decreases in the related general ledger balances during the period • testing the agreement of items on schedules with entries in related general ledger accounts	✓	✓	✓	✓	✓1, 2
Analytical procedures	2. Perform analytical procedures. (a) Calculate ratios. (b) Analyze ratio results relative to expectations based on previous year's results, industry data, budgeted amounts, or other data.	✓	✓		✓	
Tests of details of transactions	3. Compare asset additions with supporting documentation.	✓	✓	✓	✓	✓1
	4. Compare asset disposals with supporting documentation.	✓	✓	✓	✓	✓1
	5. Review repairs and maintenance and rental expense.		✓			
Tests of details of balances	6. Examine title documents and contracts.	✓		✓		
	7. Review depreciation expense.				✓	
	8. Consider the possibility of impairment.				✓	
	9. Inquire into the valuation of property, plant, and equipment.				✓	

(continued)

TABLE 12.6 Possible substantive procedures for property, plant, and equipment assertions (*continued*)

		Account Balance Audit Objective (from Table 12.5)				
Category	**Substantive Procedure**	**OE4**	**C4**	**RO1**	**AV4**	**D No.**
Classification and Disclosure	10. Compare the statement presentation with applicable accounting standards. (a) Determine that property, plant, and equipment assets and related expenses, gains, and losses are properly identified and classified in the financial statements. (b) Determine the appropriateness of disclosures pertaining to the cost, value, depreciation methods, and useful lives of major classes of assets, the pledging of assets as collateral, and the terms of lease contracts.					✓1–4

12.7.1 Initial Procedures

Before performing any of the other steps in the audit program, the auditor determines that the opening general ledger balances agree with the previous period's audit working papers. Among other functions, this comparison will confirm that any adjustments determined to be necessary at the conclusion of the previous audit and reflected in the previous period's published financial statements were also properly recorded and carried forward. Next, the auditor should test the mathematical accuracy of entity-prepared schedules of additions and disposals, and reconcile the totals with changes in the related general ledger balances for property, plant, and equipment during the period. In addition, the auditor should test the schedules by vouching items on the schedules to entries in the ledger accounts, and tracing ledger entries to the schedules to determine that they are an accurate representation of the accounting records from which they were prepared. The schedules may then be used as the basis for several other audit procedures. Figure 12.2 illustrates an auditor's lead sheet for property, plant, and equipment and accumulated depreciation.

Highlight Ltd.
Property, plant, and equipment and accumulated depreciation

Lead schedule

December 31, 2023

W/P ref. G
Prepared by: C.J.G.
Date: 03/25/2024
Reviewed by: R.C.P.
Date: 04/04/2024

			Asset cost					Accumulated depreciation				
W/P REF.	**Acct No.**	**Account Title**	**Balance Dec. 31, 2022**	**Additions**	**Disposals**	**Adjustments DR/(CR)**	**Balance Dec. 31, 2023**	**Balance Dec. 31, 2022**	**Depreciation Expense**	**Disposals**	**Adjustments DR/(CR)**	**Balance Dec. 31, 2023**
G–1	301	Land	450,000 (∿)				450,000					
G–2	302	Buildings	2,108,000 (∿)	125,000		20 (25,000)	2,208,000	379,440 (∿)	84,320		20 (1,000)	462,760
G–3	303	Mach. and equip.	3,757,250 (∿)	980,000	370,000	20 25,000	4,392,250	1,074,210 (∿)	352,910	172,500	20 1,000	1,255,620
G–4	304	Furn. and fixtures	853,400 (∿)	144,000	110,000		887,400	217,450 (∿)	43,250	21,000		239,700
			7,168,650 (∿)	1,249,000	480,000	0	7,937,650	1,671,100 (∿)	480,480	193,500	0	1,958,080
			F	F	F	F	FF	F	F	F	F	FF

(∿) Traced to general ledger and Dec. 31, 2022, working papers
F Footed
FF Cross-footed and footed
20 To reclassify cost and related accumulated depreciation for purchased addition recorded in Buildings account that should have been recorded in Machinery and Equipment account. See adjusting entry no. 21 on W/P AE–4.

FIGURE 12.2 Property, plant, and equipment asset and accumulated depreciation lead schedule

12.7.2 Analytical Procedures

Analytical procedures are less useful as a source of evidence of property, plant, and equipment balances than they are for current assets and liabilities. This is because the balances can vary substantially as the result of relatively few transactions of which the auditor is already likely to be aware. A comparison of the annual depreciation charge with the cost or written-down value of the relevant class of assets should yield a measure comparable to the depreciation rate. Such evidence could provide some of the required evidence for the accuracy, valuation, and allocation assertion. Comparison of repairs and maintenance expense with that for previous years or with net sales may indicate the possibility that some maintenance expenditures have not been recorded or that they have been capitalized in error.

12.7.3 Tests of Details of Transactions

These substantive procedures cover three types of transactions related to property, plant, and equipment: additions, disposals, and repairs and maintenance.

Substantiating Additions

The auditor first needs to ascertain management's policy with regard to the distinction between capital and expense expenditures. Most entities specify a cut-off value below which purchases are expensed regardless of their nature. A consistent policy also needs to be followed in distinguishing between improvements (which prolong the life or enhance the usefulness of existing assets) and repairs and maintenance (which are necessary for the asset to continue to function over its expected useful life). The auditor must ensure that additions are properly capitalized and that a consistent policy is followed.

The recorded amounts should be vouched to supporting documentation in the form of authorizations in the minutes, suppliers' invoices, and contracts. If there are numerous transactions, the vouching may be done on a test basis. In performing this test, the auditor ascertains that the amount capitalized includes installation, freight, and similar costs, but excludes expenses included on the supplier's invoice, such as a year's maintenance fee.

For construction in progress, the auditor may review the contract and documentation in support of construction costs. The auditor should physically inspect major items, ensuring that details of the asset inspected (such as its description and the manufacturer's serial number) agree with the documentation.

The auditor also needs to inquire about leases for property, plant, and equipment entered into during the period. Lease agreements convey, to a lessee, the right to use assets, usually for a specified period of time. Under IFRS, a lessee recognizes leased assets and liabilities unless the lease is for less than 12 months or the underlying asset has a low value. Under ASPE, a lease that transfers most of the benefits of an asset is recognized, along with any related liability. Regardless, the auditor should read the lease agreement to ensure the lease is properly accounted for. The auditor should also do some recalculations to verify the accuracy of the entity's determination of the recognized asset and the present value of the lease liability.

The vouching of additions provides evidence about the occurrence, rights and obligations, and accuracy assertions. In addition, the examination of lease contracts relates to the disclosure assertion, because of the disclosures that are required for leases.

Substantiating Disposals

Evidence of sales, disposals, and trade-ins should be available to the auditor in the form of cash remittance advices, written authorizations, and sales agreements. Such documentation should be carefully examined to determine the accuracy and propriety of the accounting records, including the recognition of gain or loss, if any.

The following procedures may also be useful to the auditor in determining whether all disposals have been recorded:

- analyzing the miscellaneous revenue account for proceeds from sales of property, plant, and equipment
- investigating the disposition of facilities associated with discontinued product lines and operations
- tracing disposal work orders and authorizations for disposals to the accounting records
- reviewing insurance policies for termination or reductions of coverage
- inquiring of management as to disposals

Inspection of the results of any inventory count of plant and machinery undertaken by the entity provides further evidence that all disposals have been recorded.

Evidence that all disposals or retirements have been properly recorded relates to the occurrence, rights and obligations, and accuracy assertions. Evidence supporting the validity of transactions that reduce property, plant, and equipment relates to the completeness assertion.

Reviewing Repairs and Maintenance and Rental Expenses

The auditor's objective in reviewing repairs and maintenance expenses is to determine the propriety and consistency of the charges to this expense. The auditor should scan the individual charges in excess of the entity's cut-off value for capitalization to ensure that they are properly expensed. This procedure is related to the examination of additions to ensure that they are properly capitalized.

This substantive procedure provides important evidence concerning the completeness assertion for property, plant, and equipment because it reveals expenditures that should be capitalized. In addition, the analysis may reveal misclassifications in the accounts that relate to the classification assertion.

Rental expenses are reviewed to ensure that such rents relate to assets under operating leases. Documentary evidence needs to be tested for evidence of leases that should be accounted for as capital leases under ASPE. This procedure provides evidence as to the completeness assertion in that all assets acquired under leases are properly accounted for.

12.7.4 Tests of Details of Balances

The auditor may conclude that the closing balance is correctly stated—with respect to the assertions of existence, completeness, and rights and obligations—after having tested the opening balance with the previous year's working papers, and verified additions and disposals. However, the auditor may examine documentary evidence as to the existence and rights and obligations assertions of the recorded balance.

The main tests of balances relate to valuation and disclosure. These test the accumulated depreciation, the need for provision for impairment, and the appropriateness of any revaluation.

Examining Title Documents and Contracts

The auditor may establish ownership of vehicles by examining registration certificates and insurance policies. For plant and equipment, the "paid" invoice may be the best evidence of ownership. Evidence of ownership of freehold property is found in title deeds, property tax bills, mortgage payment receipts, and fire insurance policies. The auditor can also verify ownership of freehold property by reviewing public records. When this form of additional evidence is desired, the auditor may seek the help of a lawyer. The examination of ownership documents contributes to the existence and rights and obligations assertions for property, plant, and equipment.

Reviewing Accumulated Depreciation

In this test, the auditor seeks evidence as to the reasonableness, consistency, and accuracy of depreciation charges.

- *Reasonableness.* The auditor determines the reasonableness of accumulated depreciation by considering such factors as the entity's past history in estimating useful lives and the remaining useful lives of existing assets. The auditor must also ensure that management has reviewed the depreciation rates during the year and adjusted the rates as necessary in accordance with IAS 16 *Property, Plant and Equipment*.
- *Consistency*. The auditor can ascertain the depreciation methods used by reviewing depreciation schedules prepared by the entity and inquiring of management. The auditor must then determine whether the methods in use are consistent with those used in the preceding year. On a recurring audit, this can be established by a review of the previous year's working papers.
- *Accuracy*. The auditor verifies accuracy through recalculation. Ordinarily, the auditor does this on a selective basis by recalculating the depreciation on major assets and testing depreciation taken on additions and disposals during the year.

These substantive procedures provide evidence about the accuracy, valuation, and allocation assertion.

Considering the Possibility of Impairment

The auditor must be satisfied that the carrying value of property, plant, and equipment does not exceed the greater of their realizable value or value in use in accordance with accounting standards.

The auditor may derive evidence of overvalued assets by observing obsolete or damaged units during a tour of the plant, identifying assets associated with discontinued operations but not yet disposed of, and inquiring of management as to budgets and forecasts for specific activities in relation to the carrying value of assets associated with those activities.

Where amounts have been written off the carrying value of any item of property, plant, or equipment, the auditor must be satisfied, by inquiring of management and assessing management's documentation of future plans, that the writedown is reasonable.

Inquiring into the Valuation

Management may also choose to revalue property, plant, and equipment to reflect more fairly their value to the business. IAS 16 *Property, Plant and Equipment* requires that any revaluation must be applied to a class of assets, not to individual assets within a class. Full valuations must be made or reviewed by an independent valuator. Interim valuations may be made by an internal valuator. The auditor would need to be satisfied with the valuator's skill, competence, and objectivity, whether that valuator is independent or an employee of the entity. In particular, it would be necessary for the auditor to:

- obtain a copy of the valuator's report
- determine the basis of valuation stated therein
- consider its appropriateness as the basis for determining the carrying amount of that class of assets in the financial statements

This substantive procedure provides evidence about the accuracy, valuation, and allocation assertion and the presentation assertion.

12.7.5 Disclosure

The financial statement disclosure requirements for property, plant, and equipment are extensive. The financial statements should show, for example, the depreciation expense for the year; the carrying value for major classes of property, plant, and equipment; and the depreciation method(s) used. For assets carried other than at cost, information that must be disclosed includes whether the valuator is internal or independent, and the date and amounts of the valuation. The auditor acquires evidence concerning these matters through the substantive procedures described in the preceding sections.

Property pledged as security for loans should be disclosed. The auditor may obtain information on pledging by reviewing the board of directors' minutes and long-term contractual agreements; by confirming debt agreements; and by making inquiries of management. The auditor can determine the appropriateness of the entity's disclosures relating to assets under lease by referring to the authoritative accounting pronouncements and the related lease agreements.

Cloud 9 Integrated Case

Josh now understands that transactions involving property, plant, and equipment tend to be infrequent and, where material, are usually subject to special treatment. For this reason, W&S Partners will adopt a substantive approach over the property, plant, and equipment and related financial statement accounts.

Josh realizes that, like inventory, the relevant assertions are the existence and accuracy, valuation, and allocation as management has an incentive to overstate the existence and/or value of property, plant, and equipment, and that valuation requires considerable estimation and judgement. He recognizes that, for Cloud 9, property, plant, and equipment transactions are few and, except for the new store costs, the makeup of the balance is relatively constant. Therefore, substantive procedures include verifying transactions to invoices and contracts and auditing any other items to reconcile the opening balance with the closing balance.

He also now sees that to gather evidence for the accuracy, valuation, and allocation assertion to consider the reasonableness, consistency, and accuracy of the year's accumulated depreciation, he must make sure all of the equipment is in use and, therefore, there are no impairments. Since Cloud 9 did not do any revaluations, no work is required in this area.

Before You Go On

12.7.1 What substantive procedures are normally performed over property, plant, and equipment additions?

12.7.2 Why does the auditor review the repairs and maintenance account?

12.7.3 What audit tests are normally performed over accumulated depreciation?

Summary

1 Identify the audit objectives applicable to inventories.

The key issues in auditing inventory are usually to ensure the inventories actually exist, are owned, and are properly valued. The auditor's objective is to gather sufficient and appropriate evidence about each key assertion.

2 Describe the functions and control procedures normally found for the custody of inventory and maintenance of inventory records.

The key control over the maintenance of inventory is the segregation of duties. The duty of recording inventory movements should be segregated from the physical custody of inventory as goods move in and out of inventory and are transferred between areas.

A key control over the custody of the inventory is the performance of the cyclical and annual inventory counts. Inventory counts are the responsibility of management and they should be well planned to ensure count results are reliable. A comparison of the count results with the accounting records indicates whether the controls over inventory are effective.

3 Discuss considerations relevant to determining the audit strategy for inventories.

Inventories and cost of sales are usually significant to most entities' financial position and the results of their operations. The main inherent risks for inventory are the existence or occurrence assertion and the accuracy, valuation, and allocation assertion. Numerous factors contribute to the inherent risk of misstatements, including the high volume of transactions, contentious valuation issues, and the high risk of theft and obsolescence.

Assessment of control risk is important where the entity does not plan to perform an inventory count at year end and for the cost of inventory for manufacturing entities. If test counts do not support an assessment of control risk as low, or if it is not an efficient audit strategy, the auditor will adopt a substantive audit strategy.

4 Design a substantive audit program for inventory.

Except where perpetual records are used as the basis for determining inventory at the end of the reporting period, and for costing records in manufacturing entities, the audit for inventories is based mainly on substantive procedures applied to the account balance at the end of the reporting period.

The emphasis is on the assertions of existence and accuracy, valuation, and allocation, because the inherent risk of their misstatement is always high. In verifying the existence of inventories, the auditor relies on physical inspection, whether through observation of cyclical counts verifying perpetual inventory records or through attendance at annual inventory counts. For valuation, the auditor verifies the cost of inventory against invoice prices or costing records.

The auditor also needs to ensure that the accounting basis adopted complies with applicable accounting standards and that required disclosures are properly made in the financial statements.

5 Identify the audit objectives applicable to property, plant, and equipment.

The key issues in auditing property, plant, and equipment are usually to gather sufficient and appropriate evidence as to the existence of the assets as well as whether the assets are owned and are properly valued with adequate provision for depreciation. Furthermore, a key focus in the audit of property, plant, and equipment relates to the purchasing of new assets and disposing of old assets, including any profits or losses on sale. In addition, consideration is required in relation to depreciation charges, the treatment of leased assets, and asset revaluations.

6 Discuss considerations relevant to determining the audit strategy for property, plant, and equipment.

There may be significant variations in the inherent risk assessments for the relevant assertions relating to different property, plant, and equipment accounts and the type of industry. For example, inherent risk for the existence assertion may be low in a merchandising entity because the plant and equipment are not normally vulnerable to theft.

Because transactions relating to property, plant, and equipment are few and usually individually material, assessment of control risk relating to these transactions is rarely necessary.

7 Design a substantive audit program for property, plant, and equipment.

In verifying property, plant, and equipment, the auditor relies on verifying changes in the recorded balance, including an inspection of additions. The auditor rarely inspects assets making up the balance, reflecting the incidence of transactions that are frequent for inventories, being a current asset, but infrequent for property, plant, and equipment.

Accuracy and accuracy, valuation, and allocation are determined by the application of accounting procedures involving a high degree of judgement. For property, plant, and equipment, this involves estimating useful economic lives, residual value, and the basis of depreciation. The auditor needs to determine the appropriateness of the judgements made and the accuracy of the resulting calculations. The auditor also needs to ensure that the accounting basis adopted complies with applicable accounting standards and that required disclosures are properly made in the financial statements.

Key Terms

Capital asset sub-ledger 12-25
Cyclical inventory counts 12-7
Finished goods 12-5
Inventory count sheets 12-8
Inventory master file 12-6
Inventory tags 12-8
Inventory transfer requisition 12-6
Perpetual inventory records 12-6
Raw materials 12-5
Work in process 12-5

Self-Test Questions

Answers to the Self-Test Questions are available in *WileyPlus*.

12.1 Ensuring inventories include all materials, products, and supplies on hand at the end of the reporting period relates to the audit assertion of:

a. accuracy, valuation, and allocation.

b. completeness.

c. existence.

d. rights and obligations.

12.2 An important procedure for the conduct of a physical inventory count is to maintain control over the count records. The following is not a common count system:

a. use of pre-printed inventory count sheets.

b. use of blank inventory tags.

c. use of blank, pre-numbered inventory count sheets.

d. use of pre-numbered three-part inventory tags.

12.3 If preliminary assessment of control risk supports management's intended reliance on inventory records, the auditor is most likely to design an audit program that:

a. excludes testing the operating effectiveness of those controls.

b. includes testing the operating effectiveness of those controls.

c. tests only inventory transactions and tests of details of the inventory balance.

d. tests only inventory transactions and excludes tests of details of the inventory balance.

12.4 Observation of an inventory count is a required audit procedure whenever:

a. inventories are material.

b. it is practicable to do so.

c. inventories are material and it is practicable to do so.

d. inventories are material and the auditor considers it to be necessary.

12.5 During the observation of the inventory count, the auditor has no responsibility to:

a. observe the count by client personnel.

b. make some test counts of inventory quantities.

c. supervise the taking of the inventory count.

d. watch for damaged and obsolete inventory items.

12.6 The auditor's strategy in performing test counts during the observation of the inventory count is to:

a. test all large-dollar items.

b. randomly select all test items.

c. concentrate tests on high-dollar items with random selection of other items.

d. concentrate tests in areas where employees seem to be disregarding the inventory instructions.

12.7 The auditor identifies the specific audit objective: "determine that property, plant, and equipment assets are in productive use at the end of the reporting period." This objective is derived from:

a. the existence or occurrence assertion.

b. the completeness assertion.

c. the disclosure assertion.

d. the rights and obligations assertion.

12.8 The following statement about inherent risk assessments for property, plant, and equipment is inaccurate:

a. normally low for the presentation assertion for plant assets acquired under lease.

b. normally low for the existence or occurrence assertion in a merchandising entity because plant assets are not generally vulnerable to theft.

c. normally moderate to high for the existence or occurrence assertion in a manufacturing entity because scrapped or retired plant assets may not be written off the books.

d. normally low for the accuracy, valuation, and allocation assertion when plant assets are purchased for cash.

12.9 When expenditures for property, plant, and equipment are processed as routine purchase transactions, the auditor:

a. must include some of these transactions in the tests of controls over the expenditures cycle.

b. may elect to use a combined approach.

c. should use mainly a substantive approach on these and all major additions.

d. should normally assess control risk as high for these transactions.

12.10 The following represents an existence test for property, plant, and equipment:

a. select a sample of items of machinery in the factory and agree that they are correctly recorded in the machinery general ledger account.

b. review entries in the repairs and maintenance expense account for items of a capital nature.

c. obtain details of material asset disposals during the period and ensure that they are not included on the non-current assets master file at the period end.

d. select a sample of invoices relating to motor vehicle purchases and ensure they are correctly recorded on the non-current assets master file.

Review Questions

12.1 Describe the alternative methods entities use to determine their inventory at the end of the reporting period and the possible effect of each method on audit strategy.

12.2 What steps should the auditor perform when observing the inventory count? Why should the auditor take test counts?

12.3 Many companies use standard costing as the basis for inventory costing. What audit procedures may be appropriate for establishing the fairness of the standard costs, for testing the maintenance of the standard cost records, and for determining the disposition of variances?

12.4 Overhead is to be absorbed into the cost of inventory on the basis of the normal level of activity. What evidence is available to the auditor in verifying management's determination of that level of activity?

12.5 Discuss the cut-off implications of the inventory count being before or after the year end and closing inventory being determined by adjusting the count by reference to purchases and sales records in the intervening period.

12.6 Why does the auditor usually adopt a substantive audit strategy for property, plant, and equipment assertions?

12.7 Discuss procedures that would be useful in ensuring that all disposals of property, plant, and equipment have been recorded.

12.8 What are the problems confronting the auditor in verifying both the rate and method of depreciation?

12.9 What steps can the auditor take to ensure that the disposal of fully depreciated assets is properly recorded? What are the implications if such assets are retained in the accounts?

12.10 When conducting tests of details of transactions for property, plant, and equipment, there are three types of transactions that need to be substantiated. These transactions are additions, disposals, and repairs and maintenance. Briefly describe what is involved with substantiating each of these types of transactions.

Professional Application Questions

Basic Moderate Challenging

12.1 Audit objectives over inventory and property, plant, and equipment Basic LO 1, 5

Required

For each of the following statements, identify the audit assertion that it relates to:

- **a.** Inventories are recorded at the lower of cost and net realizable value.
- **b.** There is no inventory on consignment.
- **c.** All asset additions during the year have been recorded.
- **d.** All inventory purchases are recorded in the correct period.
- **e.** All equipment is in use at the end of the year.
- **f.** Inventories include all materials, products, and supplies on hand at the end of the period.
- **g.** All leases are disclosed.

12.2 Inventory and capital asset documents Basic LO 2, 6

Key documents are used to record and maintain adequate inventory and property, plant, and equipment accounts.

Required

For each of the following documents, describe its purpose and how it contributes to internal control over the related function:

- **a.** inventory transfer requisition
- **b.** inventory count sheets
- **c.** inventory count tags
- **d.** capital asset sub-ledger

12.3 Inventory: computer information system Moderate LO 1, 2

You are the auditor of Fenton Electronics Ltd., which has recently installed a computerized bar code system to record goods received, sales, and inventory quantities. The company is a retailer of electrical products.

1. When the goods are received, the receiving department:
   - either reads the bar code on the box containing the product or inputs the bar code number manually;
   - manually inputs the number of items received (e.g., a box may contain 100 thumb drives) and adds the quantity of items received to the quantity of inventory recorded on the computer
2. When goods are sold to a customer, the bar code of the product is either read or input manually, and the computer produces the sales invoice using the selling price of the product, as recorded on the computer's standing data file. The quantity of items sold is deducted from the inventory quantity recorded on the computer.
3. Periodically, the inventory is counted and these counts are compared with those on the computer. The inventory quantities on the computer are amended when significant differences are found.
4. The system allows:
   - details of new products and the selling prices of products to be added or amended
   - inventory quantities to be amended from differences found at the inventory count
   - special prices to be charged to customers (e.g., when the product is damaged or discontinued)

   The main products the company sells are:
   - slow-moving products, such as televisions, video recorders, digital cameras, and audio equipment
   - fast-moving, low-value products, such as batteries, electrical and charging cords, and thumb drives

Required

- **a.** Describe the edit checks that should be incorporated into the computer system to ensure that details of goods received are correctly entered into the computer.
- **b.** **i.** Suggest how often inventory should be test-counted.
  ii. Describe the procedures the company should carry out to ensure the inventory quantities in the computer system are accurate.
- **c.** Describe the controls that should be used to ensure that the prices of the products on the computer file and on the products in the store are correct.

Source: Adapted from ACCA Audit Framework, Paper 6, December 1994.

12.4 Management of the physical inventory count **Moderate** **LO 2, 3, 4**

Lily Window Glass Co. (Lily) is a glass manufacturer that operates from a large production facility, where it undertakes continuous production 24 hours a day, seven days a week. Also on this site are two warehouses where the company's raw materials and finished goods are stored. Lily's year end is December 31.

Lily is finalizing the arrangements for the year-end inventory count, which is to be undertaken on December 31, 2023. The finished windows are stored in 20 aisles of the first warehouse. The second warehouse is for large piles of raw materials, such as sand, used in the manufacture of glass. The following arrangements have been made for the inventory count.

The warehouse manager will supervise the count as he is most familiar with the inventory. There will be 10 teams of counters and each team will contain two members of staff, one from accounting and one from the manufacturing department. None of the warehouse staff, other than the manager, will be involved in the count.

Each team will count an aisle of finished goods by counting up and then down each aisle. As this process is systematic, it is not felt that the team will need to flag areas once counted. Once the team has finished counting an aisle, they will hand in their sheets and be given a set for another aisle of the warehouse. In addition to the above, to assist with the inventory counting, there will be two teams of counters from the internal audit department and they will perform inventory counts.

The count sheets are sequentially numbered, and the product codes and descriptions are printed on them but no quantities. If the counters identify any inventory that is not on their sheets, they are to enter the item on a separate sheet, which is not numbered. Once all counting is complete, the sequence of the sheets is checked and any additional sheets are also handed in at this stage. All sheets are completed in ink.

Any damaged goods identified by the counters will be too heavy to move to a central location; hence they are to be left where they are but the counter is to make a note on the inventory sheets detailing the level of damage.

As Lily undertakes continuous production, there will continue to be movements of raw materials and finished goods in and out of the warehouse during the count. These will be kept to a minimum where possible.

The level of work in process in the manufacturing plant is to be assessed by the warehouse manager. It is likely that this will be an immaterial balance. In addition, the raw materials quantities are to be approximated by measuring the height and width of the raw material piles. In the past this task has been undertaken by a specialist; however, the warehouse manager feels confident that he can perform this task.

Required

For the inventory count arrangements of Lily Window Glass Co.:

- **a.** Identify and explain *six* deficiencies.
- **b.** Provide a recommendation to address each deficiency.

12.5 The audit of an inventory count: substantive procedures **Moderate** **LO 2, 4**

Refer to Professional Application Question 12.4 regarding Lily Window Glass Co. Now assume that you are the audit senior of Daffodil & Co. and are responsible for the audit of inventory for Lily. You will be attending the year-end inventory count on December 31, 2023. In addition, your manager wishes to use computer-assisted audit techniques for the first time for controls and substantive testing in auditing Lily's inventory.

Required

Describe the procedures to be undertaken by the auditor during the inventory count of Lily Window Glass Co. in order to gain sufficient appropriate audit evidence.

Source: Adapted from ACCA Audit and Assurance (International), Paper F8, December 2012.

12.6 Inventory count recommendations **Basic** **LO 2, 4**

You attended the inventory count of your client Davis Hydraulics Ltd. You observed the following during the count:

1. Warehouse staff counted specific areas of the inventory as determined by the warehouse supervisor; staff members, including the warehouse supervisor, were allocated their own area to count.
2. Several blank paper sheets were issued to count staff for recording inventory counted.
3. Staff were instructed to write down the inventory description and number counted.
4. Staff were told to write the inventory quantities in pencil on the sheets to ensure errors can be corrected.
5. Any staff that completed a section early were allocated to another area to help out one of the other staff.
6. The supervisor collected all sheets at the end of the count to finalize the inventory count.

Required

Identify the weaknesses in the inventory procedures above and recommend how they could be improved.

12.7 Physical inventory—substantive procedures **Moderate** **LO 2, 4**

Stenton Toys Ltd. is a toy retailer with stores in each of the Canadian provinces. Stenton has a head office and a central warehouse in Mississauga, Ontario. All inventory purchases are made centrally and are held in the Mississauga warehouse; they are then dispatched around the country as needed by each of the stores. Details of inventory movements are recorded on a perpetual inventory system and Stenton carries out year-end inventory counts at all locations.

You are the auditor of Stenton and are planning the audit of the inventory count that is about to take place. You have established the following from your planning procedures:

1. An inventory report will be produced from the inventory system for each store and the warehouse. The report gives details of inventory code, item description, units held, and unit selling price. The report also gives a breakdown of where inventory items are held and the total value of items held at each location.
2. A sales movement report is also produced that gives details of inventory code, unit descriptions, units purchased for the period and their cost price, and units sold in the period.
3. The largest shop is in Toronto and 35 percent of all inventory is held there.
4. The Winnipeg shop has suffered significant levels of inventory shrinkage recently.
5. To facilitate the inventory count, an additional report is produced that includes only the inventory code and description. Inventory counters use this report to indicate the units of inventory held at the time of the count.

Required

Describe how you would select samples to test the existence and completeness of inventory units. Indicate how the sample sizes used in the Toronto and Winnipeg stores would differ.

12.8 Inventory valuation **Basic** **LO 1, 4**

The auditor's working paper for auditing inventory balances for the client New Millennium Ecoproducts appears in **figure 12.3**. It shows the details of the net realizable value (NRV) tests.

Required

a. Why does an auditor test for NRV when auditing inventory?

b. Find the details of the inventory items selected for NRV testing. What is a "key item"? Explain how the auditor has decided whether the inventory items should be shown at NRV or cost.

c. Are any inventory items to be written down to NRV in this example? If so, by how much?

12.9 Inventory—net realizable value **Moderate** **LO 4**

You are the auditor of John Benson Ltd., a manufacturer of a variety of paper and cardboard stationery products. Product lines range from everyday items that are low value but high volume to more expensive and specialized items that are produced for niche markets. Closing inventory includes finished goods, work in process, and raw materials.

You have completed the inventory count procedures and are happy that the inventory quantities are correct. You are also happy that the cost of each product line has been correctly calculated. You are now focused on assessing the net realizable value to establish if there is any need for an inventory writedown. You have assessed a possible risk related to the net realizable value of work in process and finished goods.

CLIENT: New Millennium Ecoproducts	F07 – NET REALIZABLE VALUE TESTING	W&S PARTNERS	Prepared by: LH
Period-end: 12/31/2023		Reference	Date: 2/22/2024
Currency/unit: $		F07	Reviewed by:
			Date:

				[A]	[B]	[B/A=C]		[D]	[E]		[D – E – C]			
Sample number	**Item code**	**Description**	**Category**	**Quantity in stock**	**Total inventory value (Currency unit)**	**Unit price (Currency unit)**	**TM/ Ref**	**Selling price per unit (Currency unit)**	**Distribution costs? (Currency unit)**	**TM/ Ref**	**Variance**	**Allowance needed?**	**Amount**	**Comments**
Key item														
	700025	switches	Purchased goods	2,000	10,000	5	**SL**	33	1	✓	27	No	—	
	etc....													
Representative sample														
1	701442	routers	Purchased goods	25	13,500	540	**SL**	420	1	✓	(121)	Yes	(3,025)	**A**
2	800245	fuses	Purchased goods	700	7,000	10	**SL**	28	1	✓	17	No	—	
3	800347	covers	Purchased goods	280	4,200	15	**SL**	45	1	✓	29	No	—	
4	etc....													

Key to audit tickmarks:

✓ Agrees to supporting documentation — sales invoice post year end

✓ Obsolescence provision is detailed as follows (refer to the review of inventory obsolescence provision in **F08** in GAMx):

Item	Value ($000)	
701442	3	**A**
233999	50	
234567	49	
987239	50	
Total	152	**F-Lead**

Comments:

None (No error detected, exception noted was correctly provided for by the company.)

FIGURE 12.3 **Working paper for inventory balances**

Required

Discuss the procedures that you should carry out to satisfy yourself that the writedown to ensure inventory is recorded at the lower of cost and net realizable value is adequate.

12.10 Physical inventory: substantive procedures **Basic** **LO 2, 3, 4**

Your firm is responsible for auditing the financial statements of Hucknall Manufacturing Ltd. for the year ended November 30. The company operates from a single site. Its sales are $5 million and the profit before tax is $110,000. There are no inventory records, so the inventory counts at year end will be used to value the inventory in the financial statements. Because Monday, November 30, is a normal working day, it has been decided that the inventory count should take place on Sunday, November 29, when there is no movement of inventory.

The company has produced the following schedule to determine the value of inventory at November 30, from that counted on November 29.

		$	$
Value of inventory counted at Nov. 29			583,247
Add	Cost of goods received on Nov. 30	10,969	
	Production labour on Nov. 30	3,260	
	Overhead relating to labour at 120%	3,912	18,141
Less	Cost of sales on Nov. 30		(36,740)
Value of inventory at Nov. 30			564,648

The company keeps basic accounting records using a standard software package. The following accounting procedures are used for sales, purchases, and wages.

1. The shipping department creates shipping documents when the goods are sent to customers. Sales invoices are produced based on the shipping documents. Sales invoices are input into the computer, which posts them to the accounts receivable ledger and the general ledger.
2. When goods are received, a receiving report is prepared. Purchase invoices are matched with the receiving reports and purchase orders, and authorized by the chief executive officer. After the purchase invoices have been authorized, they are input into the computer, which posts them to the accounts payable ledger and the general ledger.

Required

a. Describe the audit procedures you should perform to verify the accuracy of the inventory count:

  i. before the inventory count

  ii. on the day of the inventory count

  Include details of the matters you should record in your working papers for follow-up at the final audit.

b. Explain the substantive procedures you should perform to check the company's schedule (as shown above) that adjusts the value of inventory at November 29, to that at the company's year end of November 30. You are required to verify only the total value of inventory of $564,648 at November 30. You are not required to describe the procedures necessary to verify the accuracy of the individual values of raw materials, work in process, or finished goods.

c. Describe the substantive procedures you should perform to check purchases cut-off at the year end.

Source: Adapted from ACCA Audit Framework, Paper 6, December 1998.

12.11 Substantive testing of inventory **Basic** **LO 2, 3, 4**

Securimax Limited has been an audit client of KFP Partners for the past 15 years. Securimax is based in Waterloo, Ontario, where it manufactures high-tech armour-plated personnel carriers. Securimax often has to go through a competitive market tender process to win large government contracts. Its main product, the small but powerful Terrain Master, is highly specialized, and Securimax does business only with nations that have a recognized, democratically elected government. Securimax maintains a highly secure environment, given the sensitive and confidential nature of its vehicle designs and its clients.

In September 2023, Securimax installed an off-the-shelf costing system to support the highly sophisticated and cost-sensitive nature of its product designs. The new system replaced a system that had been developed in-house, as the old system could no longer keep up with the complex and detailed manufacturing costing process that provides tender costings. The old system also had difficulty with the company's broader reporting requirements.

The manufacturing costing system uses all of the manufacturing unit inputs to calculate and produce a database of all product costs and recommended sales prices. It also integrates with the general ledger each time there are product inventory movements, such as purchases, sales, wastage, and damaged inventory losses.

Securimax's financial year end is December 31.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, May 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

Required

a. What inventory items would you expect to see in Securimax's accounts? How would the cost of each item be calculated?

b. Suggest some substantive procedures that you would use in the audit of inventory for Securimax. Justify your choices with respect to the risk assessment.

12.12 Property, plant, and equipment—substantive procedures Moderate LO 5, 6, 7

Your firm is auditing the financial statements of Newthorpe Manufacturing Ltd. for the year ended June 30, 2023. You have been assigned to the audit of the company's property, plant, and equipment, which includes freehold land and buildings, plant and machinery, fixtures and fittings, and motor vehicles.

The freehold land and buildings were purchased 10 years earlier (in July 2013) for $2 million. At the date of purchase, a valuator estimated that the land and the buildings each had a value of $1 million. Depreciation has been charged since 2013 on the buildings at 2 percent per year on cost. At June 30, 2023, the accumulated depreciation is $200,000 before the revaluation.

A qualified valuator, who is not an employee of the company, valued the land and buildings at $5 million ($2.9 million for the land and $2.1 million for the buildings). These values will be incorporated into the financial statements as at June 30, 2023.

The partner in charge of the audit is concerned at the large increase in the value of the land and buildings since they were purchased. She has asked you to check the reliability and accuracy of the valuation. She suggested that CAS 620 *Using the Work of an Auditor's Expert* could help you in carrying out this work.

In addition, you have been asked to verify the existence and completeness of plant and machinery recorded in the company's computerized asset register, which records the description of each asset, the original cost, the depreciation charge, and the accumulated depreciation.

Required

a. Describe the audit work you will carry out to check whether the valuator has provided an accurate and independent valuation of the land and buildings.

b. Describe the audit work you will carry out to check the existence and completeness of plant and machinery, as recorded in the company's fixed asset master file.

Source: Adapted from ACCA Audit Framework, Paper 6, June 1997.

12.13 PPE additions and disposals Basic LO 5, 6, 7

A copy of the auditor's working paper for auditing additions and disposals relevant to the balance of property, plant, and equipment (PPE) for the client New Millennium Ecoproducts is presented in **figure 12.4**.

Required

a. What assertions are relevant to **(i)** additions and **(ii)** disposals of PPE?

b. Find the details of the additions. Explain the difference between the two items, particularly with respect to depreciation.

c. Find the details of the disposal. How much was the gain or loss on sale? Why is the auditor interested in the amount of the gain or loss? Explain the comment by the auditor about the disposal in the working paper.

CLIENT: New Millennium Ecoproducts Period-end: 12/31/2023 Currency/unit: $000 Debit/<Credit>	**K02 – ADDITIONS AND DISPOSALS**	W&S PARTNERS **Reference** K02	Prepared by: LH Date: 2/22/2024 Reviewed by: Date:

Section 1: Additions

Asset Code	Description	Category	Depreciation Starting Date	TM/Ref	Asset Life (years)	Amount	TM/ Ref
700025	Semi trucks (15)	Equipment	01/05/23	c	10	2,750	✓
N/A	CPX 120	Asset under construction	N/A	c	N/A	500	✓

Section 2: Disposals

Asset Code	Description	Category	Gross Book Value	Accumulated Depreciation	Net Book Value	Selling Price	TM/Ref	Gain/(Loss) on Disposal
600662	Semi trucks (3)	Equipment	420	280	140	75	✗	(65)

Key to audit tickmarks:

✓Agrees to purchase invoice

✗ Agrees to sales invoice and receipt of payment

c OK depreciation starting date appears reasonable

Comments:
No issue from testing of additions
Loss on disposal of items tested is material and does not confirm relevance of depreciation rate used by company.

FIGURE 12.4 Working paper for PPE additions and disposals

12.14 Depreciation expense—substantive procedures **Basic** **LO 5, 7**

Pineapple Beach Hotel Co. (Pineapple) operates a hotel providing accommodation, leisure facilities, and restaurants. Its year end was April 30, 2023. You are the audit senior of Berry & Co. and are currently preparing the audit program for the year-end audit of Pineapple. You are reviewing the notes of last week's meeting between the audit manager and controller where the following material issue was discussed.

Pineapple incurred significant capital expenditures during the year on updating the leisure facilities for the hotel. The controller has proposed that the new leisure equipment be depreciated over 10 years using the straight-line method.

Required

Describe substantive procedures to obtain sufficient and appropriate audit evidence in relation to the above issue.

Source: Adapted from ACCA Audit and Assurance (International), Paper F8, June 2012.

12.15 Property, plant, and equipment—substantive procedures **Moderate** **LO 5, 7**

Your firm is the auditor of Daybrook Insurance Brokers Ltd., which operates from a number of branches and provides insurance for the general public and businesses. The company obtains insurance from large insurance companies and takes a commission for its services. You have been asked to audit certain aspects of the company's property, plant, and equipment for the year ended December 31, 2023.

The company's main property, plant, and equipment include:

- freehold land and buildings
- computers, printers, and related equipment, which are used by staff
- cars, which are provided to directors and salespeople who visit customers

The company has been operating for a number of years, and it maintains details of its office equipment and cars on a computerized fixed asset master file. The company uses the following depreciation rates:

- buildings (5 percent straight-line)
- office equipment (including computers) (10 percent straight-line)
- cars (25 percent straight-line)

You are concerned that the depreciation rate for the computers may be inadequate.

Required

a. Describe how you would verify the ownership of freehold land and buildings, computers, and cars.

b. Explain how you would determine that the depreciation rate on the various assets is adequate.

Source: Adapted from ACCA Audit Framework, Paper 6, June 1997.

12.16 Property, plant, and equipment—audit objectives **Challenging** **LO 5, 7**

Wear Wraith (WW) Co.'s main activity is the extraction and supply of building materials including sand, gravel, cement, and similar aggregates. The company's year end is December 31 and your firm has audited WW for a number of years. The main assets on the statement of financial position are property, plant, and equipment. The following draft asset note for the financial statements has been prepared. The note has not been reviewed by the senior accountant and so may contain errors.

Property, plant, and equipment (draft):

Depreciation rates stated in the financial statements are all based on cost and calculated using the straight-line basis. The rates are:

- land and buildings (2 percent)
- plant and machinery (20 percent)
- motor vehicles (33 percent)
- railway trucks (20 percent)

Disposals in the motor vehicles category relate to vehicles that were five years old. A list of all property, plant, and equipment is in table 12.7.

TABLE 12.7 **Property, plant, and equipment note details**

	Land and Buildings	Plant and Machinery	Motor Vehicles	Railway Trucks	Total
Cost	**$**	**$**	**$**	**$**	**$**
Dec. 31, 2022	100,000	875,000	1,500,000	—	2,475,000
Additions	10,000	125,000	525,000	995,000	1,655,000
Disposals	—	(100,000)	(325,000)	—	(425,000)
Dec. 31, 2023	110,000	900,000	1,700,000	995,000	3,705,000
Accumulated Depreciation					
Dec. 31, 2022	60,000	550,000	750,000	—	1,360,000
Charge	2,200	180,000	425,000	199,000	806,200
Disposals	—	(120,000)	(325,000)	—	(445,000)
Dec. 31, 2023	62,200	610,000	850,000	199,000	1,721,200
Net book value					
Dec. 31, 2023	47,800	290,000	850,000	796,000	1,983,800
Dec. 31, 2022	40,000	325,000	750,000	—	1,115,000

(*continued*)

TABLE 12.7 Property, plant, and equipment note details (*continued*)

- Land and buildings relate to company offices and land for those offices.
- Plant and machinery include extraction equipment such as diggers and dump trucks used to extract sand and gravel, etc.
- Motor vehicles include large trucks to transport the sand, gravel, etc.
- Railway trucks are containers used to transport sand and gravel over long distances on the railway network.

Required

a. List the audit work you should perform on railway trucks.

b. You have just completed your analytical procedures of the property, plant, and equipment assets note.

  i. Excluding railway trucks, identify and explain any issues with the property, plant, and equipment note to raise with management.

  ii. Explain how each issue could be resolved.

Source: Adapted from ACCA Audit and Internal Review, June 2006.

Case Study—Cloud 9

Answer the following question based on the information presented for Cloud 9 in Appendix A of this book and in the current and earlier chapters. You should also consider your answers to the case study questions in earlier chapters.

While Cloud 9 maintains a perpetual inventory system, a full inventory count was done at year end. Weijing Fei, a junior W&S staff member, attended and observed the count. She subsequently prepared the following memo to file. Sharon is quite busy and she has asked you to critique the memo on her behalf.

Memo to File re: Inventory Test Count

By: Weijing Fei

On December 31, 2023, I attended the inventory count at the Cloud 9 Ltd. warehouse located in Richmond, B.C. A perpetual inventory system is maintained and warehouse staff perform physical counts of the running shoes on a weekly basis. The warehouse was closed to ensure the count would not be affected by incoming or outgoing orders.

The count was supervised by Carla Johnson and the warehouse manager. Count teams consisted of two employees. One person counted, while the other recorded the item. Count sheets were sequential. Each count team was provided with plain paper for items that may not have been listed on the count sheets. The inventory was arranged neatly and orderly, with all footwear stacked on shelves by type. The shelves are normally stacked five boxes high by shoe type. Count tags were used and the warehouse is organized. If there were too many shoes of the same type to fit on one shelf, then the excess was stacked on the shelf above, next to it, or in another marked shelf where room was available. Therefore, some shelves had more than one type of running shoe on them as a result of this. If shoes of the same kind were located on other shelves, then a tag was added to the shelf indicating where the rest could be located and how many were stacked there.

All footwear boxes were marked with labels that described the shoe style and type (model, size) and all of the shoes were arranged such that these labels were facing outward and could therefore be read by the counters.

Sample:

Chose a sample of 20 items for testing, 10 floor to sheet and 10 sheet to floor.

Results:

No errors were detected in the sample of inventory that was chosen.

Conclusion:

The year-end inventory listing has been adjusted to actual per-count results and can be relied upon.

Required

Critique the memo to file prepared by Weijing. Note both good and bad points.

Research Question 12.1

Consider the following statement:

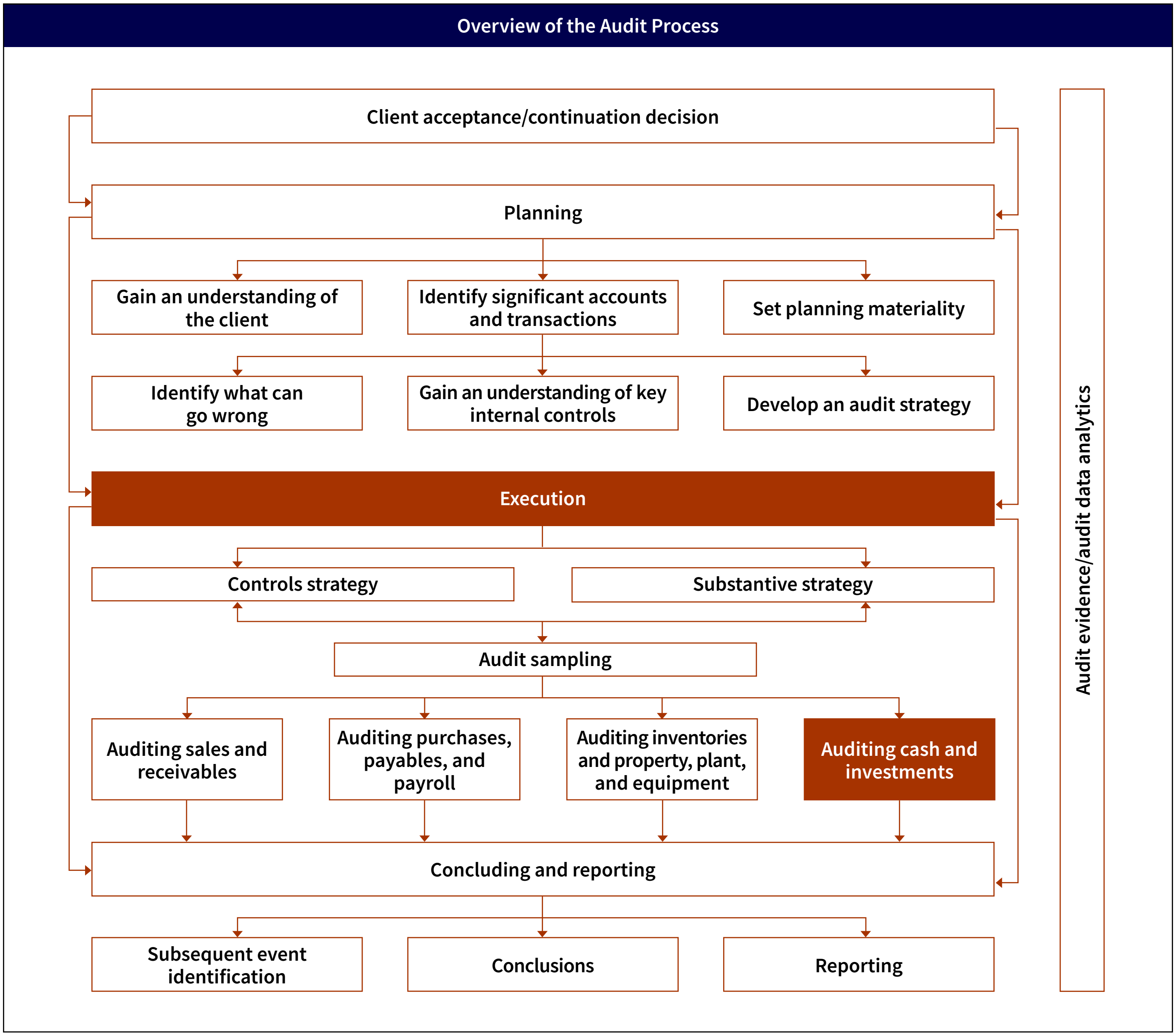
The audit of inventory is one of the riskiest areas of the audit. Management can manipulate the value of inventory through a variety of methods, such as through varying the provision for obsolescence or the method of valuation. It is therefore an area that can be "massaged" by management to achieve its required profit level.

Required

a. Evaluate the statement and illustrate by researching the corporate collapse of Australian retailer Harris Scarfe, where inventory manipulation allowed the company to report "profits" for a number of years.

b. Consider IAS 2 *Inventories* and the complementary auditing standard CAS 501. How is the issue of estimation in the recording of inventory considered, and what audit procedures should have prevented the Harris Scarfe manipulation of inventory figures?

Auditing Cash and Investments



LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
After studying this chapter, you should be able to:		Standards addressed in each learning objective are as follows:
1 Identify the audit objectives applicable to cash	**13.1** Audit Objectives for Cash	CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
2 Discuss considerations relevant to determining the audit strategy for cash	**13.2** Audit Strategy for Cash **13.2.1** Bank reconciliations **13.2.2** Imprest accounts	CAS 315 *Identifying and Assessing the Risks of Material Misstatement* CAS 330 *The Auditor's Responses to Assessed Risks*
3 Design and execute an audit program for cash balances	**13.3** Substantive Procedures for Cash Balances **13.3.1** Initial procedures **13.3.2** Analytical procedures **13.3.3** Tests of details of transactions **13.3.4** Tests of balances **13.3.5** Disclosure	CAS 330 *The Auditor's Responses to Assessed Risks*
4 Describe special considerations when auditing cash balances, including lapping, petty cash funds, and imprest bank accounts	**13.4** Special Considerations for Cash Balances **13.4.1** Detecting lapping **13.4.2** Auditing imprest petty cash funds **13.4.3** Auditing imprest bank accounts	
5 Identify the audit objectives applicable to investments	**13.5** Audit Objectives for Investments	CAS 315 *Identifying and Assessing the Risks of Material Misstatement*
6 Discuss considerations relevant to determining the audit strategy for investments	**13.6** Audit Strategy for Investments **13.6.1** Control environment **13.6.2** Functions and related controls	CAS 315 *Identifying and Assessing the Risks of Material Misstatement* CAS 330 *The Auditor's Responses to Assessed Risks*
7 Design and execute an audit program for investments	**13.7** Substantive Procedures for Investments **13.7.1** Initial procedures **13.7.2** Analytical procedures **13.7.3** Tests of details of transactions **13.7.4** Tests of details of balances **13.7.5** Disclosure	CAS 330 *The Auditor's Responses to Assessed Risks*
8 Explain the special considerations applicable to the audit of investments in subsidiaries, associates, and joint ventures	**13.8** Auditing Consolidated Financial Statements **13.8.1** Audit strategy for consolidated financial statements	CAS 315 *Identifying and Assessing the Risks of Material Misstatement* CAS 330 *The Auditor's Responses to Assessed Risks*

LEARNING OBJECTIVE	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
	13.8.2 Substantive procedures	CAS 540 *Auditing Accounting Estimates and Related Disclosures* CAS 600 *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)* IFRS 10 *Consolidated Financial Statements* IAS 27 *Separate Financial Statements* IAS 28 *Investments in Associates and Joint Ventures* IFRS 11 *Interests in Joint Arrangements* IAS 7 *Statement of Cash Flows*

Cloud 9 Integrated Case

Josh is reviewing the balance sheet and observes that cash and investments are the only assets on the balance sheet left to audit. He recognizes that, now that Cloud 9 operates a retail unit, there is cash on hand, and therefore, there is a greater risk of theft of cash. Sharon, the audit manager, indicated there is now a greater risk of skimming, a type of embezzlement that may occur when staff handle cash and have direct contact with the customer. With the use of cash registers at the Cloud 9 retail store, it is possible for employees to select the "no sale" button on the till and keep the cash; therefore, it appears the employees are using the till but a sale has not been recorded. The cash in the till at the end of the day will still reconcile to the sales recorded. Josh wonders if the Cloud 9 management has disabled the no sale button on the cash registers and implemented other strong controls over cash processing to prevent this from happening.

Chapter Preview

Cash normally comprises cash balances at the bank or similar institutions and cash on hand. In some cases, cash can, in fact, be a negative balance and thus a liability, such as when an entity is operating a bank overdraft facility. Cash on hand includes undeposited receipts and petty cash. Cash at bank includes cash held in current and savings accounts and in imprest accounts, such as payroll bank accounts, that is available on demand. Accounting standards also allow for an intermediate category of investments referred to as cash equivalents. Cash equivalents are highly liquid investments readily convertible to known amounts of cash, usually within three months. These are included with cash in the statement of cash flows and may be included with cash in the balance sheet (also known as the statement of financial position).

Other bank balances that are not readily available do not meet the definition of cash equivalents (such as debenture sinking fund cash and other accounts that have restrictions on their use). These items should ordinarily be classified as investments, rather than as part of cash balances. Unlike other balance sheet account balances, cash may be either an asset or a liability. The latter arises when the bank or other institution with which the entity holds an account grants the entity an overdraft. That is, the entity is allowed to write cheques or transfer funds in excess of the balance in the account up to an agreed limit.

The internal control structures for transactions affecting both cash and investment assets in connection with the audits of sales and purchases were described earlier. This chapter is concerned mainly with the application of substantive audit procedures aimed at verifying the cash and investment account balances, but also considers two key control procedures over the safekeeping of cash and investment assets: (1) the use of bank reconciliations in the case of cash and (2) the maintenance of an investment register.

For each of these account balances, this chapter discusses the audit objectives, considerations when determining the audit strategy including controls, and applicable substantive procedures. Special consideration is given, in the audit of cash, to procedures designed to detect a fraud known as lapping and to the audit of petty cash balances and imprest bank accounts.

A particular feature of the audit of investments is the special disclosure requirement for investments in subsidiaries, associates, and joint ventures. It is usually in the form of consolidated financial statements. This chapter also explains the additional audit responsibilities in verifying investments in group entities, and the responsibilities for the consolidated financial statements.

13.1 Audit Objectives for Cash

LEARNING OBJECTIVE 1

Identify the audit objectives applicable to cash.

In the auditing of cash and investments, the key issues are to ensure that:

- The cash exists and is owned by the client and all cash transactions at the end of the reporting period are complete and properly disclosed.
- The investments exist, are owned, are properly recorded (including profits or losses on any sales) and disclosed, and are properly valued at the end of the reporting period.

Internal control considerations and the related audit objectives for cash receipts and payments were covered previously. This chapter focuses mainly on verifying the cash account balance. Table 13.1 shows the account balance audit objectives.

TABLE 13.1 Selected specific audit objectives for cash balances

Account Balance and Related Disclosure Objectives	
Existence (**OE**)	Recorded cash balances exist at the end of the reporting period (**OE1**). Lines of credit, loan guarantees, and other restrictions on cash balances are appropriately disclosed (**OE2**).
Rights and obligations (**RO**)	The entity has legal title to all cash balances shown at the end of the reporting period (**RO1**).
Completeness (**C**)	Recorded cash balances include the effects of all cash transactions that have occurred (**C1**). Year-end transfers of cash between banks are recorded in the proper period (**C2**). Cash balances are properly identified and included in the balance sheet (**C3**).

(continued)

TABLE 13.1 Selected specific audit objectives for cash balances (*continued*)

Accuracy, valuation, and allocation (**AV**)	Recorded cash balances are realizable at the amounts stated on the balance sheet and agree with supporting schedules (**AV1**). Cash balances are disclosed accurately and at appropriate amounts (**AV2**).
Classification (**D**)	Cash balances are recorded in the correct accounts (**D1**).
Presentation (**D**)	Cash balances are appropriately aggregated or disaggregated, clearly described, and the related disclosures are relevant and understandable (**D2**).

Before You Go On

13.1.1 What items are included in cash balances?

13.1.2 What are cash equivalents?

13.1.3 What are the key issues when auditing cash and investments?

13.2 Audit Strategy for Cash

LEARNING OBJECTIVE 2

Discuss considerations relevant to determining the audit strategy for cash.

For many entities, cash balances represent only a small proportion of assets. However, the amount of cash flowing through the accounts over a period of time is usually greater than for any other account in the financial statements. Moreover, cash is vital to the survival of the business as a going concern. The inability of an entity to pay its debts as they fall due because it has a shortage of cash can render a company insolvent, despite the profitability of its operations. The cash balance is material in a qualitative way even though it may not always be material in a quantitative way. **Figure 13.1** illustrates the effects of the different transaction cycles on the cash balance, showing that the cash account is affected by all of the business processes and therefore many accounting transactions affect that account.

The high volume of transactions contributes to a significant level of inherent risk for cash balance assertions, particularly existence and completeness. In addition, the nature of cash balances makes them susceptible to theft, as evidenced by numerous kinds of fraudulent schemes involving cash. In contrast to receivables or inventories, however, the risks pertaining to the rights and obligations assertion and the accuracy, valuation, and allocation and disclosure assertions for cash are minimal, given the absence of complexities involving these assertions.

When planning the audit, it is necessary to consider the effectiveness of control procedures that are designed to ensure the correctness of the recorded balance by way of regular bank reconciliations and the use of imprest accounts.

While the auditor generally adopts a substantive approach to the audit of cash balances, an understanding of procedures for maintaining accountability over cash is necessary in designing the substantive tests of details. The main procedures are:

- independently performed bank reconciliations
- the use of imprest accounts

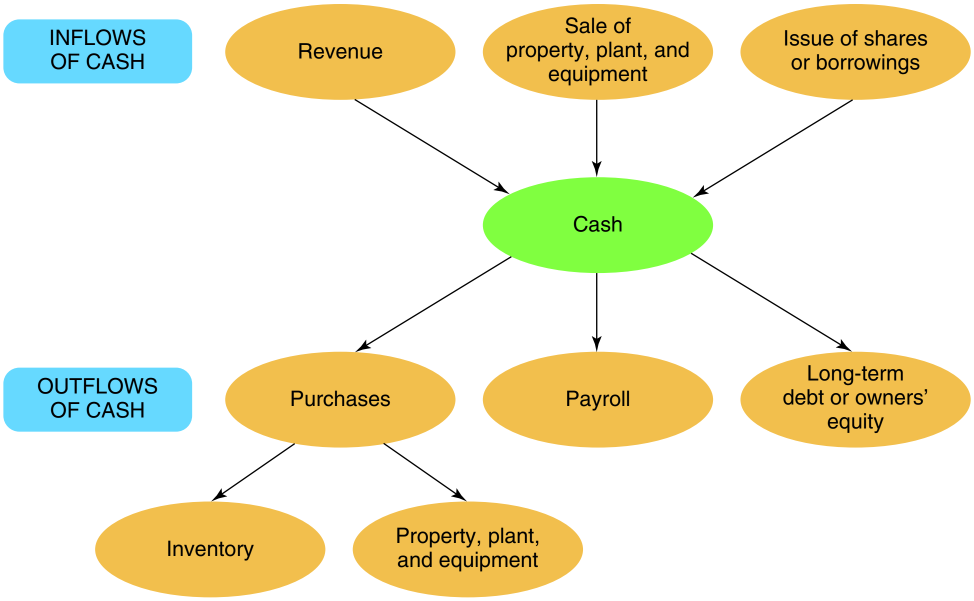


FIGURE 13.1 **The effects of major accounting transactions on cash**

13.2.1 Bank Reconciliations

bank reconciliations schedules agreeing the balance of cash at the bank per the entity's records with the balance shown per the bank. The most common reconciling items are deposits in transit and outstanding cheques.

In the audit of cash receipts and cash payments, the auditor will have obtained an understanding of **bank reconciliations** and tested controls relating to their preparation and use. A working paper including a bank reconciliation is illustrated in **figure 13.2**. This is a major internal control that relates to the audit of cash. It involves an independent comparison of the balance shown on the bank statement and the balance recorded in the entity's records. The difference between the two is reconciled by listing deposits in transit and outstanding cheques. Verifying the reconciliation of the bank account at the end of the reporting period is an important substantive procedure.

13.2.2 Imprest Accounts

imprest petty cash fund petty cash fund maintained at a constant level via replenishment with the value of amounts paid out of the fund

An **imprest petty cash fund** is established by transferring a specified amount of cash, such as $500 or $750, to a petty cash box. When cash is paid out of the fund, an authorized voucher is placed in the petty cash box in its place. This voucher could be a supplier's invoice or a special petty cash voucher authorized by a responsible official. When the cash gets low, the vouchers are used as support for a cheque requisition to replenish the fund. On replenishment, the cash in the petty cash box is restored to its imprest level.

The following internal control features apply to the management of an imprest petty cash fund:

- The fund should be maintained at the imprest level; that is, cash in the fund plus vouchers for payments should always equal the imprest amount.
- The fund should be in the custody of one person.
- The fund should be kept secure and stored in the safe when not in use.
- Payments from the fund should be for small amounts, and documentation should support each payment.
- The fund should not be mingled with other cash.
- Replenishment of the fund should be based on a review of supporting documentation.
- Upon payment, supporting documents should be stamped "paid" to prevent their reuse.

Skyward Ltd.
9/30/2023

C3

Prepared by: LH
Date: 11/15/2023
Reviewed by:
Date:

BANK RECONCILIATION

Prepared by Client

LEDGER ACCOUNT	1006-0-00
DESCRIPTION	CHEQUING ACCOUNT
BANK NAME	LOCAL BANK
RECONCILIATION DATE	Sept. 30, 2023
PERFORMED BY	Bill Reds, Oct. 2, 2023
REVIEWED BY	Noel Moorthy, Oct. 3, 2023

RECONCILIATION

BALANCE PER BANK Sept. 30, 2023			*200,448.90*	B
DEDUCT				
	Wire transfer to Supplier XX - recorded by us in Sept. 2023		41,909.00	A
	Wire transfer to Supplier XX - recorded by us in Sept. 2023		63,621.20	A
	Wire transfer to Supplier XX - recorded by us in Sept. 2023		6,575.00	A
ADD	Service charge - recorded by us in Oct. 2023		55.80	i C
	Net interest expense for September 2023 - recorded by us in Oct. 2023		752.40	i C
BALANCE PER BOOKS Sept. 30, 2023		**C1 lead**	*89,151.90* ✓	

Comments:

A Traced to October bank statement. Processed by bank in Oct. 2023. Noted agreement to description and amounts.

B Traced to bank statement at 9-30-2023. Traced to bank confirmation.

i C Not recorded by client. Amount is, however, immaterial. Pass further review.

✓ checked totals

FIGURE 13.2 **Working paper including a bank reconciliation**

Certain bank accounts, typically payroll and dividend bank accounts, are sometimes also set up on an imprest basis. The **imprest bank account** is opened or replenished with the net payroll, dividends, and so on. When all cheques written on the account have been presented, the balance will be zero or a small preset balance. Until such time, reconciliation can be achieved by comparing the balance per the bank statement with outstanding cheques. Internal controls over an imprest bank account include the following:

imprest bank account bank account funded with a sum sufficient to meet the payment of special-purpose cheques such as wages or dividends

- One person, such as a cashier or the controller, should be authorized to sign cheques drawn on the account.
- Only payroll cheques, dividend cheques, and so on should be written against the account.
- Each pay/dividend period, a cheque for the total net amount payable should be deposited in the imprest bank account.
- The imprest bank account should be independently reconciled each month.

Given the large volume of cash transactions tested in other cycles and the often small account balance, the audit strategy is invariably to concentrate on verifying the account balance.

The approach is therefore usually substantive. The main procedures for cash balances are to audit the bank reconciliation and reconcile that balance to the confirmation from the bank and the closing bank statement balance. The auditor should thus be able to verify the balance exactly because no judgement is needed in determining the figure. Therefore, any differences found will almost always be considered material because of the ease with which the auditor should be able to verify the final balance and the materiality of the transactions that affect this balance.

In auditing the cash balance, the auditor should also be aware of the possibility of fraud. Cash is an area that is more susceptible to fraud than some other areas, so this increases the inherent risk of this part of the audit. This risk is one of the reasons even a small discrepancy in the audit of cash should be followed up. Professional Environment 13.1 outlines a fraud in a large church at the hands of an unscrupulous bookkeeper.

As previously discussed, liquidity is crucial to the company's survival. The cash adequacy and the flows of cash should be reviewed carefully by the auditor.

13.1 Professional Environment Asset Misappropriation

More than 91 percent of internal corporate fraud involves asset misappropriation; of those cases, about 85 percent involve the misuse of cash, and the rest involve the misappropriation of non-cash assets, according to the Association of Certified Fraud Examiners.

There are three types of asset misappropriation. Skimming involves misappropriation before the assets are recorded in the books. Larceny involves theft of cash or misuse of tangible assets such as equipment. The third type involves a scam while the organization is purchasing goods and services, such as fake invoices.

Asset misappropriation can happen where you least expect it, as shown in the following story of a bookkeeper at a large church who skimmed her employer. Her fraud went undetected for two years, even though there were controls in place, including having volunteers count the weekly cash collections together and oversee each other. The volunteers then submitted the cash plus a sheet documenting all the collections to the bookkeeper. But the bookkeeper never deposited the cash, and the documentation was never checked against the bank statements.

How was she found out? She took a sick day, and another employee happened to see a bank statement in an envelope that was open. She looked inside, and saw that the bookkeeper had made cheques payable to herself. The church investigated and uncovered the larger fraud.

Such frauds are not limited to churches and not-for-profit organizations. On a worldwide scale, the cost of fraud to companies is so large the numbers can seem hard to fathom. According to a 2018 global fraud survey published by a UK accounting firm, the typical organization loses 7 percent of its revenues each year to fraud. This translates to "£3.24 trillion each year, a sum equal to the combined GDP of the UK and Italy."

Q: What are possible warning signs that one of your employees could be committing fraud?

Sources: Tracy Coenen, "Asset Misappropriation," *Essentials of Corporate Fraud*, John Wiley & Sons, 2009; Chad Albrecht, Mary-Jo Kranacher, and Steve Albrecht, "Asset Misappropriation Research White Paper for the Institute for Fraud Prevention," Institute for Fraud Prevention, 2008; David Malamed, "The Perils of Fraud," CPA Canada, November 1, 2014, Pat Sweet, "Global Cost of Fraud Tops £3 Trillion," *Accountancy Daily*, May 22, 2018.

Cloud 9 Integrated Case

Josh understands that Cloud 9 has a high volume of cash transactions, resulting in a high inherent risk. He also understands it is a significant account given its impact on liquidity. Even though W&S Partners tested controls over cash transactions when auditing sales and purchases, they will still take a substantive approach to the audit of cash. The substantive procedures will include sending bank confirmations to all banks Cloud 9 does business with and testing the December 31 bank reconciliation.

Before You Go On

13.2.1 What are two control procedures over cash?

13.2.2 Explain an imprest petty cash fund.

13.2.3 What are the key issues when auditing cash and investments?

13.3 Substantive Procedures for Cash Balances

LEARNING OBJECTIVE 3

Design and execute an audit program for cash balances.

Procedures described in this section exclude those for petty cash and impres bank accounts. The audit of these two accounts is considered separately.

As explained previously, the significance of cash to the entity's liquidity and the fact that the balance is relatively small mean that the acceptable level of detection risk in verifying cash balances is invariably set as low.

Table 13.2 lists possible substantive procedures to achieve the specific audit objectives for cash balances. The list is organized in accordance with the general framework for developing audit programs for substantive procedures. Note that several of the tests apply to more than one audit objective and that each objective is covered by multiple possible procedures. Not all of the procedures will be performed in every audit. Each procedure is explained in the sections that follow, including comments on when certain of the tests could be omitted and on how some tests can be tailored based on applicable risk factors.

13.3.1 Initial Procedures

The starting point for verifying cash balances is to trace the current period's opening balances to the closing audited balances in the previous year's working papers. Next, the auditor should review the current period's activity in the general ledger cash accounts for any significant entries that are unusual in nature or amount and that may require investigation. In addition, the auditor obtains any schedules that might have been prepared by the entity showing summaries of undeposited cash receipts at different locations and/or summaries of bank balances. The auditor should determine the mathematical accuracy of such schedules and check their agreement with related cash balances in the general ledger. This test provides evidence about the accuracy, valuation, and allocation assertion. The auditor should also obtain copies of all bank reconciliations for the year.

13.3.2 Analytical Procedures

Cash balances do not normally show a stable or predictable relationship with other current or historical financial or operating data. As a result, the auditor will often not perform any analytical review procedures in this part of the audit. If the auditor does decide to perform some analytical review procedures, they are usually limited to comparisons with previous years' cash balances or with budgeted amounts.

13.3.3 Tests of Details of Transactions

Tests of details of cash receipt and cash payment transactions are performed during the audit of the sales and purchases cycles and give the auditor comfort over the assertions in relation to cash transactions. This chapter looks at tests of transactions around the end of the reporting period (cut-off) that help verify the balance as at that year-end date.

Cash Cut-Off Tests

A proper cut-off of cash receipts and cash payments at the end of the year is essential to the proper statement of cash at the end of the reporting period. Two **cash cut-off tests** are performed:

- a cash receipts cut-off test
- a cash payments cut-off test

cash cut-off tests audit procedures verifying the agreement of cash receipts recorded in the accounting records at close of business with the physical movement of cash

TABLE 13.2 Possible substantive procedures for cash balance assertions

		Cash Balance Audit Objective (from Table 13.1)				
Category	**Substantive Procedure**	**OE 1**	**C No.**	**RO1**	**AV1**	**D No.**
Initial procedures	1. Perform initial procedures on cash balances and records that will be subjected to further testing.				✓	
	(a) Trace opening balances for cash on hand and in the bank to previous year's working papers.					
	(b) Review activity in general ledger accounts for cash and investigate entries that appear unusual in amount or source.					
	(c) Obtain entity-prepared summaries of cash on hand and in the bank, verify mathematical accuracy, and determine agreement with general ledger.					
Analytical procedures	2. Perform analytical procedures by comparing cash balances with expected amounts.	✓	✓1		✓	
Tests of details of transactions	3. Perform cash cut-off tests. (Note: These tests may have been performed as part of the audit programs for accounts receivable and accounts payable.)	✓	✓1			
	(a) Observe that all cash received by the close of business on the last day of the financial year is included in cash and that no receipts of the subsequent period are included, or					
	(b) review documentation such as daily cash summaries, duplicate deposit slips, and bank statements covering several days before and after the year-end date to determine proper cut-off.					
	(c) Observe the last cheque issued and mailed on the last day of the financial year and trace to the accounting records to determine the accuracy of the cash payments cut-off, or					
	(d) compare dates on cheques issued for several days before and after the year-end date to the dates on which the cheques were recorded to determine proper cut-off.					
	4. Trace bank transfers before and after the end of the reporting period to determine that each transfer is properly recorded as a payment and a receipt in the same accounting period.	✓	✓2			
Tests of details of balances	5. Confirm bank balances.	✓	✓1	✓	✓	
	6. Confirm other arrangements with banks.	✓	✓1,3	✓	✓	✓2
	7. Verify reconciliations as appropriate.	✓	✓1,2	✓	✓	
	8. Obtain and use the subsequent period's statements to verify bank reconciliation items and look for evidence of window dressing.	✓	✓1,2	✓	✓	
	9. Count undeposited cash on hand.	✓	✓1	✓	✓	
Classification and presentation	10. Compare statement presentation with applicable accounting standards.					
	(a) Determine that cash balances are properly identified and classified.					✓1
	(b) Determine that bank overdrafts are reclassified as current liabilities.					✓1,2
	(c) Make inquiries of management, review correspondence with banks, and review minutes of board meetings to determine matters requiring disclosure, such as lines of credit, loan guarantees, compensating balance agreements, or other restrictions on cash balances.					✓2

The use of the subsequent period's bank statement (described below) is also helpful in determining whether a proper cash cut-off has been made. Cash cut-off tests are directed mainly at the financial statement assertions of existence and completeness.

Tracing Bank Transfers

Many entities maintain accounts with more than one bank. A company with multiple bank accounts may transfer money between bank accounts. Money may be transferred, for example, from a general bank account to a payroll bank account for payroll cheques (or for direct transfers to employees) that are to be distributed on the next payday. When a bank transfer occurs, there may be a time lag before the transfer clears the bank on which it is drawn. Thus, cash on deposit per bank records will be overstated during this period because the cheque will be included in the balance of the bank in which it is deposited and will not be deducted from the bank on which it is drawn. Bank transfers may also result in a misstatement of the bank balance per books if the payment and receipt are not recorded in the same accounting period.

Intentionally recording a transfer as a deposit in the receiving bank while failing to show a deduction from the account on which the transfer cheque is drawn is an irregularity known as **kiting**. Kiting may be used to conceal a cash shortage or overstate cash in bank at the end of the reporting period.

kiting an irregularity overstating the cash balance by intentionally recording a bank transfer as a deposit in the receiving bank while failing to show a deduction from the bank account on which the transfer is drawn

The auditor identifies bank transfers by analyzing the cash book for a few days either side of the end of the reporting period, then enters these into a **bank transfer schedule**. The schedule is then completed by determining, from applicable bank statements, the dates on which the bank recorded the transfers, as illustrated in **table 13.3**.

bank transfer schedule a schedule prepared by the auditor listing bank transfers for a few days either side of the end of the reporting period, and the dates recorded in the records and the bank statement

If we assume all cheques are dated and issued on December 31, cheque 4100 in table 13.3 has been handled properly because both book entries were made in December and both bank entries occurred in January. This cheque would be listed as an outstanding cheque in reconciling the general bank account at December 31 and as a deposit in transit in reconciling the payroll bank account. Cheque 4275 illustrates a transfer cheque in transit at the closing date. Cash per books is understated by $10,000 because the cheque has been deducted from the balance per books by the issuer in December, but has not been added to the Branch 1 account per books by the depositor until January. Thus, an adjusting entry is required at December 31 to increase the branch balance per books.

Cheques 4280 and B403 illustrate the likelihood of kiting because these December cheques were not recorded as payments per books until January, even though they were deposited in the receiving banks in December. Cheque 4280 results in a $20,000 overstatement of cash at bank because the receipt per the books occurred in December, but the corresponding book deduction was not made until January. Cheque B403 may illustrate an attempt to conceal a cash shortage because the bank deposit occurred in December, presumably to permit the reconciliation of bank and book balances, and all other entries were made in January. Similar issues can apply when transfers are done electronically, although this is much less likely because transactions are often completed on the same day, so the timing issues that relate to cheques around the end of the reporting period would seldom apply.

TABLE 13.3 Bank transfer schedule

	Bank Accounts			Payment Date		Receipt Date	
Cheque Number	From	To	Amount of Cheque ($)	Per Books	Per Bank	Per Books	Per Bank
4100	General	Payroll	50,000	Dec. 31	Jan. 4	Dec. 31	Jan. 4
4275	General	Branch 1	10,000	Dec. 31	Jan. 4	Jan. 3	Jan. 3
4280	General	Branch 2	20,000	Jan. 3	Jan. 3	Dec. 31	Dec. 31
B403	Branch 4	General	5,000	Jan. 3	Jan. 4	Jan. 3	Dec. 31

Kiting is possible when weaknesses in internal controls allow one person to issue and record cheques (that is, there is an improper segregation of duties) or when there is collusion between the people responsible for the two functions. In addition to tracing bank transfers, the auditor may detect kiting by:

- obtaining and using a subsequent period's bank statement, because the kited cheque clearing in January will not appear on the list of outstanding cheques for December
- performing a cash cut-off test, because the last cheque issued in December will not be recorded in the cheque register

The tracing of bank transfers provides reliable evidence concerning the existence and completeness assertions.

13.3.4 Tests of Balances

There are five commonly used substantive tests for cash balances in this category:

1. confirming bank balances
2. confirming other arrangements with banks
3. verifying bank reconciliations
4. obtaining and using the subsequent period's bank statement
5. counting cash on hand

Confirming Bank Balances

bank confirmation written confirmation of the balance at bank and other matters received directly by the auditor from the entity's bank

The auditor normally confirms the bank balance directly with the bank through a **bank confirmation**. This letter is sent to all banks with whom the auditor is aware that the client has a relationship. The form requests information about account balances, securities, loan documents, and other related information held by the bank on behalf of the entity.

The accepted practice is that bank confirmation requests are sent on every audit and it would be considered highly unusual not to send one. The client must sign a letter of authorization to the bank requesting completion of the form. The auditor (in consultation with the client) fills in the account information and the bank is then responsible for completing the information requested. See **figure 13.3** for an example of a bank confirmation.

Confirming cash on deposit provides evidence mainly of the existence of cash at bank (because there is written acknowledgement that the balance exists) and of rights and obligations (because the balances are in the name of the entity). The response from the bank also provides some evidence for the accuracy, valuation, and allocation assertion for cash in that the confirmed balance is used in arriving at the correct cash balance at the end of the reporting period.

Confirming overdraft and loan balances provides evidence of:

- existence, because there is written acknowledgement that the loan balance exists
- rights and obligations, because the loan is a debt of the entity
- accuracy, valuation, and allocation, because the response indicates the amount of the loan balance

This test also contributes to the completeness assertion in the same manner as for confirming deposit balances.

Confirming Other Arrangements with Banks

The bank confirmation also requests information about other arrangements with the bank, such as loans and other contingent liabilities.

The confirmation of other arrangements with the banks is helpful in meeting the disclosure assertion. It also provides evidence for each of the other assertions. However, the evidence for the completeness assertion is limited to information known by the branch officer who is completing the confirmation.

BANK CONFIRMATION

(Areas to be completed by client are marked §, while those to be completed by the financial institutions are marked †)

FINANCIAL INSTITUTION (Name, branch and full mailing address) § Regional Bank of Canada 1234 West Street Toronto, Ontario M5J 2X8 **CONFIRMATION DATE** § December 31, 2023 (**All information to be provided as at this date**) (See Bank Confirmation Completion Instructions)	**CLIENT** (Legal name) § ABC Company Ltd. 987 South Road Toronto, Ontario M8G 3R1 The financial institution is authorized to provide the details requested herein to the below-noted firm of accountants § John Smith Client's authorized signature Please supply copy of the most recent credit facility agreement (initial if required) § ____________________

1. LOANS AND OTHER DIRECT AND CONTINGENT LIABILITIES (If balances are nil, please state)

NATURE OF LIABILITY/ CONTINGENT LIABILITY†	INTEREST (Note rate per contract) RATE †	DATE PAID TO †	DUE DATE †	DATE OF CREDIT FACILITY AGREEMENT †	AMOUNT AND CURRENCY OUTSTANDING †	

ADDITIONAL CREDIT FACILITY AGREEMENT(S)

Note the date(s) of any credit facility agreement(s) not drawn upon and not referenced above †

2. DEPOSITS/OVERDRAFTS

TYPE OF ACCOUNT §	ACCOUNT NUMBER §	INTEREST RATE §	ISSUE DATE (If applicable)§	MATURITY DATE (If applicable)§	AMOUNT AND CURRENCY (Brackets if Overdraft)†

EXCEPTIONS AND COMMENTS
(See Bank Confirmation Completion Instructions)†

STATEMENT OF PROCEDURES PERFORMED BY FINANCIAL INSTITUTION †
The above information was completed in accordance with the Bank Confirmation Completion Instructions.

______________________________ ______________________________
Authorized signature of financial institution BRANCH CONTACT - Name and telephone number

Please mail this form directly to our chartered professional accountant in the enclosed addressed envelope.

Name:	Jason Power, Staff Accountant
Address:	W&S Partners 1200-90 Eglinton Avenue Toronto, Ontario M4P 2Y3 236-8743
Telephone:	(416) 864-1234

Developed by the Canadian Bankers Association and The Chartered Professional Accountants of Canada

FIGURE 13.3 **Bank confirmation**

Where the auditor believes there may be material accounts, agreements, or transactions that they are unaware of, the auditor should contact the bank and request further information.

Verifying Bank Reconciliations

Testing a client's bank reconciliation is central to the audit of cash balances. This testing verifies that the balance confirmed with the bank agrees with the bank balance per the client's records. Follow the steps below by referring to the reconciliation shown in figure 13.2.

1. Check the mathematical accuracy (✓̸) and compare with the general ledger (✓̸̸).
2. Verify the bank balance per the bank confirmation with the bank balance per the reconciliation (ᔐ).
3. Trace outstanding cheques on the bank reconciliation to the subsequent period's bank statement (✓).
4. Trace deposits in transit on the bank reconciliation to the subsequent period's bank statement (✓).
5. Verify any bank charges or errors on the reconciliation with the bank statement or other supporting documentation (ϕ).

Testing or preparing a bank reconciliation establishes the correct cash at the end of the reporting period. Thus, it is a primary source of evidence for the accuracy, valuation, and allocation assertion. It also provides evidence for the existence, completeness, and rights and obligations assertions.

Obtaining and Using the Subsequent Period's Bank Statement

subsequent period's bank statement the first bank statement issued after the end of the reporting period, which is used by the auditor to verify the existence of outstanding deposits and uncleared cheques listed on the bank reconciliation as at the end of the reporting period

The **subsequent period's bank statement** is normally issued at the end of the month following the entity's financial year end. In most situations, this time frame will be sufficient. However, if the audit deadline does not permit waiting for the issue of this statement, then a special statement can be requested. The date should be at a point in time that will permit most of the year-end uncleared cheques to clear the bank, usually 7 to 10 business days after the end of the entity's financial year. On receipt of the subsequent period's bank statement, the auditor should:

- trace all cheques and bank transfers dated but not cleared in the previous financial year to the outstanding cheques and bank transfers listed on the bank reconciliation
- trace deposits or bank transfers in transit on the bank reconciliation to deposits on the statement
- scan the statement for unusual items such as large transfers close to year end

Tracing cheques is designed to verify the list of outstanding cheques. In this step, the auditor may also find that a cheque dated in the previous period that is not on the list of outstanding cheques has cleared the bank and that some of the cheques listed as outstanding have not cleared the bank. The former may be indicative of the irregularity known as kiting, which we explained earlier in connection with bank transfers; the latter may be due to delays in the entity mailing the cheques or in the payees depositing the cheques. The auditor should investigate any unusual circumstances.

window dressing a deliberate attempt to enhance some aspect of a company's apparent short-term solvency, such as by misstating the cut-off of cash receipts and payments

When the aggregate effect of outstanding cheques is material, it may indicate an irregularity known as **window dressing**. This is a deliberate attempt to enhance a company's apparent short-term solvency. (Assume that the entity's balances at the end of the reporting period show current assets of $800,000 and current liabilities of $400,000. If $100,000 of cheques to short-term creditors have been prematurely entered, then the correct totals are current assets of $900,000 and current liabilities of $500,000, which results in a 1.8:1 current ratio instead of the reported 2:1.) Window dressing is normally perpetrated by writing cheques on the last day of the financial year but not mailing them until several weeks later, when cleared funds are available at the bank to meet those cheques. If none of a sequence of cheques is presented for payment on the bank statement for more than two weeks after the end of the reporting period, then the auditor should make inquiries of the treasurer. Recipients do not usually delay depositing cheques once received, and it is normal for most cheques to clear the bank statement within a week of issue. Where the evidence is clear that the company has engaged in material window dressing, the auditor should recommend appropriate adjustments to the cash balance.

The tracing of deposits in transit to the subsequent period's bank statement is normally a relatively simple matter because the first deposit on that statement should be the deposit in transit shown on the reconciliation. When this is not the case, the auditor should determine the underlying circumstances for the time lag from the accountant, and corroborate their explanations. Delays in depositing cash receipts could indicate the practice of lapping. Generally, deposits in transit would be expected to be minimal because of the use of electronic transfers and the speed of processing.

In scanning the subsequent period's statement for unusual items, the auditor should be alert for such items as unrecorded bank debits and credits, and bank errors and corrections. **Figure 13.4** illustrates a deposit made before the year end returned by the drawer's bank after the year end, marked "not sufficient funds" (NSF) and requiring adjustment.

Bates Ltd. Prepared by: <u>C.J.W.</u>
Bank reconciliation—City Bank Date: Jan. 7, 2024
Dec. 31, 2023 Reviewed by: <u>A.C.E.</u>
(Prepared by client) Date: Jan. 11, 2024

Account no. 110 Dec. 31, 2023
Bank acc. no. 12345-642

Balance per bank				$120,262.47 〽
Deposits in transit:	*Per books*	*Per bank*		
	Dec. 29	Jan. 2	8,425.15 ✓	
	Dec. 30	Jan. 7	17,844.79 ✓	26,269.94 ✗
Outstanding cheques:		1047	225.94 ✓	
		1429	21,600.00 ✓	
		1435	47.25 ✓	
		1436	1,428.14 ✓	
		1437	1,000.00 ✓	
		1440	832.08 ✓	
		1441	41.08 ✓	(25,174.49) ✗
Add NSF cheque—ZIM Dec. 28				200.00 ɸ
Balance per books				121,557.92 (✗)
Adjusting entry—AJE4				(200.00)
Balance as adjusted				121,357.92
				To A ✗
Adjusting entry				
Dr Accounts receivable ZIM			200	
Cr Cash in bank				200
NSF cheque charged by bank Dec. 28.				

〽 Verified with bank statement and bank confirmation
✓ Traced to January bank statement
✗ Footed (added)
ɸ Traced to statement and debit memoranda
(✗) Traced to general ledger

FIGURE 13.4 **Review of entity-prepared bank reconciliation**

Counting Cash on Hand

cash count audit procedure of counting cash on hand and agreeing the balance with the accounting records

Cash on hand consists of undeposited cash receipts and change. To perform **cash counts** properly, the auditor should:

- control all cash and negotiable instruments held until all funds have been counted
- insist that the custodian of the cash be present throughout the count
- obtain a signed receipt from the custodian on return of the funds
- ascertain that all undeposited cheques are payable to the order of the entity, either directly or through endorsement

The control of all funds is designed to prevent transfers by entity personnel of counted funds to uncounted funds. The sealing of funds and the use of additional auditors are often required when cash is held in many locations. Having the custodian present and requiring their signature on return of the funds minimizes the possibility, in the event of a shortage, of the custodian claiming that all cash was intact when released to the auditor for counting.

This procedure provides evidence of each of the financial statement assertions except disclosure. Note that the evidence about rights is weak because the custodian of the fund may have substituted personal cash to cover a shortage.

Companies generally try to keep cash on hand to a minimum and therefore this amount is often very immaterial. As a result, in many audits this procedure is not performed, although this should be reassessed when there are circumstances indicating a higher risk of fraud associated with cash.

13.3.5 Disclosure

Cash should be correctly identified and classified in the balance sheet. Cash on deposit, for example, is a current asset, but a fixed-term deposit may be a long-term investment. In addition, there should be appropriate disclosure of arrangements with banks, such as lines of credit, compensating balances, and contingent liabilities.

The auditor determines the appropriateness of the statement presentation from a review of the draft of the entity's financial statements and the evidence obtained from the foregoing substantive procedures. In addition, the auditor should review the minutes of board meetings and inquire of management for evidence of restrictions on the use of cash balances.

Cloud 9 Integrated Case

Josh reviews the cash account at Cloud 9. He notes that there are several bank accounts that make up the cash balance on the balance sheet. For each bank account, he has obtained the bank reconciliation from Carla, the controller, and he has checked that it is mathematically correct. He has also agreed the balance per the bank with the bank confirmation. He has just obtained the subsequent bank statement from the bookkeeper and he is verifying that the deposits in transit and outstanding cheques have cleared since year end. He knows this will verify their existence at year end.

Before You Go On

13.3.1 Why are analytical procedures not often useful when auditing the cash balance?

13.3.2 What is kiting?

13.3.3 Describe the purpose of the subsequent bank statement.

13.4 Special Considerations for Cash Balances

LEARNING OBJECTIVE 4

Describe special considerations when auditing cash balances, including lapping, petty cash funds, and imprest bank accounts.

This section covers three topics: (1) testing to detect an irregularity known as lapping, (2) auditing imprest petty cash funds, and (3) auditing imprest bank accounts.

13.4.1 Detecting Lapping

Lapping is an irregularity that results in the deliberate misappropriation of cash receipts, either temporarily or permanently, for the personal use of the individual perpetrating the unauthorized act. Lapping is usually associated with collections from customers, but it may also involve other types of cash receipts. Conditions conducive to lapping exist when the same person handles cash receipts and maintains the accounts receivable ledger. The auditor should assess the likelihood of lapping in obtaining an understanding about the segregation of duties in the receiving and recording of collections from customers.

lapping an irregularity concealing the misappropriation of cash by using subsequent cash receipts to conceal the original misappropriation

An Example of Lapping

Assume on a given day that cash register receipts totalled $600 and mail receipts opened by the defrauder consisted of one payment on account by cheque for $200 from customer A (total actual receipts = $800). The lapper would steal $200 in cash and destroy all evidence of the mail receipt, except for the customer's cheque. The cash receipts journal entry would agree with the register ($600), and the deposit slip would show cash of $400 and customer A's cheque for $200. These facts can be tabulated as shown in **figure 13.5**.

To conceal the shortage, the defrauder usually attempts to keep bank and book amounts in daily agreement so a bank reconciliation will not detect the irregularity. The defrauder will also need to ensure that customer A's account is correct. This can be done by allocating some of the payment received from another customer (customer B) to customer A's account. As shown in **figure 13.6**, a cheque for $300 is received from customer B, enabling the defrauder to steal another $100 and cover the amount missing from customer A's account. The total shortage is now $300: $200 from the first example plus $100 from the second example.

There will, of course, now be a shortfall in customer B's account that will eventually be covered by a cheque from someone else. To enable this to continue, the same person must always deal with cash receipts. Thus, when the person involved with cash receipts never takes holidays, the auditor needs to take extra care.

A greater risk of fraud occurs when the person in cash receipts is able to make adjustments to the accounts receivable subsidiary ledger. In this situation, the defrauder can take cash as described above, but does not need to cover up because it is a simple matter to record

Actual Receipts		Documentation		Cash Receipts Journal Entry		Bank Deposit Slip	
Cash	$600	Cash tape	$600	Cash sales	$600	Cash	$400
Customer A's cheque	200		—		—	Customer A's cheque	200
	$800		$600		$600		$600

FIGURE 13.5 Sample cash receipts journal entry—customer A

Actual Receipts		Documentation		Cash Receipts Journal Entry		Bank Deposit Slip	
Cash	$500	Cash tape	$500	Cash sales	$500	Cash	$400
Customer B's cheque	300	Customer A's cheque	200	Customer A's cheque	200	Customer B's cheque	300
	$800		$700		$700		$700

FIGURE 13.6 **Sample cash receipts journal entry—customer B**

a credit note against the customer's balance. (This may be queried by the customer when a detailed statement is sent at the end of the month, as it would show a credit note reducing an amount owing rather than a payment made.)

Auditing Procedures

Tests to detect lapping are performed only when the control risk for cash receipts transactions is moderate or high. There are three procedures that should detect lapping:

1. *Confirm accounts receivable on a surprise basis at an interim date*. Confirming at this time will prevent the person engaged in lapping from bringing the "lapped" accounts up to date. Confirmation at the end of the reporting period may be ineffective because the defrauder may anticipate this procedure and adjust the lapped accounts to their correct balances at this date.
2. *Make a surprise cash count*. The cash count will include coin, currency, and customer cheques on hand. The auditor should oversee the deposit of these funds. Subsequently, the auditor should compare the details of the deposit shown on the duplicate deposit slip with cash receipts journal entries and postings to the customers' accounts.
3. *Compare details of cash receipts journal entries with the details of corresponding daily deposit slips*. This procedure should uncover discrepancies in the details such as those shown in the above two examples.

As has been outlined so far in this chapter, cash in the bank is an area where the risk of fraud is higher than in some other parts of the audit. This is particularly the case where cash registers and actual cash are involved.

Professional Environment 13.2 provides tips for preventing cash register fraud.

13.2 Professional Environment How to Prevent Cash Register Fraud

For retailers, cash register fraud is a huge concern. Many employees might have access to the cash drawer with little stopping them from "dipping their hands into the cookie jar" or ringing up only part of the merchandise and letting their friends walk away with unpaid goods. Customers can just lean over and help themselves to cash when no one is looking. And the public can even walk away with the entire register if it's not secured to the countertop. Cash is hard to trace.

Here are some tips for preventing cash register fraud and theft by employees and the public.

1. Use codes. Purchase more expensive cash registers that require each employee to have their own security code to use them. This makes it easier to trace missing cash and sales to a particular employee.
2. Lock it down. Secure the cash register to the countertop.
3. Install cameras. Use CCTV cameras to keep an eye on staff and customers, and post signs indicating that there are cameras in use, which deters theft.
4. Clear the drawer. Periodically remove large bills and sums of cash and store in a safe or deposit in the bank.
5. Buddy up. Assign at least two staff on every shift to be responsible for the cash registers and to watch over each other.
6. Look out. Train staff to be alert to possible scams, such as thieves who try to distract employees at the till. In one case, a CCTV camera in a clothing retailer caught thieves who distracted staff and installed a device on the cash register that recorded customers' credit card information and defrauded the customers and the store.

7. Check receipts. Carefully monitor cash register receipts to see if there's anything fishy. An internal auditor reviewing register receipts uncovered employee fraud by noticing that customer refunds were always in even amounts, such as $300 or $400, when sales are normally in uneven amounts. An investigation uncovered the fact that an employee rang up fictitious refunds and removed that amount of cash from the till after almost every shift.

Q: What are some concerns an auditor might have when auditing cash balances?

Sources: Herb Weisbaum, "New Security Threat: Cash Register Skimmers," CNBC, October 16, 2013; Barry Fish, "How Safe Is Your Money? Top 10 Tips to Prevent Cash Register Fraud and Theft," September 18, 2009, www.a2boffice.co.uk/; Joseph T. Wells, "Control Cash-Register Thievery," *Journal of Accountancy*, June 2002.

13.4.2 Auditing Imprest Petty Cash Funds

The balance of petty cash is rarely material and for this reason the majority of audits do not involve an audit of petty cash. Generally, the only time this part of the audit is performed is when the company expects or requests petty cash to be audited. If the auditor does happen to audit petty cash, it is often a good "litmus test" for the controls that operate throughout the entity. For this reason, the auditor may sometimes document the controls that operate over petty cash, particularly for small clients. If substantive testing of petty cash is done, the following substantive procedures are performed.

In auditing petty cash, the auditor performs tests of details of transactions and tests of balances. The auditor tests a number of replenishing transactions, including reviewing supporting documentation, accounting for all pre-numbered receipts, and determining that the reimbursement cheque was for the correct amount. The test of balances involves counting the fund. The count is usually made by surprise at an interim date rather than at the end of the reporting period. The auditor may also count the fund at the end of the reporting period, along with all other cash funds, to avoid the possibility that petty cash may be used to conceal a shortage elsewhere.

13.4.3 Auditing Imprest Bank Accounts

An entity may use an imprest bank account for payroll and dividends.

The substantive tests should include confirming the balance with the bank, reviewing the reconciliation prepared by the entity, and using the subsequent period's bank statement. The adjusted or true cash balance at the end of the reporting period should be the imprest amount. The only reconciling items on the bank statement will be unpresented payroll or dividend cheques. Employees usually cash their paycheques promptly, so all the unpresented cheques should clear the bank on the subsequent period's bank statement. Uncleared dividends are more likely to be a problem. However, larger entities with quoted share capital (which are more likely to experience uncleared dividend cheques) usually employ an independent share registrar, one of whose functions is to distribute dividends. In such cases, the entity pays the total dividend to the registrar in a single cheque, and it is the registrar's responsibility to pay individual dividends and to maintain records of uncleared dividend cheques.

Cloud 9 Integrated Case

Now that the bank reconciliations have been audited, Josh is reviewing the sales processes at the new Cloud 9 retail store. He has specifically asked Carla how cash and credit card sales are processed at the retail location. Carla explains all sales are recorded using cash registers, which includes recording the amount of each sale and the items removed from inventory sold. The sales data from the cash registers are transferred electronically to the accounting department at the end of each day. The cash is counted by two sales associates and the store manager takes the daily deposits to the bank, while the total cash deposited is agreed to the sales information that has been transferred from the store. Total cash received is then recorded in the cash receipts journal, and then the general ledger.

Carla explains that the process is similar for credit card sales, whereby payments by credit cards are authorized at the retail location when the customer uses their credit card to pay for the goods purchased. The credit card sales are transferred electronically to the accounting department and recorded for each credit card company in an accounts receivable sub-ledger account. When payment is received from the credit card companies, the accounting clerk agrees the total sales to the amounts received from the credit card companies, less the commission payable to those companies. The receivables ledger is updated with the payments received.

Carla explains that the store managers perform surprise cash counts.

Josh is glad to hear they have processes in place over the cash and credit card sales.

Before You Go On

13.4.1 What is lapping?

13.4.2 What are three auditing procedures for lapping?

13.4.3 Describe substantive procedures relevant for imprest bank accounts.

13.5 Audit Objectives for Investments

LEARNING OBJECTIVE 5

Identify the audit objectives applicable to investments.

Entities commonly invest in other entities. These investments take a variety of forms: equity securities such as preferred or common shares, or debt securities such as corporate debentures or government bonds. Investments may be held for one of two reasons:

- to hold surplus funds or funds earmarked for a future purpose
- to secure a long-term relationship with the other party

A special category of this latter type of investment is investment for the purpose of acquiring influence or control over the activities of the other entity. Such entities may be classified as subsidiaries, associates, or joint ventures, and are regarded as part of the economic entity. The financial statements of the investing or "parent" entity are required to include appropriate balances relating to these other entities, so as to present a consolidated picture of the group or reporting entity. The audit of such investments extends to the verification of the balances in the separate entity financial statements, which are then consolidated with the parent entity's accounts.

Investment transactions involve cash receipts, such as dividends and interest received on investments, and proceeds on their disposal. Investment transactions also involve cash payments for the purchase of investments. Control considerations over cash receipts and payments were previously considered. This chapter considers additional controls applicable to investing transactions only. We discuss these controls in the course of discussing the development of the audit plan.

For the five categories of financial statement assertions, **table 13.4** lists specific account balance audit objectives relating to accounts affected by investing transactions. The following sections explain considerations and procedures relevant to meeting these objectives.

TABLE 13.4 Selected specific audit objectives for investments

Account Balance, Transaction, and Related Disclosure Objectives	
Existence (**OE**)	Recorded investment balances represent investments that exist at the end of the reporting period (**OE1**). Investment revenues, gains, and losses resulted from transactions and events that occurred during the period (**OE2**).
Rights and obligations (**RO**)	All recorded investments are owned by the reporting entity (**RO1**).
Completeness (**C**)	The balance sheet includes all investment accounts (**C1**). The income statement includes the effects of all investment transactions and events during the period (**C2**). All required disclosures are made concerning (1) related party investments, (2) the bases for valuing investments, and (3) the pledging of investments as collateral (**C3**).
Accuracy, valuation, and allocation (**AV**)	Recorded investment balances are realizable at the amounts stated on the balance sheet and agree with supporting schedules (**AV1**). Investment revenues, gains, and losses reported at proper amounts (**AV2**). Investments are disclosed accurately and at appropriate amounts (**AV3**).
Classification (**D**)	Investment balances are properly classified in the financial statements (**D1**).
Presentation (**D**)	Investment accounts are appropriately aggregated or disaggregated, clearly described, and the related disclosures are relevant and understandable (**D2**).

Cloud 9 Integrated Case

Cloud 9 does not currently report any significant investments. Josh understands that identifying investments is important as there are inherent risks relating to how investments are accounted for. One reason for this risk is the difficulty in accounting for investments depending on whether they are considered strategic or non-strategic. If the investment is non-strategic, it should be reported at fair value. If the investment is strategic, the method of accounting depends on how many shares are held. If the company does not have "significant influence," the method of accounting is the same as it is for a non-strategic investment.

Before You Go On

13.5.1 Describe the various types of investments.

13.5.2 Define the rights and obligations assertion with respect to investments.

13.5.3 Explain completeness for investments.

13.6 Audit Strategy for Investments

LEARNING OBJECTIVE 6

Discuss considerations relevant to determining the audit strategy for investments.

Often the purchases and sales of investments are processed separately from other purchases and sales, especially for entities holding substantial investment portfolios, where specific control procedures over investments are likely implemented.

13.6.1 Control Environment

The understanding of several control environment factors is relevant to the audit of the investments. The authority and responsibility for investing transactions, for example, should be assigned to a company officer such as the treasurer. This individual should be a person of integrity, with appropriate knowledge and skills, who realizes the importance of observing all prescribed control procedures and can help other participating members of management make initial and ongoing assessments of the risks associated with individual investments.

The information system must include provision for capturing the data required for each method of accounting for the various categories of investments in equity and debt securities, both at the acquisition date and at the end of subsequent reporting periods. Accounting personnel must be familiar with these requirements and capable of implementing them.

In addition, internal auditors and the audit committee of the board of directors should closely monitor the effectiveness of controls over investing activities.

13.6.2 Functions and Related Controls

Activities in the investing cycle include the following investing functions and related controls.

Purchases and sales should be made in accordance with management's authorizations. The purchase and sale of investments intended to be retained as non-current assets normally require board approval. Where substantial investments are held, the entity may maintain a separate **investment subsidiary ledger** or **investment register**. This records details of acquisitions and disposals, the receipt of interest and dividends, and market values.

investment subsidiary ledger (investment register) a subsidiary ledger recording individual investments in shares and bonds. Entries show purchases and sales, the cost of each bundle purchased, and the quantity and the cost of the balance owed.

- Dividend and interest cheques must be promptly deposited intact, and the completeness of recorded investment income must be independently verified.
- Transactions should be recorded on the basis of appropriate supporting documentation, and the duties of recording of transactions and custody of the securities should be segregated.
- Securities should be stored in safes or vaults, with access restricted to authorized personnel. Periodically, relevant documents should be independently compared with recorded balances.
- Changes in value and in circumstances relating to the appropriate classification of investments should be periodically analyzed.
- Management should undertake performance reviews to detect poor investment performance and/or incorrect reporting.
- Periodically, the classification of individual investments should be reviewed.

The auditor should obtain an understanding of the entity's prescribed procedures to identify potential misstatements that could occur in investment balances and to design substantive procedures accordingly. If investment certificates are kept in the entity's safe and not independently verified, for example, then the audit program must call for physical inspection at or close to the end of the reporting period.

The most important audit risk where the investment is non-strategic or there is no significant influence is in relation to ensuring that the market value has been properly assessed. This is not a problem for investments that relate to shares listed on a stock exchange, as there is an active market. When the shares are in unlisted companies, more judgement is required by the auditor and there is a higher level of inherent risk, particularly in relation to the accuracy, valuation, and allocation assertion where fair value is determined using a valuation technique.

Another difficulty for the auditor is that there are judgements associated with assessing significant influence and control, and sometimes the company may be unwilling to adopt a certain treatment because of the effect that it may have on its financial statements.

For most companies, the volume of investing transactions is quite low. For this reason, it is generally more efficient to use a substantive approach in the audit of investment balances. That is the approach discussed in this chapter. As with any transaction cycle, of course, the auditor should still obtain an understanding of the internal control structure applicable to investments.

Because of the complexity of accounting for some investments, there is also a heightened risk of fraud in this area, which the auditor should take into consideration when planning the audit.

Another risk arising from investments that affects the overall audit strategy is one associated with related party transactions when these investments meet the definition of related parties in accordance with accounting standards. The auditor should ensure that all transactions between related parties and the company meet the requirements of the financial reporting framework selected by the entity.

As demonstrated, inherent risk and control risk assessments can vary widely, owing to the various types of investments and circumstances across entities. However, the small number of transactions means that it is not usually cost-effective to test controls. Acceptable detection risk is usually set as being low, and most evidence is obtained through the performance of substantive procedures.

Cloud 9 Integrated Case

Josh is relieved that Cloud 9 does not have any strategic investments; therefore, he doesn't have to worry about the equity method of accounting or consolidation. However, because Cloud 9 Ltd. is a subsidiary of Cloud 9 Inc., the separate entity financial statements will be consolidated with those of the parent company. Sharon has advised the audit team that the work to be performed on the consolidation will be done by another team of auditors.

After reviewing the balance sheet, Josh notes that Cloud 9 does not hold any non-strategic investments for the purpose of generating investment income at year end.

Before You Go On

13.6.1 What is an investment subsidiary ledger?

13.6.2 List six controls that should be implemented over investments.

13.6.3 What is the most important audit risk when investments are classified as non-strategic?

13.7 Substantive Procedures for Investments

LEARNING OBJECTIVE 7

Design and execute an audit program for investments.

For most entities, investment transactions are infrequent, but individual transactions are usually for substantial amounts. Investment transactions rarely present cut-off problems so the auditor may perform many substantive procedures before or after the end of the reporting period. Income statement account balances relating to investments are usually verified at the same time.

Table 13.5 lists possible substantive procedures for investment balances and the specific audit objectives to which they relate. Procedures are explained in the sections that follow.

13.7.1 Initial Procedures

First, the auditor verifies the agreement of opening investment balances with audited amounts in the previous year's working papers. Next, the auditor reviews the activity in investment-related accounts to identify entries that are unusual in nature or amount and that should be investigated. Then the auditor checks entity-prepared schedules of investment additions and disposals in the period for mathematical accuracy and agreement with the underlying accounting records. This procedure includes determining that schedules and subsidiary investment ledgers agree with related general ledger control account balances. The schedules can then serve as the basis for additional substantive procedures.

TABLE 13.5 Possible substantive procedures for investment balance assertions

		Investment Balance Audit Objective (from Table 13.4)				
Category	**Substantive Procedure**	**OE No.**	**C No.**	**RO1**	**AV No.**	**D No.**
Initial procedures	1. Perform initial procedures on investment balances and records that will be subjected to further testing. (a) Trace opening balances for investment accounts to the previous year's working papers. (b) Review activity in all investment-related balance sheet and income statement accounts, and investigate entries that appear unusual in amount or source. (c) Obtain entity-prepared schedules of investments and determine that they accurately represent the underlying accounting records from which they are prepared by: • adding and cross-adding the schedules and reconciling the totals with the related subsidiary and general ledger balances • testing the agreement of items on schedules with entries in related subsidiary and general ledger accounts				✓1, 2	
Analytical procedures	2. Perform analytical procedures by analyzing interest and dividend yields relative to expectations.	✓1, 2	✓1, 2		✓1, 2	
Tests of details of transactions	3. Vouch entries in investment and related income and equity accounts.	✓1, 2	✓1, 2	✓	✓1, 2	✓1
Tests of details of balances	4. Inspect and count securities on hand. (Note: The majority will be held with registries.)	✓1	✓1	✓		✓1
	5. Confirm securities held by others (e.g., share registries).	✓1	✓1	✓		
	6. Recalculate investment revenue earned.	✓2	✓2		✓2	
	7. Review documentation concerning fair values.				✓1, 2	
Classification and presentation	8. Compare statement presentation with the applicable accounting standards. (a) Determine that investment balances are properly identified and classified in the financial statements.					✓1
	(b) Determine the appropriateness of disclosures concerning the valuation basis for investments, realized and unrealized gains or losses, related party investments, and pledged investments.					✓2

13.7.2 Analytical Procedures

It is rarely possible to obtain much evidence from the application of analytical procedures to investment balance sheet accounts. Current asset investments tend not to have any predictable relationship with other balances, and non-current investments are subject to so few transactions that it is easier to proceed directly to tests of details. Analytical procedures can be applied in comparing interest and dividend revenues with investment balances. Unexpected differences in interest or dividend yields may indicate misstatements; for example, a higher-than-expected rate of return may be found to have been caused by erroneously recording a gain on the sale of an investment in the interest or dividend revenue account.

13.7.3 Tests of Details of Transactions

Auditors usually vouch purchases and sales of investments by examining brokers' advices and evidence of appropriate approval. Purchases and sales of non-current investments, for example, should be vouched to authorizations in the minutes of directors' meetings. These tests provide evidence about the occurrence of transactions, the transfer of ownership of securities, and the valuation of the securities at the transaction date.

Evidence as to the completeness of recorded purchases is determined through verification of purchase and payment transactions. Evidence as to the completeness of sales of investments is determined through verification of the existence of recorded investment assets as one of the tests of details of balances.

The auditor can vouch dividend and interest receipts to remittance advices accompanying the payment. A problem often arises as to completeness. Receipt of dividends cannot always be foreseen, and the misrecording or even misappropriation of a dividend payment may not be readily detected by the information system. Interest can normally be verified by analytical procedures. Dividends paid by listed companies can normally be checked against reference works recording dividend payments. For substantial investments in unlisted companies, the auditor may need to verify dividends received against copies of the companies' financial statements.

13.7.4 Tests of Details of Balances

Tests of details of balances involve inspecting or confirming recorded investments, verifying income from investments, and checking their market value. There may also be a need to assess controls of a service organization if the entity hires the services of a custodian or broker. The work done will depend on whether the securities are listed or unlisted. If they are listed, the following will apply.

Where the securities relate to listed companies, the auditor may inspect broker statements to provide evidence on the existence and the rights and obligations assertions. However, depending on the materiality of the shareholdings, the auditor may obtain a confirmation directly from the broker at the end of the financial year. This provides evidence on the existence, completeness, rights and obligations, classification, and presentation assertions.

Securities held at the entity's own premises should be inspected and counted at the same time as the count of cash and other negotiable instruments. In performing the test, the custodian of the securities should be present throughout the count, a receipt should be obtained from the custodian when the securities are returned, and the auditor should control all securities until the count is completed.

For securities stored for safekeeping in bank safety deposit boxes, the banks will generally seal the boxes on the nominated date of the count at the entity's request and will confirm to the auditor that there was no access to the box, other than by the auditor, until all locations have been counted. When the count is not made at the end of the reporting period, the auditor should prepare a reconciliation from the date of the count to the year-end date by reviewing any intervening security transactions.

In inspecting securities, the auditor should observe such matters as the:

- certificate number on the document
- name of the owner (which should be the entity, either directly or through endorsement)
- description of the security
- number of shares (or bonds)
- value of the shares (or bonds)
- name of the issuer

These data should be recorded as part of the auditor's analysis of the investment account. All securities should be checked against the records in the investment register and, for securities purchased in previous years, the details should be compared with those shown on the previous year's working papers. A lack of agreement between the certificate numbers may indicate unauthorized transactions for those securities.

This substantive procedure provides evidence about the existence, completeness, rights and obligations, classification, and presentation assertions.

Securities held by outsiders for safekeeping must be confirmed as at the date on which securities held by the entity are checked. The steps in the confirmation process for securities are identical to those for confirming receivables. Thus, the auditor must control the mailings and receive the responses directly from the custodian. The data confirmed are the same as the data that should be noted when the auditor is able to inspect the securities.

Securities may also be held by creditors as collateral against loans. In such cases, the confirmation should be sent to the indicated custodian. The confirmation of securities held by third parties provides evidence as to the existence or occurrence and the rights and obligations assertions. It also furnishes evidence about the completeness assertion if the confirmation response indicates more securities on hand than recorded.

The auditor verifies income from investments by use of documentary evidence and recalculation. Dividends on all shares listed on stock exchanges and many others are included in dividend record books published by investment services. The auditor can independently verify the dividend revenue by referring to the declaration date, amount, and payment date as shown in the record book. The verification of dividend income is usually incorporated into the schedule of investments.

The auditor can verify the interest earned in relation to bonds by examining the interest rates and payment dates indicated on the bond certificate. This substantive procedure is directed mainly at the accuracy and completeness assertions for interest revenue. However, it also provides evidence about the existence assertion for interest receivable.

For quoted equity securities and marketable securities, the auditor should verify market quotations by referring to published security prices on stock exchanges. For infrequently traded securities, the auditor may need to seek advice from an independent broker as to the estimated market value at the end of the reporting period. When market quotations are based on a reasonably broad and active market, they ordinarily constitute sufficient appropriate audit evidence as to the current market value of the securities. For investments where quoted market values do not exist, audited financial statements of the entity in which investments are held help in the valuation of unquoted shares, bonds, and similar debt obligations.

13.7.5 Disclosure

To conform to the requirements of the accounting standards, the presentation of investments in securities in the financial statements requires the following:

- analysis of investments as either current or non-current
- recognition of dividends, interest, and realized gains and losses in the income statement
- recognition of impairment write offs in the income statement
- disclosure of the basis and methods of accounting

- disclosure of the market value of quoted investments
- disclosure of any liens

The foregoing substantive procedures should provide evidence of the first five of the above items. Inspection of the minutes and loan agreements should reveal the existence of liens. The auditor must determine whether the proposed presentations and classifications are appropriate.

Before You Go On

13.7.1 List four substantive procedures usually performed for investments.

13.7.2 When inspecting securities, what things should the auditor note?

13.7.3 Describe the disclosure requirements over investments.

13.8 Auditing Consolidated Financial Statements

LEARNING OBJECTIVE 8

Explain the special considerations applicable to the audit of investments in subsidiaries, associates, and joint ventures.

Where a company (or other entity) controls another company (or other entity), consolidated financial statements must be prepared for the economic entity. The economic entity comprises both the parent company and the controlled entities unless the company or entity is itself a controlled entity (IFRS 10 *Consolidated Financial Statements* and IAS 27 *Separate Financial Statements*). The auditor is required to report on the consolidated financial statements. To do so, the auditor must identify the controlled companies (or other entities) constituting the reporting entity, verify the amounts pertaining to the other companies (or entities) to be consolidated, and verify the accuracy of the preparation of the consolidated financial statements.

Similar but less extensive disclosure requirements apply in respect of investments in associates (IAS 28 *Investments in Associates and Joint Ventures*) and in joint arrangements (IFRS 11 *Joint Arrangements*). The same audit procedures with respect to subsidiaries also apply to investments in associates and joint arrangements. The parent entity and its subsidiaries, associates, and joint ventures are referred to collectively as group entities.

Auditors should be sure to gather sufficient appropriate audit evidence in the following areas:

- representations made by those charged with governance of the investor as to the existence and ownership of the investment, and the existence or otherwise of significant influence
- the appropriateness of the carrying amount of an investment
- the appropriateness of adjustments to the carrying amount of an investment
- the adequacy of financial statement disclosures
- the appropriateness of other equity accounting adjustments such as adjustments for dissimilar accounting policies and elimination of unrealized profits and losses

Some of this guidance is also relevant to the audit of subsidiaries and joint ventures.

13.8.1 Audit Strategy for Consolidated Financial Statements

It is difficult to make generalizations about the level of inherent risk for related account balance assertions. Sometimes the investment will be very passive and very low risk. However, there will also be instances where the relationship is very complex and high risk. This may give rise to uncertainty about the existence of control over the related entities, in which case the inherent risk for the completeness assertion may be high. Sometimes, too, the consolidation adjustments may be particularly complex and involve a significant degree of management estimation. This can happen with the consolidation of foreign group entities whose financial statements may be prepared on accounting bases different from those appropriate to the parent entity, or with new acquisitions requiring determination of the fair value of their net assets at the acquisition date. In such cases, the inherent risk related to the accuracy, valuation, and allocation assertion may be moderate or high.

Another reason related account balances can be risky is if the investor company does not closely monitor the actions of the subsidiary or associate but provides guarantees over its activities. There have been many examples where the unchecked activities of subsidiaries or associates have resulted not only in their own failure but also in the failure of the investor company.

Given the materiality of the amounts involved, the audit approach will be primarily substantive. Detection risk will, therefore, be inversely related to the relevant inherent risk assessments.

Sometimes there will be an additional risk in the audit of investments in associates or subsidiaries, because the audit may be performed by another auditor. In these situations, the auditor should consider the requirements of CAS 600 *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*. As part of the review of the other auditor's work, the head office auditor may sometimes send a very detailed questionnaire to the other auditor for completion.

Outlined below are some of the substantive procedures involved in performing an audit of consolidated financial statements.

13.8.2 Substantive Procedures

Table 13.6 shows a list of possible substantive procedures for the consolidated financial statements, together with the assertions to which each test relates.

TABLE 13.6 Possible substantive tests of consolidated financial statement assertions

	Assertions				
Substantive Procedure	**OE**	**C**	**RO**	**AV**	**D**
Identify the reporting entity.	✓	✓	✓		
Verify the financial statements of other group entities.	✓	✓		✓	
Verify the consolidating adjustments.				✓	
Compare the statement presentation with applicable accounting standards.					✓

Identifying the Reporting Entity

Where an entity has investments in entities that it controls, and where that entity is a reporting entity, it must prepare consolidated financial statements of the economic entity comprising the parent entity and its subsidiaries. The auditor ensures that all entities included in the consolidated financial statements are properly recognized as subsidiaries and that no such entities are excluded.

The auditor must make an assessment as to whether the entity's investment in other entities constitutes control, thereby requiring consolidation. IFRS 10 provides a definition of control as follows: *Control is when an investor is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee*. The auditor needs, therefore, to exercise judgement on the appropriateness of management's assertions about control (or lack thereof) of other entities.

The auditor also investigates the possibility that cumulative investments by the entity and its subsidiaries enable the economic entity to exercise control over other entities. If, for example, the parent holds 15 percent of the shares of another entity and one of its subsidiaries holds 40 percent, then that other entity is controlled by the group and is to be accounted for as a subsidiary. In obtaining an understanding of the business in the planning stage and in reviewing related party transactions, the auditor should be alert for evidence of the existence of control over other entities other than through ownership of voting rights. The auditor will need to obtain and verify an explanation as to why such entities are excluded from the consolidation.

This procedure provides evidence as to the existence assertion and the rights and obligations assertion with respect to entities consolidated as controlled entities, and to the completeness assertion that all controlled entities are included in the consolidation.

Verifying the Financial Statements of Other Group Entities

To verify the amounts included in the consolidated financial statements, the auditor must obtain and verify the financial statements of each group entity. Where the auditor is not also the auditor of another group entity, CAS 600 *Special Considerations—Audits of Group Financial Statements* recommends that the principal auditor:

- obtain information regarding the professional competence of the other auditor
- advise the other auditor of the independence requirements and obtain representation as to the other auditor's compliance
- communicate to the other auditor any special requirements, such as identification of intercompany transactions
- advise the other auditor of applicable accounting and auditing requirements and obtain representation of the other auditor's compliance
- consider the findings of the other auditor

This procedure provides evidence as to the existence assertion and the completeness assertion with respect to assets, liabilities, and transactions with entities consolidated with the parent entity.

Verifying the Consolidating Adjustments

Consolidation adjustments fall into four categories: (1) acquisitions and disposals, (2) the elimination of inter-entity balances and transactions, (3) the standardization of accounting policies, and (4) the translation of foreign currencies.

1. *Acquisitions and disposals.* On the acquisition of an interest in an associate or subsidiary, its assets are consolidated at their fair value at the acquisition date. The difference between the fair value of the parent entity's ownership interest in the net assets and the consideration paid constitutes purchased goodwill. It is important that the auditor verify the amounts recorded as fair value. This involves applying CAS 540 *Auditing Accounting Estimates and Related Disclosures*. The auditor should test the entity's fair value measurements and disclosures and, where applicable, evaluate whether the assumptions used by management provide a reasonable basis for the fair value measurements. This involves testing management estimates and evaluating the work of experts. Of particular concern are valuations placed on intangibles not recorded in the books of the controlled entity. Adjustments on the disposal of a controlling interest must be verified against the carrying amount of the controlled entity's net assets immediately before disposal.

2. *Elimination of inter-entity balances and transactions.* In the course of auditing each group entity, the auditor ensures that inter-entity transactions are properly identified and recorded. Where group entities are audited by other auditors, they must be asked to ensure that all such transactions are properly accounted for. At year end, the auditor obtains an analysis of inter-entity balances, verifies their reconciliation to one another, and ensures that they are properly eliminated. Inter-entity transactions that require particular scrutiny by auditors are those that occur around the year end. The auditor should also ensure that any inter-entity profit in assets held by any of the group entities is properly identified and eliminated on consolidation.
3. *Standardization of accounting policies.* Where the financial statements of group entities have been prepared using accounting policies inconsistent with those of the reporting entity, appropriate adjustments must be made on consolidation. When auditing group entities or when communicating with other auditors of group entities, the auditor must identify any accounting policies inconsistent with those of the reporting entity, and verify the consolidating adjustment.
4. *Translation of foreign currencies.* Where a group entity's financial statements are prepared in a foreign currency, they must be translated for purposes of consolidation. The auditor must verify the exchange rates used, check the translations, and ensure that the accounting treatment conforms with accounting standards.

These substantive procedures provide evidence as to the existence, completeness, and accuracy, valuation, and allocation assertions.

The auditor should ensure that the disclosures in the consolidated financial statements conform to the requirements of applicable accounting standards. Particular requirements are explanations as to why control exists over entities in which the parent entity's ownership interest is 50 percent or less, and why control does not exist over entities in which the ownership interest is greater than 50 percent.

Before You Go On

13.8.1 What is the common audit approach for auditing consolidated financial statements?

13.8.2 What things should the auditor consider when group entities are audited by other auditors?

13.8.3 Discuss the substantive procedures normally performed over inter-entity balances.

Summary

1 Identify the audit objectives applicable to cash.

Cash normally includes cash balances at the bank or similar institutions, cash on hand, and cash equivalents. In the auditing of cash, the key issues are to ensure that the cash exists and is owned by the client and that all cash transactions at the end of the reporting period are complete and properly disclosed.

2 Discuss considerations relevant to determining the audit strategy for cash.

The verification of cash balances is an important part of the financial statement audit. Even though the balances at the end of the reporting period may appear immaterial, the amount of cash flowing through the accounts can be very material. The high volume of transactions contributes to a significant level of inherent risk for cash balance assertions, particularly existence and completeness. While the audit approach to cash is usually substantive, the auditor should understand the procedures the client uses for maintaining accountability over cash. This often includes independently performed bank reconciliations and the use of imprest accounts.

3 Design and execute an audit program for cash balances.

Several types of substantive procedures to test cash balances are performed during most audits, including conducting cash cut-off tests, tracing bank transfers, counting cash on hand, confirming certain balances and other arrangements with banks, reviewing bank reconciliations, obtaining and using subsequent period bank statements, and determining the adequacy of management's disclosures for cash balances.

4 Describe special considerations when auditing cash balances, including lapping, petty cash funds, and imprest bank accounts.

Lapping is an irregularity that results in the misappropriation of cash receipts for personal use. The auditor should assess the likelihood of lapping in obtaining an understanding about the segregation of duties in the receiving and recording of collections from customers. Three procedures that should detect lapping include confirming accounts receivable on a surprise basis at an interim date, making surprise cash counts, and comparing details of cash receipts journal entries with the details of corresponding daily deposit slips.

The balance of petty cash is rarely material and for this reason the majority of audits do not involve an audit of petty cash. Generally, the only time this part of the audit is performed is when the company expects or requests petty cash to be audited. When auditing petty cash, the auditor performs tests of details of transactions and tests of balances. The auditor tests a number of replenishing transactions.

An entity may use an imprest bank account for payroll and dividends. Substantive tests should include confirming the balance with the bank, reviewing the bank reconciliations, and using the subsequent period's bank statement.

5 Identify the audit objectives applicable to investments.

In the auditing of investments, the key issues are to ensure that the investments exist, are owned, are properly recorded (including profits or losses on any sales) and disclosed, and are properly valued at the end of the reporting period.

6 Discuss considerations relevant to determining the audit strategy for investments.

Investing transactions occur infrequently and internal control over the processing of transactions is generally good. However, because transactions are infrequent and usually individually significant, it is common for the auditor to use a substantive approach.

7 Design and execute an audit program for investments.

Auditors usually vouch purchases and sales of investments by examining brokers' advices and evidence of appropriate approval. Tests of details of balances involve inspecting or confirming recorded investments, verifying income from investments, and checking their market value.

8 Explain the special considerations applicable to the audit of investments in subsidiaries, associates, and joint ventures.

Where a company controls another company, consolidated financial statements must be prepared. The auditor generally uses a substantive approach in verifying the consolidation of investments in group entities in the consolidated financial statements of the economic entity.

Key Terms

Bank confirmation 13-12
Bank reconciliations 13-6
Bank transfer schedule 13-11
Cash count 13-16
Cash cut-off tests 13-9
Imprest bank account 13-7
Imprest petty cash fund 13-6
Investment subsidiary ledger (investment register) 13-22
Kiting 13-11
Lapping 13-17
Subsequent period's bank statement 13-14
Window dressing 13-14

Self-Test Questions

Answers to the Self-Test Questions are available in *WileyPlus*.

13.1 In the planning of an audit, it was decided that cash would not be audited because it made up only 1 percent of total assets. You respond to this decision by saying:

a. Whether or not this was acceptable would depend on the company and the type of industry.

b. Cash is always going to be material, no matter what amount it is.

c. An amount of 1 percent of total assets is likely to be immaterial.

d. It is probable that this amount would still be considered material, because of the nature of cash.

13.2 The main evidence regarding year-end bank balances is documented in the:

a. bank deposit schedule.

b. interbank transfer schedule.

c. bank reconciliation.

d. standard bank confirmation.

13.3 In reviewing the bank reconciliation prepared by the client, the auditor finds a "miscellaneous reconciling item." From discussion with the client, the auditor is told that this relates to foreign exchange fluctuations. The auditor should:

a. accept the client's explanation.

b. accept the client's explanation, provided it is also noted in the management representation letter.

c. ask the client to provide a detailed schedule of the amounts that make up this variance for subsequent review.

d. try to find what constitutes the difference personally.

13.4 The following would be the best protection for an entity that wishes to prevent the lapping of trade accounts receivable:

a. ask that customers' payment cheques be made payable to the entity and addressed to the treasurer.

b. have customers send payments directly to the entity's bank.

c. segregate duties so that no employee has access to both the cheques from customers and currency from daily cash receipts.

d. segregate duties so that the bookkeeper in charge of the general ledger has no access to incoming mail.

13.5 The assertion that is the highest risk for an auditor in auditing investments is:

a. accuracy, valuation, and allocation.

b. existence.

c. completeness.

d. presentation.

13.6 The control that would be the most effective in assuring that the proper custody of assets in the investing cycle is maintained is:

a. the purchase and sale of investments are executed on the specific authorization of the board of directors.

b. the recorded balances in the investment subsidiary ledger are periodically compared with the contents of the safety deposit box by independent personnel.

c. direct access to securities in the safety deposit box is limited to only one corporate officer.

d. personnel who post investment transactions to the general ledger are not permitted to update the investment subsidiary ledger.

13.7 When the client company does not maintain its own share register, the auditor should obtain written confirmation from the transfer agent and registrar concerning:

a. the number of shares subject to agreements to repurchase.

b. guarantees of preferred share redemption values.

c. the number of shares issued and outstanding.

d. restrictions on the payment of dividends.

13.8 An auditor testing the reasonableness of long-term investments would ordinarily use analytical procedures to ascertain the reasonableness of the:

a. existence of unrealized gains or losses in the portfolio.

b. completeness of recorded investment income.

c. classification of current and non-current portfolios.

d. valuation of marketable equity securities.

13.9 If a client is not deemed to have "significant influence" in an investee company, to obtain audit evidence to verify the investment balance, the auditor should:

a. review the audited accounts of the investee company.

b. get an independent valuation of the assets and liabilities of the investee company.

c. perform the audit of the investee company.

d. obtain the market value of the investee company's shares.

13.10 When the client has control over an investee company, the most appropriate audit procedure to obtain evidence to verify the investee company's accounts is to:

a. re-perform the audit of the investee company.

b. get an independent valuation of the assets and liabilities of the investee company.

c. if satisfied as to the reliability of the investee company's auditor, rely on their work.

d. obtain the market value of the investee company's shares.

Review Questions

13.1 Explain the use and audit of imprest accounts.

13.2 Explain why the balance of cash on hand and at bank is always audited, and why a substantive approach is preferred.

13.3 Explain why it is important to trace transfers between bank accounts on either side of the end of the reporting period.

13.4 Describe the procedures for counting cash on hand.

13.5 Outline the procedures involved in verifying the bank reconciliation.

13.6 Explain lapping. Describe appropriate audit procedures to perform where it is suspected.

13.7 What substantive tests apply to the existence and valuation assertions for investment balances?

13.8 When inspecting securities on hand, what things should the auditor observe?

13.9 Explain the financial reporting principle underlying the audit verification of the existence and completeness assertions with respect to entities consolidated into group financial statements.

13.10 Describe procedures to be undertaken where group entities are audited by other auditors.

Professional Application Questions

Basic Moderate Challenging

13.1 Audit objectives over cash and investments Basic **LO 1, 5**

Required

For each of the following statements, identify the audit assertion to which it relates:

a. All cash transfers are recorded in the correct period.

b. All investment gains are recorded in the correct amount.

c. All cash inflows are recorded.

d. The line of credit is appropriately disclosed.

e. Sales of investments during the period have been recorded as disposals.

f. All recorded investments are owned by the reporting entity.

13.2 Substantive procedures for cash balances **Basic** **LO 1, 3**

You are an audit senior performing the audit of Stella's Stars Ltd., a talent agency. In performing the audit, Stella informs you of the following:

1. She does not want you to send the bank a confirmation because she objects to the cost and feels that the year-end bank statement issued by the bank should be sufficient.
2. She would like you to prepare the bank reconciliation at the end of the year.
3. She would like the audit done within one month of the end of the financial year.

Required

Write a memo to your audit manager outlining any concerns you might have with any of Stella's requests.

13.3 Bank reconciliation errors **Moderate** **LO 2, 3**

You have spent two years working as an auditor. In that time, you have come across a number of errors in performing bank reconciliations. Outlined below are some of them:

1. An unreconciled item of $340 was on the client's final bank reconciliation and was deemed by the client to be immaterial.
2. Two deposits totalling $4,070 relating to accounts receivable were collected on January 2 (the company has a December 31 year end) but recorded as cash receipts on December 31.
3. An amount from an associated company of $40,000 was deposited two days before the end of the year in the client's bank account and then paid back one week after the end of the year.
4. A cheque for $6,000 was omitted from the outstanding cheque list on the bank reconciliation at December 31. It cleared the bank on January 14.
5. A bank transfer of $20,000 was included as a deposit in transit at December 31 in the accounting records.

Required

a. What control could be implemented to reduce the likelihood of each of the above?

b. What is an audit procedure to detect each of the above?

13.4 Cash control system **Moderate** **LO 1, 2, 3, 4**

Shiny Happy Windows Co. (SHW) is a window cleaning company. Customers' windows are cleaned monthly and the window cleaner then posts a stamped addressed envelope for payment through the customer's front door.

SHW has a large number of receivable balances and these customers pay by cheque or cash, which is received in the stamped addressed envelopes in the mail. The following procedures are applied to the cash receipts cycle:

1. A junior clerk from the accounting department opens the mail and if any cheques or cash have been sent, she records the receipts in the cash received log and then places all the monies into the locked cash box.
2. The contents of the cash box are counted each day and every few days these sums are deposited at the bank by whichever member of the accounting team is available.
3. The cashier records the details of the cash received into the cash receipts journal and also updates the sales ledger.
4. Usually on a monthly basis, the cashier performs a bank reconciliation, which he then files. If he misses a month, he catches it up in the following month's reconciliation.

Required

a. For the cash cycle of SHW:

  i. Identify and explain three deficiencies in the system.

  ii. Suggest controls to address each of these deficiencies.

  iii. List tests of controls the auditor of SHW would perform to assess if the controls are operating effectively.

b. Describe substantive procedures an auditor would perform in verifying this company's bank balance.

Source: Adapted from ACCA Audit and Assurance Paper F8, June 2010.

13.5 Performing a bank reconciliation **Challenging** **LO 3**

Your firm is the auditor of Thai Textiles Ltd. and you are auditing the financial statements for the year ended June 30, 2023. The company has sales of $2.5 million and a before-tax profit of $150,000. The company has supplied you with the following bank reconciliation at year end. You have entered the "date cleared" on the bank statement (the date on which the cheques and deposits appeared on July's bank statement).

Required

a. List the matters that cause you concern on the client's bank reconciliation. Describe the investigations that you will carry out on these items.

b. Explain what adjustments to the financial statements would be required from part (a).

Source: Adapted from ACCA Audit Framework, Paper 6Y, December 1997.

			$	$
Balance Per Bank Statement at June 30, 2023				**(9,865)**
Add: Deposits not Credited				
CJ date	**Type**	**Date cleared**		
June 30	ARL	July 4	11,364	
June 24	CS	July 4	653	
June 27	CS	July 5	235	
June 28	CS	July 6	315	
June 29	CS	July 7	426	
June 30	CS	July 8	714	
June 30	CS	July 11	362	14,069

				$	$
Less: Uncleared Cheques					
CJ date	**Cheque no.**	**Type**	**Date cleared**		
June 29	2163	CP	July 4	1,216	
June 30	2164	APL	July 18	10,312	
June 30	2165	APL	July 19	11,264	
June 30	2166	APL	July 18	9,732	
June 30	2167	APL	July 20	15,311	
June 30	2168	APL	July 21	8,671	
June 30	2169	APL	July 19	12,869	
June 30	2170	APL	July 21	9,342	
June 30	2171	CP	July 4	964	(79,681)
Balance per cash journal at June 30, 2023					(75,477)

Notes

- "CJ date" is the date on which the transaction was entered into the cash journal.
- Type of transaction: ARL (accounts receivable receipt); CS (receipt from cash sales); APL (accounts payable payment); CP (cheque payment [for other expenses]).
- All cheques for accounts payable payments are written out at the end of the month.

13.6 Substantive procedures for cash balances **Challenging** **LO 1, 2, 3, 4**

You have been asked by the financial controller, Walid Hossain, of Potter Ltd. to carry out an investigation of a suspected fraud by the company's cashier. The cashier, Alfred Blyton, has left the firm without notice.

Potter is a small company, and there were few controls and checks over Alfred's work because the company had employed him for a number of years. You are aware that the auditor found a discrepancy in the bank reconciliation for the company's year end of December 31, 2023, and that Alfred left the day on which it was discovered. Walid has asked you, rather than the company's auditor, to carry out the investigation. He is not happy with the auditor because he believes he should have found the fraud earlier or at least warned him that there were control weaknesses.

Walid says that Alfred was responsible for:

- receiving cash from customers for both credit and cash sales
- making all payments, including purchase journal and sundry payments
- drawing the cash for wages
- recording all cash receipts and payments and preparing a bank reconciliation
- making and approving petty cash payments and recording these transactions in the petty cash book

The computerized sales and purchase ledgers are maintained by the staff in the accounting department, who post all transactions to these ledgers. Alfred used to send the sales clerk a schedule showing the cash he had received. The remittance advices from customers were attached to this schedule, and they showed the invoices that were being paid.

The purchases clerk would inform Alfred of the payments she wished to make, and Alfred would then prepare the cheques, which Walid signed. A remittance advice was attached to the payment that was sent to the supplier. Alfred would prepare the purchases and sales ledger control accounts each month and the reconciliation of these balances to the total balances on the respective ledgers.

For cash sales, the sales department creates a sales order, which is sent to the shipping department, which, in turn, creates a shipping note. The first copy of the shipping note is given to the customer, the second copy is sent to the accounting department, and the third copy is retained in the shipping department. The accounting department then prices the invoice. The customer would pay the cash to Alfred, who retained a copy of the invoice for his records. Alfred would record the sales details in his analyzed cash book, and the month's cash sales were posted from the total in the cash book to the ledger.

The payroll department calculates the wages. Alfred would draw the cheque to pay the wages and receive the cash. The payroll department makes up the payroll and pays the wages to employees. Alfred would retain any wages not given to employees.

Walid is the authorized signatory for cheques; however, Alfred was the signatory when Walid was on holiday.

Required

Describe what checks you would conduct to:

a. Determine whether a fraud has actually taken place.

b. Quantify the loss. Consider:

i. bank reconciliations

ii. cash receipts

iii. cash payments

iv. petty cash

Source: Adapted from ACCA Audit Framework, Paper 3.4, December 1991.

13.7 Controls over petty cash **Moderate** **LO 24**

Mathias Co. sells cars, car parts, and gasoline from 25 different locations across Canada. Each branch has up to 20 staff working there, although most of the accounting systems are designed and implemented from the company's head office. All accounting systems, apart from petty cash, are computerized, with the internal audit department frequently advising and implementing controls within those systems.

Mathias has an internal audit department of six staff, all of whom have been employed at Mathias for a minimum of five years and some for as long as 15 years. In the past, the chief internal auditor appointed staff within the internal audit department, although the chief executive officer is responsible for appointing the chief internal auditor. The chief internal auditor reports directly to the chief financial officer (CFO). The CFO also assists the chief internal auditor in deciding on the scope of work of the internal audit department.

You are an audit manager in the internal audit department of Mathias. You are currently auditing the petty cash systems at the different branches. Your initial systems notes on petty cash contain the following information:

1. The average petty cash balance at each branch is $5,000.
2. Average monthly expenditure is $1,538, with amounts ranging from $1 to $500.
3. Petty cash is kept in a lock box on a bookcase in the accounts office.
4. Vouchers for expenditures are signed by the person incurring that expenditure to confirm they have received reimbursement from petty cash.

5. Vouchers are recorded in the petty cash book by the accounting clerk; each voucher records the date, reason for the expenditure, amount of the expenditure, and person incurring that expenditure.
6. Petty cash is counted every month by the accounting clerk, who is in charge of the cash. The petty cash balance is then reimbursed using an imprest system and the journal entry produced to record expenditure in the general ledger.
7. The cheque to reimburse petty cash is signed by the accountant at the branch at the same time as the journal entry to the general ledger is reviewed.

Required

Explain the internal control weaknesses in the petty cash system at Mathias Co. For each weakness, recommend a control to overcome that weakness.

Source: Adapted from ACCA Audit and Assurance (International), Paper F8, December 2007.

13.8 Banking of cash receipts **Basic** **LO 4**

Your firm is the auditor of Trojan Trading Ltd. The audited financial statements for the year ended December 31, 2023, show the company's revenue was $5 million and the profit before tax was $320,000. The part of the working papers that records audit work on the bank reconciliation at December 31, 2023, noted cash receipts of $14,000 recorded in the cash book before the year end that were not credited to the bank statement until a week after year end. No further work was carried out because the amount was not considered material, and that conclusion was noted in the audit working papers. In February 2024, the company investigated delays in depositing cash receipts and discovered a fraud of $36,000. The fraud was carried out by the cashier who was responsible for depositing all receipts and preparing the bank reconciliation.

Required

a. What further work should the auditor have done in this situation (if any)?
b. Should this have been reported? If so, to whom?

Source: Adapted from ACCA Audit Framework, June 1998.

13.9 Audit of investments **Challenging** **LO 5, 6, 7**

Your firm is the auditor of Zhao's Charity for Pensioners. The charity was formed many years ago from a large gift by the Zhao family, the income from which is used to pay pensions to needy people. The original gift has been invested in fixed-interest investments and shares in listed companies. The trustees manage the charity, and the full-time administrator keeps the accounting and other records.

The draft summarized income and expenditure account for the year ended September 30, 2023, and an extract from the balance sheet are shown below, together with the audited figures for 2022.

The following information has been provided:

1. During the year, some shares were sold at a profit of $182,900 and the proceeds were reinvested in shares of other companies.
2. There were no purchases or sales of fixed-interest investments in the year ended September 30, 2023. In the year ended September 30, 2022, some of the fixed-interest investments were sold and others were purchased using the proceeds of sale.
3. The charity is managed by voluntary trustees who meet four times a year, and the administrator keeps the minutes of the meetings.
4. The administrator keeps the accounting records.
5. As auditor of the charity, you prepare the financial statements from the accounting records kept by the administrator and audit those financial statements. Your auditor's report is addressed to the trustees of the charity.

Income and Expenditure Account for Year Ended September 30

	2023	2022
	$	$
Income		
From fixed-interest investments	44,200	41,900
From shares in listed companies	123,900	123,500
	168,100	165,400

(continued)

	2023	2022
	$	$
Expenditure		
Payments to pensioners	141,300	144,300
Administration costs	21,600	20,500
Audit and accounting	4,700	4,500
Sundry expenses	2,800	2,600
	170,400	171,900
Net (deficit) for the year	(2,300)	(6,500)

Extract from Balance Sheet as at September 30

Cost of investments	$	$
Fixed-interest investments	511,200	511,200
Shares in listed companies	1,445,600	1,262,700
	1,956,800	1,773,900

Required

Describe the audit work you would carry out to verify:

a. Income from investments: your audit tests should verify that all the income from the investments has been received by the charity and included in the financial statements, including dividends from the shares in listed investments bought and sold during the year.

b. The ownership of the fixed-interest investments and shares in listed companies.

Source: Adapted from ACCA Audit Framework, Paper 6, December 1996.

13.10 Substantive procedures for investments **Moderate** **LO 5, 7**

Ingrid Shalansky, an audit senior, was given the task of auditing Crabapple Ltd., an investment company. Her firm had not performed the audit before; however, from a discussion with the previous year's auditors, she found out that the following transactions occurred during the previous year:

- payment of bond interest
- accrual of bond interest, payable at the year end
- redemption of outstanding bonds
- purchase of a portfolio of shares

Ingrid has been asked to detail audit procedures for this year's audit based on the assumptions that similar transactions will occur.

Required

a. Identify a substantive procedure that Ingrid would need to perform to verify each of the above transactions, and the assertion to which each relates.

b. Indicate the type of evidence obtained from each of the procedures noted in part (a).

13.11 Substantive procedures for investments **Moderate** **LO 6, 7**

You are completing the audit of Toledo Ltd. for the financial year ended December 31, 2023. Under the terms of a major loan contract, Toledo is required to maintain certain financial ratios. If the ratios are breached, then the loan is immediately due for repayment. This would create significant cash flow problems. To comply with the loan covenant and maintain the ratios, Toledo must continue to hold its 100-percent shareholding in Granada Ltd. as a long-term investment.

You have obtained a draft of the management representation letter from the client, which says in part: "Toledo Ltd. warrants for the period January 1, 2024, to December 31, 2024, it intends to retain ownership of its entire parcel of ordinary shares in Granada Ltd. Toledo has not entered into any discussions with any party, directly or indirectly, regarding the sale of these shares."

On February 24, 2024, you noted an article in the financial press that described the rumoured sale of Granada's business assets to a foreign investor.

Required

a. Does the management representation letter from Toledo regarding its shareholding in Granada constitute sufficient appropriate audit evidence? Give reasons for your answer.

b. Describe the procedures you need to perform in relation to this situation before signing the auditor's report.

Source: Adapted from Professional Year Programme of the ICAA, 1997, Advanced Audit Module. Provided courtesy of Chartered Accountants Australia and New Zealand.

13.12 Audit of consolidated financial statements **Challenging** **LO 8**

Your firm of accountants is the auditor of Oxford Ltd., a reporting entity. Oxford's consolidated financial statements incorporate the financial statements of its four subsidiaries. Three subsidiaries are incorporated in Canada and audited by your firm. The fourth subsidiary is located in another country and audited by another firm of professional accountants.

Required

a. Explain how you would verify the intercompany balances.

b. Describe other audit adjustments you would expect to find and explain how you would verify each of them:

  i. where the subsidiary had been acquired *before* the financial year under audit.

  ii. where the subsidiary had been acquired *during* the financial year under audit.

  iii. Describe the procedures necessary to determine the level of reliance to be placed on the audited financial statements of the foreign subsidiary.

Case Study—Cloud 9

The worksheet you completed for the case study question in chapter 8 includes your estimates of the overall risk assessment (ORA) and the acceptable detection risk (DR) in the sales to cash receipts process.

Required

Based on your ORA and DR estimates, design substantive audit procedures for Cloud 9 that would address the DR for cash.

Research Question 13.1

The audit of short-term investments can be a high-risk area for auditors. A case in Australia (*AWA Ltd v. Daniels t/a Deloitte Haskins & Sells & Ors* (1992) 10 ACLC 933) found the auditors negligent for failing to report weaknesses in the foreign exchange trading to an adequate level of management. The collapse of Barings Bank in Singapore also focused questions on whether adequate attention was paid to reviewing internal controls over foreign currency transactions. Consider, for example, the following extract:

> The refusal of Coopers & Lybrand's Singapore partnership to cooperate with the inquiry into the collapse of Barings Bank has left gaping holes in the explanation of the auditors' role in the affair. The inquiry by the Board of Banking Supervision concluded that the collapse could be attributed to concealed and unauthorized trading by Nick Leeson, which the bank's management and the external auditors and regulators failed to notice.

Crucial from the auditors' point of view is why they failed to notice the "absolute failure" of Barings' internal controls. Some indication of the crisis was picked up by Barings' internal auditors in 1994, but their recommendations were never implemented, and the external auditors subsequently ruled the company's controls acceptable.

Source: Extract from "Auditors' Silence Leaves Questions Unanswered," *Accountancy* 116(1224), August 1995, p. 11.

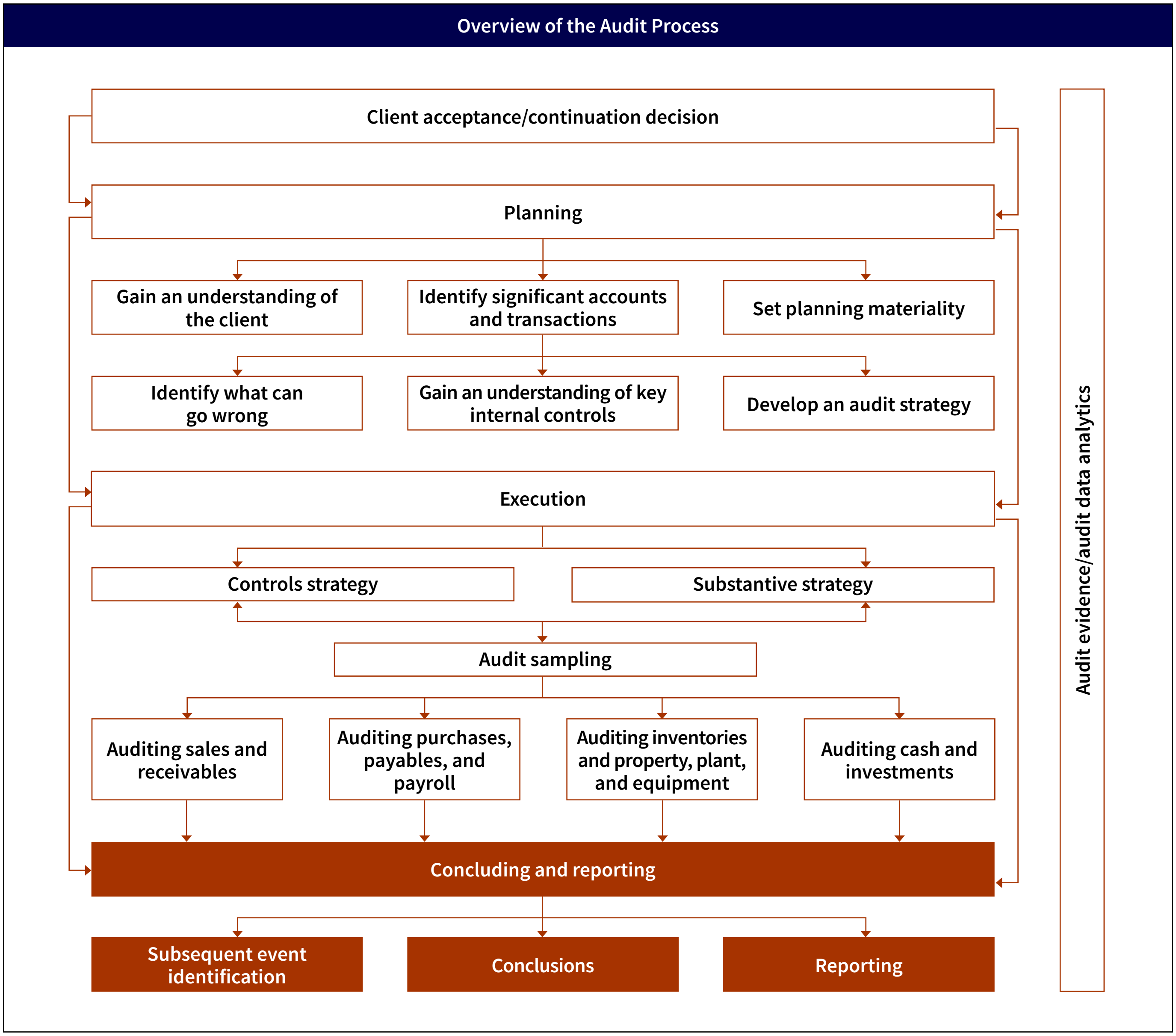
Required

a. For one of the above two cases mentioned, research the alleged or actual deficiencies of the work performed by the auditor.

b. What are specific issues of importance in performing an audit of short-term investments?

CHAPTER **14**

Completing and Reporting on the Audit



LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
After studying this chapter, you should be able to:		Standards addressed in each learning objective are as follows:
1 Explain the procedures performed as part of the engagement wrap-up, including gathering and evaluating audit evidence	**14.1** Engagement Wrap-Up **14.1.1** Sufficient appropriate audit evidence **14.1.2** Evaluating audit evidence	CAS 230 *Audit Documentation* CAS 320 *Materiality in Planning and Performing an Audit* CAS 330 *The Auditor's Responses to Assessed Risks* CAS 500 *Audit Evidence* CAS 520 *Analytical Procedures* CAS 705 *Modifications to the Opinion in the Independent Auditor's Report* CAS 720 *The Auditor's Responsibilities Relating to Other Information* CSQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance Engagements*
2 Understand the considerations when assessing the going concern assumption used in the preparation of the financial statements	**14.2** Going Concern	CAS 570 *Going Concern* IAS 1 *Presentation of Financial Statements*
3 Understand the purpose of and the procedures performed in the review for contingent liabilities and commitments	**14.3** Contingent Liabilities	CAS 501 *Audit Evidence—Specific Considerations for Selected Items*
4 Compare the two types of (material) subsequent events to determine what effect they have on the financial statements (if any)	**14.4** Subsequent Events **14.4.1** Type 1 subsequent events **14.4.2** Type 2 subsequent events **14.4.3** Procedures used when conducting a subsequent events review **14.4.4** Auditor responsibility for subsequent events	CAS 560 *Subsequent Events* CAS 580 *Written Representations* IAS 10 *Events after the Reporting Period* ASPE 3820 *Subsequent Events*
5 Analyze misstatements and explain the difference between quantitative and qualitative considerations when evaluating misstatements	**14.5** Misstatements **14.5.1** Current-year misstatements **14.5.2** Prior-year misstatements **14.5.3** Qualitative considerations	CAS 450 *Evaluation of Misstatements Identified During the Audit*
6 Evaluate conclusions obtained during the performance of the audit and explain how these conclusions link to the overall opinion formed on the financial statements	**14.6** Evaluating the Conclusions and Forming an Opinion	CAS 700 *Forming an Opinion and Reporting on Financial Statements*

LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
7 Describe the components of an audit report	**14.7** Components of the Audit Report	CAS 700 *Forming an Opinion and Reporting on Financial Statements* CAS 701 *Communicating Key Audit Matters in the Independent Auditor's Report* CAS 800 *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks* CAS 805 *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement* CAS 810 *Engagements to Report on Summary Financial Statements*
8 Identify the types of modifications to an audit report	**14.8** Identification of the Types of Modifications to an Audit Report **14.8.1** Emphasis of matter and Other Matters **14.8.2** Inability to obtain appropriate audit evidence **14.8.3** Material misstatement of financial statements	CAS 705 *Modifications to the Opinion in the Independent Auditor's Report* CAS 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*
9 Explain what reporting is required to management and those charged with governance	**14.9** Communication with Those Charged with Governance **14.9.1** Audit matters of governance interest to be communicated **14.9.2** Documentation considerations	CAS 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* CAS 250 *Consideration of Laws and Regulations in an Audit of Financial Statements* CAS 260 *Communication with Those Charged with Governance* CAS 265 *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*
10 Understand the various types of other engagements that auditors may be asked to perform	**14.10** Other Engagements **14.10.1** Reports prepared in accordance with a special purpose framework **14.10.2** Reports on a component of the financial statements **14.10.3** Review engagements **14.10.4** Review engagements on interim financial statements **14.10.5** Assurance engagements **14.10.6** Compliance engagements	CAS 800 *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks* CAS 805 *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement* CSAE 3000 *Attestation Engagements Other than Audits or Reviews of Historical Financial Information* CSAE 3001 *Direct Engagements*

LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
	14.10.7 Reporting on controls **14.10.8** Reports on supplementary matters **14.10.9** Reports on the results of applying specified procedures to financial information other than financial statements **14.10.10** Reports on the application of accounting principles **14.10.11** Reports used in an offering document or designated document	CSAE 3416 *Reporting on Controls at a Service Organization Relevant to User Entities' Internal Control Over Financial Reporting* CSAE 3530 *Attestation Engagements to Report on Compliance* CSAE 3531 *Direct Engagements to Report on Compliance* CSAE 7060 *Auditor Review of Interim Financial Statements* CSRE 2400 *Engagements to Review Historical Financial Statements* CSRS 4460 *Reports on Supplementary Matters Arising from an Audit or a Review Engagement* Section 7150 *Auditor's Consent to the Use of a Report of the Auditor Included in an Offering Document* Section 7170 *Auditor's Consent to the Use of the Auditor's Report in Connection with a Designated Document* Section 7600 *Reports on the Application of Accounting Principles* Section 9100 *Reports on the Results of Applying Specified Auditing Procedures to Financial Information Other than Financial Statements*

Cloud 9 Integrated Case

The partner on the Cloud 9 Ltd. audit, Jo Wadley, has called a meeting with the senior staff (Sharon Gallagher, Josh Thomas, Suzie Pickering, and Mark Batten) to discuss the completion of the audit. The partner wants to be sure that all issues are "in hand" and that she is briefed on all contentious matters so that she can resolve them at the scheduled meetings with Cloud 9's board and management. Meetings with clients at the end of the audit can be quite difficult. Sometimes the audit partner considers qualifying the audit report if the client's management will not adjust the financial statements to reflect errors found during the audit.

Sharon, Josh, Suzie, and Mark decide to hold a preliminary meeting to prepare for the meeting with the partner. On the agenda are:

- final evidence and misstatements evaluation
- going concern procedures and assessment
- subsequent events procedures and evidence
- overall conclusion and audit opinion
- legal issues
- communication with Cloud 9's board

What issues have arisen with Cloud 9's audit? How can the audit team make sure that the partner is fully prepared for the meeting with the client's management?

Chapter Preview

During the completion phase of the audit, a number of procedures are performed. First, the auditor evaluates the audit evidence obtained and reviews the documentation to ensure that it is of sufficient quality and quantity. Before drawing an overall conclusion on the audit, the auditor also reassesses the going concern assumption, considers the existence of contingent liabilities and subsequent events, performs any additional wrap-up procedures, and assesses any misstatements (sometimes referred to as audit differences) identified throughout the audit and the effect they may have on the overall conclusion (and opinion). The auditor also performs analytical procedures on the adjusted financial statements as a means of assessing their fair presentation.

The final step in the audit process is to evaluate the conclusions drawn from the audit evidence obtained (which will form the basis for the auditor's opinion on the financial statements) and to prepare an appropriately worded audit report. At the same time, a management representation letter is obtained from the client and appropriate communication with those charged with governance is prepared. Consideration is given to compliance with laws and regulations throughout the audit and again as part of the wrap-up and conclusion procedures.

14.1 Engagement Wrap-Up

LEARNING OBJECTIVE 1

Explain the procedures performed as part of the engagement wrap-up, including gathering and evaluating audit evidence.

During the wrap-up of an engagement, the auditor finalizes any open items before issuing the audit report, including determining if any remaining procedures are to be completed for the audit. Any remaining audit procedures are assigned to team members, with due dates for completion of the open items. This includes determining that the audit team has properly completed and executed the audit procedures that were planned and that all relevant matters have been appropriately considered.

The following areas are ordinarily covered during the wrap-up of an engagement:

1. Review the audit file to ensure that the planned audit procedures were executed properly and completely. The file is typically reviewed in detail by the manager or above and high-risk areas are typically reviewed by the partner. During the review process, the reviewer makes a list of "review comments" identifying issues not yet resolved, issues requiring further clarification, and any audit procedures not yet completed. As each working paper is reviewed, it is initialled and dated as evidence that the review was performed.
2. Determine that all necessary matters have been appropriately considered. All significant issues should be documented and conclusions reached. For open items that are no longer relevant to the audit (or necessary to complete), the auditor documents in the audit working papers this fact and the reason(s) why they are no longer relevant.
3. Clear all outstanding review notes and "to-do" items and perform any audit procedures not yet completed. At this stage, if additional audit attention is needed, the auditor performs the necessary audit procedures to resolve open items and issues until they are cleared to the reviewer's satisfaction.
4. Remove all unnecessary documentation, drafts, and cleared review notes from the engagement files. The auditor retains records relevant to the audit, such as audit working papers and other documents that form the basis of the audit opinion, including memoranda, correspondence, communications, and other documents and records (including electronic records) that (1) are created, sent, or received in connection with the audit and (2) contain conclusions, opinions, analyses, or financial data related to the audit. Superseded working papers and financial statements, notes that reflect incomplete or preliminary thinking, and duplicates of documents should be removed.
5. For multi-location engagements, check to ensure that all documents requested from other audit teams have been obtained and reviewed.
6. Consider the amount used for materiality. The auditor considers whether the amount that was used for **materiality** (as addressed in CAS 320 *Materiality in Planning and Performing an Audit*) when planning the audit and detecting misstatements (rather than evaluating them) is still appropriate as the basis for their conclusion on the fair presentation of the financial statements taken as a whole. They consider whether, during the course of the

materiality information that has an impact on the decision-making of users of the financial statements audit, they have identified any factors or conditions about the client or its environment (for example, a significant change in anticipated operating results) that would cause them to determine that a different (lower) amount would have been appropriate in establishing their planning materiality. It is important to revisit the amount used for materiality when evaluating misstatements, taking into consideration qualitative as well as quantitative factors.

When the amount considered material at the end of the audit is significantly lower than at the beginning of the audit (for example, because the basis used for calculating materiality at the planning stage was substantially higher), the auditor considers whether the procedures used throughout the audit were sufficient and whether additional audit procedures need to be performed. To avoid possible surprises at the end of an audit, the auditor should reassess the appropriateness of the materiality set throughout the audit to make sure that sufficient audit procedures are being performed.

7. Reconsider the assessments of internal control at the entity level and the risk of fraud. When planning an audit, the auditor identifies the presence or absence of factors related to the five components of internal control and the risk of fraud and makes an initial assessment of control and fraud risk. They then consider throughout the audit whether additional factors or risks are present, whether they need to revise their conclusion of control risk at the entity level, and whether the controls are supportive of the prevention and correction of material misstatements, whether due to fraud or error. The auditor specifically reconsiders the assessment of internal control at the entity level when they become aware of significant changes in the client's system of internal controls and after they perform tests of controls. Their conclusions about the effectiveness of internal control at the entity level may be affected by control exceptions that they identify when executing their tests of controls.

   When the results of their audit tests identify misstatements in the financial statements, the auditor considers whether such misstatements may be indicative of fraud. The auditor's consideration of fraud risk, and the results of their audit procedures, may indicate that they need to consider withdrawing from the engagement. For example, the auditor may determine that the fraud is so pervasive in the business that they will be unable to complete their audit procedures, or that the fraud will have such an impact on the client's reputation that they no longer wish to have it as a client. In these rare cases, any decision to withdraw from the engagement is not taken lightly and extensive consultation both internally within the audit firm and externally with legal counsel will occur before any action is taken. Whether or not the decision is taken to withdraw from the audit engagement depends on (1) whether the evidence suggests that management has been involved in perpetrating the fraud (or there are concerns regarding management's integrity, based on how it dealt with the fraud once it was identified) and (2) the diligence and co-operation of management in investigating the circumstances of the fraud and taking appropriate action.

   At the conclusion of the audit, the auditor formally reconsiders their assessment of internal control and fraud risk by considering whether the accumulated results of their audit procedures and other observations affect the assessments they made when planning the audit. This evaluation also considers qualitative matters based on the engagement team and audit team executives' **professional judgement**.

professional judgement the exercise of the auditor's professional characteristics, such as their expertise, experience, knowledge, and training

8. Revisit the planning documentation to ensure that all significant issues identified during the planning phase have been addressed.
9. Perform analytical procedures on the adjusted financial statements. Analytical procedures are used at the end of the audit to evaluate whether the final financial statements are consistent with the knowledge of the business obtained during the audit. Analytics are employed to corroborate the conclusions formed on the individual financial statement elements and the financial statements overall.
10. During the audit, adjustments to the client's original balances may be made, and therefore the financial statements may change. It is important that at the end of the audit, the auditor reconciles the client's final trial balance and other records to the final financial statements. The auditor should also perform a final review of the financial statements to ensure the level of aggregation, wording, and disclosures are appropriate.
11. Perform a review for contingent liabilities and commitments to ensure that they are properly accounted for or disclosed. Specific audit procedures are performed in this area, usually toward the end of the audit. This is discussed further in section 14.3.

12. Perform subsequent events procedures. During the wrap-up of the engagement, the auditor performs what is referred to as subsequent events procedures. The objective of subsequent events procedures is to identify those events occurring between year end (that is, the reporting date) and the date of the audit report that may require adjustment to or disclosure in the financial statements. Subsequent events procedures are normally performed through to and including the date of the audit report. Subsequent events are discussed in more detail in section 14.4.
13. The auditor should have a discussion with management to understand what documents will be included in the annual report and when it will be ready for review. When available, the auditor should read the other information included in the entity's annual report to consider if there are any material inconsistencies between the audited financial statements and the other information, and any material inconsistencies between the other information and the auditor's knowledge obtained through the audit, in the context of audit evidence obtained and conclusions reached. (These requirements can be found in CAS 720 *The Auditor's Responsibilities Relating to Other Information*.) The auditor's work effort on other information applies regardless of whether the other information is obtained prior to or after the date of the auditor's report on the financial statements.
14. It is important that the audit file be completed on a timely basis. The engagement quality standards require engagement teams to assemble the final engagement file on a timely basis after the audit report has been finalized. Many firms refer to this as "archiving" the audit file. Once a file is "archived," nothing is to be removed, deleted, or discarded from the file. If the auditor finds it necessary to modify existing audit documentation or add new audit documentation, the nature of the modifications, why the changes were made, and by whom they were made must be documented.

14.1.1 Sufficient Appropriate Audit Evidence

The objective of an audit is to obtain sufficient appropriate evidence to reduce the risk of material misstatement in the financial statements to an acceptably low level.

What constitutes **sufficient appropriate evidence** is ultimately a matter of professional judgement. It will be based on the satisfactory performance of audit procedures designed to address the assessed risk of material misstatement (as addressed in CAS 500 *Audit Evidence*). This includes any additional or modified procedures performed to address changes identified in the original assessment of risk. Factors to consider in evaluating the sufficiency and appropriateness of audit evidence (assuming the tests were appropriate to the type of account and assertions most at risk) include:

sufficient appropriate evidence quantity (sufficiency) and quality (appropriateness) of audit evidence gathered

- materiality of misstatements
- management responses
- previous experience
- results of audit procedures performed
- quality of information obtained
- persuasiveness of the audit evidence
- whether the evidence obtained supports or contradicts the results of the risk assessment procedures

If it is not possible to obtain sufficient appropriate audit evidence, the auditor should express a qualified, adverse, or disclaimer of opinion, as described in CAS 705 *Modifications to the Opinion in the Independent Auditor's Report*.

14.1.2 Evaluating Audit Evidence

The goal in evaluating audit evidence is to decide, after considering all the relevant data obtained, whether:

1. the assessments of the risk of material misstatement at the assertion level are appropriate, and

2. sufficient evidence has been obtained to reduce the risk of material misstatement in the financial statements to an acceptably low level.

An audit is an ongoing, cumulative, and iterative process of gathering and evaluating evidence. This requires an attitude of professional scepticism to be applied by each member of the audit team, ongoing discussions among the audit team members throughout the engagement, and timely modifications being made to planned procedures to reflect any changes to the original risk assessments.

When misstatements or deviations from controls are found in planned procedures, consideration should always be given to:

- the reason for the misstatement or deviation
- the impact on risk assessments and other planned procedures
- the need to modify or perform further audit procedures

Before evaluating the results of procedures and any misstatements identified, as discussed previously, consideration should be given to whether the materiality levels established during the planning phase need to be revised. A change in materiality could be a result of:

- new information—for example, the bank supplying the company with funding may have decided to refinance the debt during the year and put in place very restrictive covenants relating to certain balances
- a change in the auditor's understanding of the entity and its operations
- new circumstances—for example, actual profit may be significantly lower than expected profit at the planning stage of the audit

Cloud 9 Integrated Case

Sharon suggests that the members of the team ask themselves whether they believe that sufficient appropriate evidence on which to base an audit opinion has been gathered. Which issues are not satisfactorily resolved? Where do they need to gather additional evidence? Which notes can be cleared and removed from the files? Are assessments of risk and materiality still valid, given the evidence obtained from substantive procedures?

The team members have performed a final review of the audit evidence on the audit sections they were assigned, and have identified the major audit differences that the partner will need to resolve with Cloud 9's management. It appears that the only other major outstanding items are the going concern assessment, the search for contingent liabilities, and the subsequent events procedures. None of these can be finalized prior to year end, and certain procedures need to be performed up until the audit report date.

Before You Go On

14.1.1 Explain why it is important to reassess materiality at the end of the audit.

14.1.2 What is the goal in evaluating audit evidence?

14.1.3 Provide three considerations when evaluating the sufficiency and appropriateness of audit evidence.

14.2 Going Concern

LEARNING OBJECTIVE 2

Understand the considerations when assessing the going concern assumption used in the preparation of the financial statements.

going concern the viability of a company to remain in business for the foreseeable future

As discussed in CAS 570 *Going Concern*, the going concern assumption is a fundamental principle in the preparation of the financial statements. Under the **going concern** assumption, an entity is viewed as continuing in business for the foreseeable future with neither the intention nor the need for liquidation, ceasing trading, or seeking protection from creditors pursuant to laws or regulations. As a result, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

Some financial reporting frameworks contain an explicit requirement for management to make an assessment of the entity's ability to continue as a going concern. For example, IAS 1 *Presentation of Financial Statements* requires management to make an assessment of an entity's ability to continue as a going concern, and when management is aware of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, to disclose those uncertainties.

Under other financial reporting frameworks (for example, preparing information in accordance with a joint venture or sale agreement), there may be no explicit requirement for management to make a specific assessment of the entity's ability to continue as a going concern. Nevertheless, since the going concern assumption is a fundamental principle in the preparation of the financial statements, management has a responsibility to assess the entity's ability to continue as a going concern even if the financial reporting framework does not include an explicit requirement to do so.

The following factors are relevant when management is assessing the going concern assumption:

- Generally, the further into the future an event is likely to take place, the greater the uncertainty surrounding that event. For that reason, most financial reporting frameworks specify the period for which management is required to assess all available information when making its going concern assessment, which is typically 12 months from the date of the financial statements.
- Any judgement about the future is based on information available at the time at which the judgement is made. Subsequent events can contradict a judgement that was reasonable at the time it was made. Management of clients in industries subject to frequent change face more difficulty when assessing the going concern assumption.
- The size and complexity of the entity, the nature and condition of its business, and the degree to which it is affected by external factors all affect judgement regarding the outcome of events or conditions.

CAS 570 *Going Concern* requires that the auditor consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements. Consideration of management's use of the going concern assumption is based on knowledge of conditions or events obtained through planning and performing the audit. The auditor considers whether their procedures identify conditions and events that, when considered in the aggregate, indicate that there could be substantial doubt about the entity's ability to continue as a going concern. If there is a significant doubt about an entity's ability to continue as a going concern, the auditor should ask management to develop a plan showing how they plan to turn things around. The auditor should assess the feasibility of the turnaround plan, which may involve future plans to borrow money, sell assets, or reduce costs. CAS 570 (para. 16(b)) indicates the auditor should evaluate whether the outcome of these plans is likely to improve the situation. If the plan includes a financial forecast, the auditor should assess the assumptions used by management. Lastly, the auditor should include a reference to the plan in the management representation letter.

With respect to reporting, the auditor also considers whether there are material uncertainties about the entity's ability to continue as a going concern that need to be disclosed in the financial statements and any impact this may have on the audit report. Usually, material uncertainties relate to an entity's inability to meet obligations as they become due without substantial disposals of assets outside the ordinary course of business, restructuring of debt or equity, or major operational improvements. If a material uncertainty exists and it is adequately disclosed, the auditor may issue an unmodified opinion but refer to the issue in the audit report using the heading "Material Uncertainty Related to Going Concern." This is required to draw the user's attention to the going concern note in the financial statements. The going concern note disclosure should include a description of the conditions that give rise to the going concern issue and management's plan to address it. If a material uncertainty exists but it is not adequately disclosed, the auditor will issue a qualified or adverse report depending on the circumstances.

The going concern assumption does not apply to financial statements prepared on a liquidation basis. For example, when owners decide to dissolve the business or bankruptcy proceedings reach a point at which liquidation is probable, they prepare the financial statements on a liquidation basis. When the financial statements are not prepared on a going concern basis, that fact needs to be disclosed, together with the basis on which the financial statements have been prepared and the reason why the entity is not considered to be a going concern.

Cloud 9 Integrated Case

Sharon and the team discuss whether there are any issues casting doubt on the appropriateness of the going concern assumption at Cloud 9. The financial ratios indicate no problems with solvency, and the major borrowings are not due to be repaid or refinanced for another four years. However, because of the costs associated with the new store opening and the sponsorship deal, Cloud 9 is not expecting a significant profit. The team concludes that there are no significant issues casting doubt on the going concern assumption.

Before You Go On

14.2.1 Provide one consideration management should take into account when assessing the going concern assumption.

14.2.2 Provide one consideration the auditor should take into account when assessing the going concern assumption.

14.2.3 Does the going concern assumption always apply to all audits?

14.3 Contingent Liabilities

LEARNING OBJECTIVE 3

Understand the purpose of and the procedures performed in the review for contingent liabilities and commitments.

Contingent liabilities are existing or possible obligations on the balance sheet date when the final outcome is uncertain and contingent upon a future event. Most financial reporting frameworks require an entity to record or disclose such contingent liabilities, depending on whether they are "likely" or "probable" and "measurable." While it is management's responsibility to determine the appropriate accounting treatment, given the financial reporting framework under which the financial statements will be prepared, CAS 501 *Audit Evidence—Specific Considerations for Selected Items* requires the auditor to "search" for any litigation and claims involving the entity that the auditor may not be aware of but which may give rise to a material misstatement. The auditor is required to perform the following procedures:

- Inquire of management and others within the entity, including in-house legal counsel, if there are any unreported contingent liabilities.
- Review minutes of meetings of **those charged with governance** and correspondence between the entity and its external legal counsel.
- Review correspondence with taxation authorities.
- Review legal expense accounts for unexpected fluctuations.

those charged with governance generally the board of directors, and may include management of an entity

- Include in the management representation letter the fact that all contingent liabilities have been disclosed to the auditor.

If the auditor has assessed a risk of material misstatement regarding litigation and claims, they are required by CAS 501.10 to request permission from the client to contact the entity's external counsel. This is usually done via the legal letter. If the client does not grant permission for this communication, then the auditor will look to gather evidence by performing alternative procedures. If the alternative procedures do not provide sufficient and appropriate evidence, then the auditor will need to modify the opinion in the auditor's report.

The procedures for contingent liabilities are usually performed at the end of the audit to ensure that there is sufficient and appropriate evidence in the audit file to support not only contingent liabilities but also the work performed for subsequent events, as described in the next section. While performing the procedures for contingent liabilities, the auditor will also look for evidence that the entity has entered into long-term commitments that have not been appropriately disclosed.

Before You Go On

14.3.1 What is a contingent liability?

14.3.2 What are management's responsibilities with respect to contingent liabilities? What are the auditor's responsibilities?

14.3.3 List three procedures the auditor is required to perform with respect to contingent liabilities.

14.4 Subsequent Events

LEARNING OBJECTIVE 4

Compare the two types of (material) subsequent events to determine what effect they have on the financial statements (if any).

The financial statements are prepared on the basis of conditions existing at year end (that is, the reporting date). However, significant events, both favourable and unfavourable, can occur after year end but before the issuance of the audit report that, unless reflected in the financial statements or suitably disclosed therein, could make the financial statements misleading. Therefore, the auditor is responsible for gathering evidence for subsequent events up to the date of the audit report. Once the audit report has been signed, the auditor is no longer responsible for detecting subsequent events.

There are three key dates that are important when considering subsequent events:

1. The date on which the financial statements are approved. This is the date on which those with the recognized authority assert that they have prepared the entity's complete financial statements, including the required disclosures, and that they have taken responsibility for the financial statements. The audit report should not be dated before this date.
2. The date of the audit report. This is the date on which the auditor signs the audit report on the financial statements. The audit report is not dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base their opinion on the financial statements. Sufficient appropriate audit evidence includes evidence that the entity's complete financial statements have been prepared and that those with the recognized authority have asserted that they have taken responsibility for the statements.

3. The date on which the financial statements are issued. This is the date on which the audit report and audited financial statements are made available to third parties, which may be, in many circumstances, the date on which they are filed with a regulatory authority.

Each of these terms becomes important when considering the date when fieldwork is completed. They are further explained below.

CAS 560 *Subsequent Events* establishes standards and provides guidance on the auditor's responsibility regarding subsequent events. This standard describes the two types of **subsequent events** that require consideration and evaluation:

subsequent events both events occurring between year end and the date of the audit report, and facts discovered after the date of the audit report

1. events that provide additional evidence with respect to conditions that existed at the date of the financial statements (type 1 subsequent events)
2. events that provide evidence with respect to conditions that arose subsequent to the date of the financial statements (type 2 subsequent events)

The two types of subsequent events are also defined in IAS 10 *Events After the Reporting Period* and ASPE Section 3820 *Subsequent Events*. Each of them is now discussed in more detail.

14.4.1 Type 1 Subsequent Events

Type 1 subsequent events provide additional evidence with respect to conditions that existed at year end. Such events may affect the estimates inherent in the financial statements or indicate that the going concern assumption in relation to the whole or a part of the entity is not appropriate. Therefore, the financial statements should be adjusted to reflect any material type 1 subsequent event up to the date of the audit report. This may include revisions to estimates where new information is now available. Examples of type 1 subsequent events (requiring changes of amounts in the financial statements) are:

- the bankruptcy of a customer subsequent to year end, which would be considered when evaluating the adequacy of the allowance for doubtful accounts
- an amount received with respect to an insurance claim that was being negotiated at year end
- deterioration in operating results and financial position after year end that is so significant that it may indicate that the going concern assumption is not appropriate to use in the preparation of the financial statements
- the settlement of a lawsuit after the reporting period for an amount different from what was originally estimated

14.4.2 Type 2 Subsequent Events

Type 2 subsequent events are those events that do not result in changes to amounts in the financial statements. However, these events may be of such significance as to require disclosure in the financial statements. Examples of type 2 subsequent events (not requiring adjustment but possibly requiring disclosure in the financial statements) are:

- the uninsured (or underinsured) loss of plant or inventory as a result of a fire or flood subsequent to year end
- the purchase of a business
- the issuance of shares or debt securities

14.4.3 Procedures Used When Conducting a Subsequent Events Review

The subsequent events review performed for identifying type 1 or type 2 events requires the auditor to perform specific audit procedures different from the usual examination of transactions after year end (for example, the verification of the cut-off of sales or the collection of trade receivables). However, when the usual examination of transactions after year end is performed as part of the substantive tests of certain account balances, primarily to ensure that routine transactions are recorded in the proper period, or to review the appropriateness at year end of the carrying amounts of assets and the adequacy of liabilities for losses or expenses, the auditor will be alert for items that may indicate significant subsequent events. When performing these procedures, the auditor may become aware of significant events occurring subsequent to the balance sheet date that may require adjustment to or disclosure in the financial statements.

The procedures performed to identify events that may require adjustment of or disclosure in the financial statements are performed as near as practicable to the date of the audit report and include some or all of the following:

- gaining an understanding of and evaluating processes that management has established to determine that subsequent events are identified and dealt with
- reading minutes of meetings of the board of directors and executive committees held after year end and inquiring about matters discussed at meetings for which minutes are not available
- reading and analyzing the latest available interim financial statements and, as considered necessary and appropriate, budgets, cash flow forecasts, and other related management reports for events such as changes in accounting principles, significant changes in results or working capital, and non-compliance with loan terms; and reviewing sales, receipts, journals, and other accounting records relating to transactions that have occurred subsequent to the date of the financial statements
- inquiring, or extending previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims
- assessing continued compliance with borrowing limits and loan covenants
- inquiring of those charged with governance as to whether any subsequent events have occurred that might affect the financial statements
- inquiring of management as to whether any subsequent events have occurred that might affect the financial statements. Examples of inquiries of management on specific matters are:
  - whether new commitments, borrowings, or guarantees have been entered into or any other factors have changed the classification of any liabilities
  - whether sales of assets have occurred or are planned, or any other plans have been made that may affect the carrying value or classification of assets
  - whether new shares have been issued, long-term debt have been put in place, or an agreement to merge or liquidate has been made, or any of these events are planned
  - whether any change of ownership has occurred or is contemplated
  - whether any assets have been seized (or appropriated) by the government or destroyed—for example, by flood or fire
  - whether there have been any developments regarding risk areas and contingencies
  - whether any unusual adjustments have been made since the date of the financial statements or are contemplated
  - whether any significant changes in foreign exchange rates have occurred that could affect the entity
  - whether there has been any change in the status of related party transactions, including those entered into subsequent to the date of the financial statements
  - whether any significant assessments have been made by tax authorities with respect to tax assessments, fines, and penalties
  - the current status of items involving subjective judgement or that were accounted for on the basis of preliminary information, such as provisions for litigation in progress
  - whether any events have occurred or are likely to occur that will bring into question the appropriateness of accounting policies used in the preparation of the financial statements; for example, if such events call into question the validity of the going concern assumption

– sales and profit trends, industry and general economic climate, exceptional bad debt losses, decreases in raw material prices or possible inventory losses, renegotiation of prices under contract, or sales of inventory at a loss

The auditor obtains written representations (as covered in CAS 580 *Written Representations*) from management as part of the management representation letter confirming oral representations made with respect to subsequent events and stating that it is not aware of other relevant subsequent events.

The extent to which the results of these procedures will need reviewing and updating immediately prior to issuing the audit report depends on the length of time that has elapsed since the procedures were carried out and the susceptibility of the matters under consideration to change over time.

Figure 14.1 shows the subsequent event timeline and the responsibility of the auditor to gather evidence up to the release of the audited financial statements.

14.4.4 Auditor Responsibility for Subsequent Events

Subsequent events may require adjustments to the financial statements. For subsequent events occurring *up to the date of the auditor's report*, if the client indicates that it will not change the financial statements in a situation where the auditor believes they should be changed, a qualified or adverse opinion is issued. When the audit report has been released to the entity (but not released to the public), the auditor would notify those charged with governance (generally the board of directors and management) not to issue the financial statements and audit report to any third parties. If the financial statements have been released or are subsequently released anyway (without being changed), the auditor must take action to prevent reliance on the audit report. This is usually done by withdrawing the audit report and the company issuing a communication to those third parties that have received the report.

After the audit report is signed, the auditor is not required to perform any further procedures relating to subsequent events. But if *after the financial statements have been issued* the auditor becomes aware of a fact that existed at the date of the audit report and that, if the auditor had known at that date, could have caused them to modify the audit report, the auditor should:

1. Consider whether the financial statements need revision.
2. Discuss the matter with management and those charged with governance.
3. Consider whether the actions taken are appropriate in the circumstances. This would include performing any additional audit procedures necessary, and reviewing and approving any revisions to the financial statements. In addition, anyone in receipt of the previously issued financial statements and audit report should be informed of the situation and advised that a new audit report has been issued on the revised financial statements.

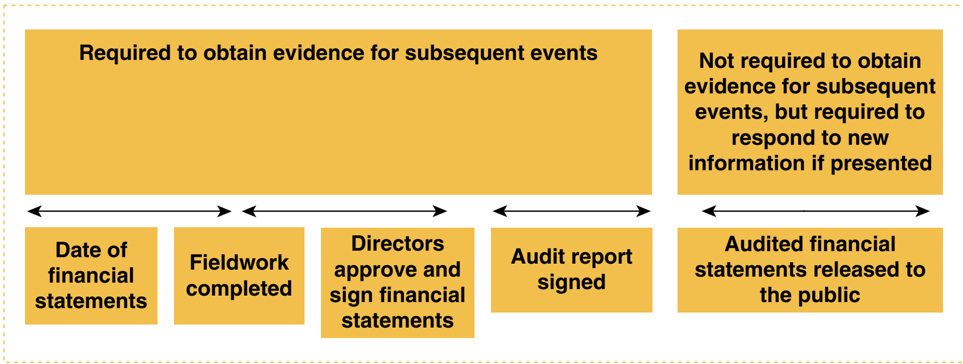


FIGURE 14.1 Subsequent event timeline

The revised audit report may be dated no earlier than the date on which the new financial statements are approved and should include an emphasis of matter paragraph referring to the note in the financial statements that more extensively outlines the reason(s) for the revision to the previously released financial statements. If the impact of the item requiring adjustment is not pervasive to the financial statements overall, the auditor may alternatively choose to double-date the audit report. In this case, the audit report date would be the original date and a new date would be added for the change to the financial statements. For example, if the original audit report was signed and issued on March 15, 2024, and subsequently the auditor became aware of a lawsuit that should have been disclosed but was not, the financial statements should be amended to include the note disclosure of the contingent liability. As the impact of the subsequent event in this example can be isolated, the auditor can still date the financial statements March 15, 2024, adding "except for note X dated April 15, 2024."

When management does not take the necessary steps, the auditor should notify those charged with governance (such as the audit committee or board of directors) of the entity that action will be taken by the auditor to prevent future reliance on the auditor's report. As discussed above, this is usually done through communication with regulatory filers and through the entity's website.

Cloud 9 Integrated Case

Procedures to search for subsequent events at Cloud 9 are documented in the audit program. These include a review of minutes of board meetings in December, January, and February, and analysis of the interim results for these months (including analytical procedures). The partner on the audit will also formally ask management about any subsequent events that have come to its attention in the meetings to be held between year end and the audit report date. The team will also search for additional borrowings or other matters involving significant contracts.

Before You Go On

14.4.1 Describe the two types of subsequent events that are required to be considered as part of the audit of the financial statements.

14.4.2 Provide two types of procedures an auditor may perform to identify a subsequent event.

14.4.3 What should an auditor do when, after the discovery of a subsequent event, the client does not take appropriate action?

14.5 Misstatements

LEARNING OBJECTIVE 5

Analyze misstatements and explain the difference between quantitative and qualitative considerations when evaluating misstatements.

When performing substantive testing, the key objective is to determine whether there are material errors within each account balance and to quantify any identified errors. A **misstatement** is a difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. It is important to note that CAS 450, *Evaluation of Misstatements Identified During the Audit*, indicates that misstatements in disclosures include the inappropriate aggregation or disaggregation of information, missing or incomplete disclosures, and the omission of a significant disclosure necessary for the fair presentation of the financial statements beyond what is required. An **error** is an unintentional misstatement in the financial statements,

misstatement a difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

error an unintentional misstatement in the financial statements, including the omission of an amount or a disclosure including the omission of an amount or a disclosure. When an error or exception is identified during substantive testing, the first response is to find out why it has arisen. It may require an increase to the sample size to ensure that there are no other errors in the balance (unless the total error in the account balance can be quantified without performing additional testing; for example, if the error was found after performing an audit data analytic on an entire population, then further testing is not required. In this case, the actual amount of the total error will be known). It is important when errors are identified to continue testing until the error can either be accurately quantified or the balance has been fully tested to an extent that proves that a material error can no longer exist within the balance.

In reaching a conclusion as to whether the misstatements need to be corrected by the client, the auditor evaluates whether the misstatement either causes the financial statements to be materially misstated or requires additional disclosure. This evaluation involves considerable professional judgement. Both quantitative and qualitative considerations are taken into account, including:

- the risk of additional misstatements remaining undetected
- the effects of identified misstatements on the client's compliance with covenants under debt or similar agreements
- whether the proposed corrections result from an error or are the result of a **judgemental misstatement** between the client's and the auditor's application of accounting policies
- the reversing effect of uncorrected misstatements identified in the prior year on the current year's financial statements (see section 14.5.2)
- the likelihood that recurring differences, which currently are immaterial, will have a material effect in the future
- the sensitivity of the circumstances surrounding the misstatements—for example, the implications of differences involving fraud and possible illegal acts, or violations of contractual provisions
- the significance of the financial statement elements and disclosures affected by the misstatements
- the significance of the misstatements relative to known user needs—for example, the magnifying effects of the misstatements on the calculation of a purchase price in a transfer of interests (buy/sell agreement)
- the effect of the misstatements on segment information or on another portion of the client's business that has been identified as playing a significant role in the client's operations or profitability
- the effects of offsetting misstatements in different financial statement captions (or balance names within the financial statements—for example, cash at bank, prepayments, or payables)

judgemental misstatement a misstatement that arises as a result of a difference in the application of judgement by the client and the auditor, such as the use of an estimate the auditor considers unreasonable or the application of an inappropriate accounting policy. A judgemental misstatement is not the same as an error.

14.5.1 Current-Year Misstatements

When misstatements identified during the audit are not corrected by the client, the auditor prepares a working paper (sometimes referred to as a schedule or summary of audit differences) that accumulates all identified misstatements in order to be able to consider their effect on the financial statements as a whole. The auditor also considers these misstatements against individual items or balances, such as profit before tax or net income, trend of earnings, working capital, shareholders' equity, and loan covenants.

When evaluating the materiality of misstatements, the auditor considers the cumulative effect of the misstatements at the end of the current year on pre-tax income and/or net income, working capital, and shareholders' equity. The auditor also considers whether the matters underlying the misstatements could cause a material misstatement in future years' financial statements if the client should decide to correct all the misstatements in one year, even though the misstatements are not material to the current year's financial statements. This is particularly

December 31, 2023
Worksheet—Summary of identified misstatements

Prepared by: LH
Date: Mar. 22, 2024
Reviewed by: NV
Date: Mar. 30, 2024

Objectives

To document misstatements identified during the audit and to evaluate:

- The effect of identified misstatements on the audit.
- The effect of uncorrected misstatements, if any, on the financial statements.

Performance materiality $ 75,000 Insignificant misstatements under $ 200 need not be recorded below.

		Amount of Over (Under) Misstatement in the Financial Statements						
Description	**Circumstances of Occurrence**	**Assets**	**Liabilities**	**Pre-tax Income**	**Equity**	**F/S Disclosures**	**Corrected? Yes/No**	**W/P Ref**
Record Allowance for Doubtful Accounts	Estimate	75,000		75,000	75,000		No	B-1
Revenue Misstatement	Cut-Off Error	(25,000)		(25,000)	(25,000)		No	S-100
Total identified misstatements during the audit		50,000		50,000	50,000			
Misstatements corrected by management		–		–	–			
Total uncorrected misstatements		50,000		50,000	50,000			
Effect of income taxes on uncorrected misstatements				(10,000)	(10,000)			
Effect of uncorrected **misstatements** from prior periods					–			
Uncorrected misstatements to be carried forward				40,000	40,000			

FIGURE 14.2 **Summary of audit differences**

Source: Summary of identified misstatements, PEG Forms—Audits, Form 335. © 2017 CPA Canada PEG.

relevant when the misstatements represent recurring, and generally increasing, differences in particular areas or accounts, such as certain expense accruals. See **figure 14.2** for an example of a summary of audit differences.

14.5.2 Prior-Year Misstatements

Misstatements may not have been corrected by the client in the prior period because they did not cause the financial statements for that period to be materially misstated. As described in CAS 450 *Evaluation of Misstatements Identified During the Audit*, the cumulative impact of immaterial uncorrected misstatements related to prior periods may have a material effect on the current period's financial statements.

When these misstatements in the prior year have been identified, they are considered by the auditor to "reverse" in the following reporting period. For example, if expenses are understated due to a cut-off error in the prior period, the misstatement is considered to "reverse" in the following period and therefore overstates expenses in that period. Misstatements that are due to errors (or fraud) are always considered to reverse in the following period, whereas misstatements that arise due to judgemental misstatements between the client and the auditor may not necessarily reverse. Assessing prior-period judgemental misstatements is a complex area that requires a high level of professional judgement and experience, and is considered an advanced auditing concept.

The identification and resolution of misstatements is one of the most important responsibilities in an audit and is a critical step in the formulation of the opinion on the fairness of the client's financial statements. Considerable judgement is required when reaching a conclusion on the materiality of unrecorded misstatements, and is influenced by the evaluation of the needs of a reasonable person who will rely on the financial statements. This requires the evaluation of the total mix of information available, both quantitative (the dollar amounts of the misstatements relative to the position and results of the entity) and qualitative (other considerations that are not influenced by the dollar amount of the misstatements). This is why the final evaluations and conclusions formed regarding misstatements are always performed by the partner responsible for the audit engagement. Forensic accounting, discussed in Professional Environment 14.1, represents an extension of the investigation of misstatements into the realm of crime, and even terrorism.

14.1 Professional Environment Forensic Accounting

One of the more popular television genres in recent years has been crime with a heavy reliance on forensic science to solve cases (for example, the *CSI* franchise, *Dexter*, and *Bones*). The programs are so popular there are claims that they have led to a jump in enrolments in forensic science courses. According to Long, demand for forensic accounting has also never been higher, although this is more likely due to the fallout from corporate scandals such as Enron and WorldCom than from any television program. These cases have made boards of directors more aware of their liability for fraud. If a problem is brought to their attention, they appear to be more willing to order an investigation, and forensic accountants are called in to do the work.

Another potential cause of the increased interest in forensic accounting is terrorism. Since the tragedy of 9/11, tracing the money trail behind terrorism has been a high priority for security agencies. Forensic accounting expertise is similar to auditing in the sense that both rely on a deep understanding of double-entry accounting plus a large dose of other skills and attributes; in the case of forensic accounting, these include expert knowledge of legal systems and interview techniques. However, at its heart, forensic accounting relies on accounting knowledge because some fraudsters go to great lengths to hide their trail and a knowledge of double-entry bookkeeping is necessary to keep up.

A third reason for the increase in growth in forensic accounting is simply the increase in fraud, and the fact that technology makes it harder to identify.

Forensic accountants need to have an eye on how their findings will be used in court. In fact, "forensic" means something that will be used in, or is suitable to be used in, courts of law. In the past, most forensic accounting work related to accountants appearing in court as expert witnesses for personal injury or divorce cases. Now, forensic accounting practices are focusing more on investigation, fraud risk management, anti-money laundering, and computer forensics.

The world's largest anti-fraud organization and premier provider of anti-fraud training and education, the Association of Certified Fraud Examiners (ACFE), has experienced a sharp rise in membership over the last few years. The fraud investigators say they have been trying for years to get regulators interested in investigating potential fraud cases, such as the Bernard Madoff Ponzi scheme. Now they say they have noticed a recent increase in community appreciation of their work.

Q: Is forensic accounting a relatively new profession?

Sources: C. Long, "Forensic Frenzy," *Charter*, June 2007; Kessler International, "Study Shows an Increased Demand for Forensic Auditors," news release, March 1, 2017.

14.5.3 Qualitative Considerations

Qualitative considerations may cause immaterial misstatements or disclosures to be considered material to the financial statements. Misstatements of disclosures are assessed in terms of the impact on the financial statements and the entity overall. An example of a qualitative misstatement is an inaccurate disclosure of an accounting policy for a significant asset, liability, revenue, or expense item in the financial statements. Further examples of qualitative misstatements are when correcting the misstatement would affect:

- the client's compliance with regulatory requirements or covenants under debt or similar agreements
- the client's compliance with contractual requirements of operating and other agreements
- management's satisfaction of requirements for the awarding of bonuses or other forms of incentive compensation
- the reported profit, by changing it to a loss or vice versa
- individual line items, subtotals, or totals, by a material amount
- key ratios monitored by analysts or other key users of the financial statements

Cloud 9 Integrated Case

Numerous misstatements have been found during the Cloud 9 audit. Sharon and the team review these items individually as they arise and collectively at the completion of the audit fieldwork.

For any matters they believe are material, either quantitatively or qualitatively, they will prepare a summary for the partner. The partner needs to understand the nature of the item, including the probable cause of the error and whether it is an indicator of more serious issues in the client's systems. The summary will outline the nature of the evidence gathered and the additional work completed to verify the size and nature of the misstatement, including whether there was an expansion of the sample size and the results of any alternative procedures performed. The summary will make a recommendation and outline why the audit team believes that an adjustment should or should not be made to the client's financial statements.

Before You Go On

14.5.1 What does an auditor do when misstatements identified during the audit are not corrected by the client?

14.5.2 Why is it important to consider the prior-year unadjusted misstatements?

14.5.3 Name two qualitative considerations that may be taken into account when assessing misstatements.

14.6 Evaluating the Conclusions and Forming an Opinion

LEARNING OBJECTIVE 6

Evaluate conclusions obtained during the performance of the audit and explain how these conclusions link to the overall opinion formed on the financial statements.

The final phase of the audit is to assess all of the audit evidence obtained and determine whether it is sufficient and appropriate to reduce the risk of material misstatement in the financial statements to an acceptably low level. Forming an opinion on the financial statements involves the following four steps:

1. evaluating the audit evidence obtained
2. evaluating the effects of unrecorded misstatements identified and the qualitative aspects of the entity's accounting practices
3. evaluating whether the financial statements have been properly prepared and presented in accordance with the applicable reporting framework
4. evaluating the fair presentation of the financial statements, which includes assessing how amounts are reported in the financial statements. The auditor should ensure amounts are properly classified and the level of aggregation is appropriate. The auditor should also ensure that if additional information is included in the financial statements, it is not confusing.

Before You Go On

14.6.1 What is the purpose of the final phase of the audit?

14.6.2 What steps are involved in forming an opinion on the financial statements?

14.6.3 How do the conclusions obtained link to the formation of the audit opinion?

14.7 Components of the Audit Report

LEARNING OBJECTIVE 7

Describe the components of an audit report.

The format of an audit report for general purpose financial statements is governed by CAS 700 *Forming an Opinion and Reporting on Financial Statements*. The auditor should also consider whether CAS 701 *Communicating Key Audit Matters in the Independent Auditor's Report* is appropriate. For audit reports that are not prepared for financial statements but rather are provided on other historical financial information, CAS 800 *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*, CAS 805 *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*, and CAS 810 *Engagements to Report on Summary Financial Statements* detail the required components of the audit report, which are the same as required by CAS 700.

Recently, auditing reporting standards have changed. The most significant change has been the addition of CAS 701, and the introduction of the concept called key audit matters. While international standards require the reporting of KAMs, in Canada, KAMs are manadatory only if required by law or regulation. Canadian auditors may also elect to report KAMs until December 15, 2020. For year ends after December 15, 2020, the reporting of KAMs will be required for all entities reporting on the TSX, except for certain investment funds. If KAMs are included in the audit report, they are to be reported in accordance with CAS 701. KAMs are those matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period. For example, they might include areas where there was a higher risk of material misstatement, areas that included significant judgements or estimates, or the effect of significant events or transactions during the period. KAMs should be specific to the entity and the audit that was performed in order to provide relevant and meaningful information to users. Therefore, CAS 701 includes a judgement-based decision-making framework to help auditors determine which matters, from those communicated by those charged with governance, are KAMs. This decision-making framework was developed to focus auditors' attention on areas about which investors and other users have expressed interest—in particular, areas of the financial statements that involve the most significant or complex judgements by management and those areas of focus that are in accordance with the risk-based approach in the CASs.

The number of KAMs that may be communicated in the auditor's report may be affected by the complexity of the entity, the nature of the entity's business and environment, and the facts and circumstances of the audit engagement. CAS 701 outlines the required elements that must be included in each KAM. The description of a KAM is required to include a reference to the related disclosures, if any, in the financial statements and must address:

- why the matter was considered to be one of most significance in the audit and therefore determined to be a KAM
- how the matter was addressed in the audit

Whether a KAM is presented or not, the main components of the auditor's report are required by CAS 700 to be in writing. The required components include:

1. Title
2. Addressee
3. Opinion paragraph:
    - includes the auditor's opinion on whether the financial statements give a true and fair view or are presented fairly, in all material respects, in accordance with the applicable financial reporting framework
    - identifies the entity whose financial statements have been audited
    - states that the financial statements have been audited
    - identifies the title of each of the statements that make up the complete financial statements
    - refers to the summary of significant accounting policies and other explanatory notes
    - specifies the date and period covered by the financial statements

4. Basis for opinion:
   - states that the audit was conducted in accordance with Canadian generally accepted auditing standards
   - refers to the section of the report that refers to the auditor's responsibilities
   - provides an affirmative statement about the auditor's independence and fulfillment of relevant ethical responsibilities, and the identification of the relevant ethical requirements applicable within Canada
   - states that the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion
5. Key audit matters, when required by law or regulation or if the auditor elects to include KAMs
6. Other information: a separate heading and section relating to both the financial and non-financial information when the financial statements and audit report are included with other documents, such as an annual report. This section explains management's and the auditor's responsibility for the other information. It also includes the auditor's conclusion whether the information is consistent with the financial statements and the knowledge obtained during the audit.
7. Management's responsibility for the financial statements, which includes:
   - establishing and maintaining internal controls relevant to the preparation and fair presentation of the financial statements that are free from material misstatements, whether due to fraud or error
   - a description of management's responsibility for going concern
8. Auditor's responsibility for the financial statements, which is to:
   - obtain reasonable assurance about whether the financial statements, as a whole, are free from material misstatement, whether due to fraud or error, and express an opinion on the financial statements based on the audit
   - state that reasonable assurance is a high level of assurance, but it is not a guarantee that an audit will always detect material misstatements when they exist
   - state that misstatements can arise from fraud or error
   - state that the auditor exercises professional judgement and maintains professional scepticism throughout the audit
   - includes an enhanced description of the responsibilities of the auditor and key features of an audit, together with the provision that certain components of this description may be presented in an appendix to the auditor's report if referenced in the report, or on a website if permitted by law, regulation, or national auditing standards
9. Other reporting responsibilities; for example, in some cases auditors may be required to report on other matters
10. The name of the engagement partner for listed entities and the auditor's signature either in the firm's name, the personal name of the auditor, or both (depending on the legislative requirements)
11. Date of the report
12. Auditor's address

The standard wording used when providing an opinion on the financial statements in accordance with an applicable accounting framework and expressing an unmodified opinion is provided in CAS 700. An example of the audit report was provided in chapter 1. An example of an unmodified report with an emphasis of matter is also provided in figure 14.3.

There are also special reporting considerations with respect to the going concern assumption and auditor reporting. The audit report should include:

- a description of the respective responsibilities of management and the auditor for going concern
- a separate section under the heading "Material uncertainty related to going concern," if a material uncertainty exists and it is adequately disclosed, that draws attention to the relevant going concern note disclosure and the fact that the report is not modified
- a new requirement to challenge the adequacy of financial statement disclosures for so-called close calls in view of the applicable financial reporting framework when events or conditions are identified that may cast significant doubt on an entity's abil-

ity to continue as a going concern. Note, where a close call exists, this is likely an item to be reported as a KAM.

If there is a going concern issue that is not disclosed, this would give rise to a modified report. Professional Environment 14.2 further discusses KAM reporting.

14.2 Professional Environment Key Audit Matters

For a long time, auditor reporting had been very standardized. This led standard setters to question the value of the audit report, and to wonder what could be changed to add more value. Could it be modified to reduce the expectation gap, where financial statement users' beliefs do not align with what the auditor has actually done? After some exploration, standard setters developed key audit matter (KAM) reporting requirements. Those requirements were effective for those using International Auditing Standards in late 2016. Canada chose to defer the implementation of KAM reporting until a later date.

Because KAM reporting has been in use outside of Canada for a few years, studies have been conducted with respect to the most common types of KAMs. Studies have found that:

- The most common KAMs related to the carrying amount or valuation assessments of goodwill and intangibles. This is predominantly due to the complexity and judgements involved in the valuation models used.
- The second most popular KAM is related to revenue recognition. This is because for most entities, revenue is significant. Besides magnitude, other reasons revenue recognition may be considered a KAM is when a client has a high volume of revenue transactions, a variety of revenue streams, or a diverse range of products and services offered.
- Other common KAMs relate to tax issues, business acquisitions, and inventory.

A study published by the *Journal of Accounting* found that in reporting KAMs, auditors are providing more detailed discussions of the audit procedures conducted while also cross-referencing the notes in the financial statements that relate to the KAM. For example, in its December 31, 2018, audit report, adidas AG included both an intangible asset and revenue recognition KAM. Both KAMs referenced the related notes in the financial statements. While the notes met the requirements of the accounting standards, the KAMs provided further explanation as to how each item impacted audit risk, and how the auditor responded. For adidas, the KAM relating to intangible assets focused on the valuation of its Reebok brand. The report indicated that there was a risk of an impairment loss that was not recognized due to the complex valuation model that relied heavily on the prediction of future cash flows for the Reebok brand. The report provided in detail what the auditor did to respond to this risk, such as assessing key assumptions and growth rates. Another KAM was included in the adidas audit report with respect to revenue recognition. The KAM discussed the complexities with adidas's right of return policy, where customers may return items for a full refund. This right of return created an estimated return liability at year end. The report presented the auditor's response to this estimation risk, such as assessing the internal controls over returns and assessing the accuracy of the calculations.

As audit reports for TSX-listed entities in Canada move away from the one-size-fits-all approach, and include more audit-specific information, similar to the adidas example, this should provide users with more information about the audit and the work performed in areas deemed higher risk. The goal is to improve users' understanding of an audit, as the profession continues to look for ways to reduce the expectation gap.

Q: Besides reducing the expectation gap, how might the communication of key audit matters benefit an audit?

Sources: KPMG, "Key Audit Matters, Auditor's Report Snapshot 20 September 2017," https://home.kpmg/au/en/home/insights/2017/09/key-audit-matters-auditor-report-20-september-2017.html; Maria L. Murphy, "Critical Audit Matters: What Firms Are Reporting," *Journal of Accountancy*, October 4, 2019; adidas AG, Annual Report, December 31, 2018.

Before You Go On

14.7.1 Name two factors included in the description of management's responsibility for the financial statements, as included in the audit report.

14.7.2 Name five components of the audit report.

14.7.3 What is the auditor's responsibility for the financial statements, as included in the audit report?

14.8 Identification of the Types of Modifications to an Audit Report

LEARNING OBJECTIVE 8

Identify the types of modifications to an audit report.

In some situations, the auditor's report will require modified wording to emphasize a certain matter or to express a qualified, adverse, or disclaimer of opinion (as outlined in CAS 705 *Modifications to the Opinion in the Independent Auditor's Report* and CAS 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*). This usually happens when:

1. a matter should be brought to the reader's attention,
2. there is an inability to obtain appropriate audit evidence, or
3. the financial statements are materially misstated.

14.8.1 Emphasis of Matter and Other Matters

An emphasis of matter does not affect the auditor's opinion and it is not a key audit matter. It applies where there is a matter the auditor feels is important to the user's understanding of the financial statements, the matter is disclosed in the financial statements, and the auditor wants to draw the users' attention to it. CAS 706 identifies the following examples as to when an emphasis of matter paragraph would be appropriate:

- A subsequent event results in a new auditor's report on revised financial statements.
- A major catastrophe has had or continues to have an impact on the entity.
- There has been early adoption of a new accounting standard with a significant impact on the financial statements.

See **figure 14.3** for an unmodified audit report with an emphasis of matter. This report also refers the users to a website for the expanded auditor's responsibilities that forms part of the report.

FIGURE 14.3 **Unmodified audit report with an emphasis of matter**

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INDEPENDENT AUDITOR'S REPORT

To the Shareholders of Celestial Inc.

Report on the Audit of the Financial Statements

Opinion

We have audited the financial statements of Celestial Inc. (the Company), which comprise the statement of financial position as at December 31, 2023, 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.

> Opinion includes identification of the financial statements audited, followed by Basis for Opinion with positive affirmation regarding independence and ethical requirements.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2023, and 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 Canadian generally accepted auditing standards. 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 ethical requirements that are relevant to our audit of the financial statements in Canada, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Emphasis of Matter

We draw attention to Note 14 of the financial statements, which describes the effects of a flood at the Company's warehouse facility. Our opinion is not modified in respect of this matter.

> Emphasis of Matter draws attention to a matter disclosed in the financial statements that the auditor wants to draw the users' attention to.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the

(continued)

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 CAS 701*.]

Description of management's responsibility for the financial statements and going concern.

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

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.

Description of the auditor's responsibility and includes key features of an audit.

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 Canadian generally accepted auditing standards 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.

A further description of our responsibilities for the audit of the financial statements is located at W&S Partners website at: wands.org. This description forms part of our auditor's report.

The engagement partner on the audit resulting in this independent auditor's report is Nicholas Summers.

Toronto, Canada	"W&S Partners"
February X, 2024	Chartered Professional Accountants Licensed Public Accountants

FIGURE 14.3 Unmodified audit report with an emphasis of matter (*continued*)

Source: CPA Handbook, CAS 705

Both emphasis of matter and KAM relate to items disclosed in the financial statements. If an item could be both a KAM and an emphasis of matter, the matter should be included as a KAM rather than an emphasis of matter. This is because the KAM provides more information. It would not be appropriate for the same item to be reported as both.

There are times the auditor may also include an "Other Matter" in the audit report. This is included when there is a matter not included or disclosed in the financial statements, but the auditor wants to ensure users are aware of it. For example, this is appropriate when there is a restriction in use, or when the prior-year financial statements were audited by another practitioner. This should be indicated in the audit report with a separate heading "Other Matter."

14.8.2 Inability to Obtain Appropriate Audit Evidence

A limitation on the scope of the auditor's work could result from an inability to perform procedures (the most common form of scope limitation) or an imposition by the entity (rare). The auditor may not be able to perform procedures believed necessary due to factors such as timing, damage to accounting records, and lack of or restricted access to key personnel, accounting records, or operating locations; or the absence of adequate accounting records to provide sufficient and appropriate audit evidence upon which to rely. For example, it may not be possible for the auditor to verify the existence of inventory if the client has not held an inventory count, or does not have particularly reliable perpetual inventory records. If this is material but not pervasive to the financial statements overall, this would then form the basis for a qualified opinion due to a scope limitation.

Figure 14.4 shows a sample audit report with a qualification due to a scope limitation. Where a scope limitation is material and pervasive to the financial statements overall, a disclaimer of opinion would be issued. For example, if there was a flood at the client's office and all of the accounting records were not recoverable, the auditor would not be able to gather sufficient and appropriate evidence for many of the financial statement accounts, and therefore, a disclaimer of opinion would be issued. The disclaimer indicates that the auditor could not gather enough evidence to form an opinion. See an example in **figure 14.5**. Note that in both cases, the opinion paragraph refers to the type of opinion issued; that is, it is titled a qualified or a disclaimer of opinion. Also the title of the basis of opinion title is modified to mirror the type of opinion. The basis of opinion paragraph includes a description of the matter that gave rise to the modified audit report, as required by the CAS. Note that CAS 705 states that when the auditor expresses a disclaimer of opinion, then the auditor's report should not include a KAM section.

FIGURE 14.4 Sample audit report with a qualification due to a scope limitation

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INDEPENDENT AUDITOR'S REPORT

To the Shareholders of Blue Sky Inc.

Report on the Audit of the Consolidated Financial Statements

Qualified Opinion

Heading refers to Qualified Opinion and the opinion is modified.

We have audited the consolidated financial statements of Blue Sky Inc. and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 2023, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion section of our report, the accompanying consolidated financial statements present fairly, in all material respects, the financial position of the Group as at December 31, 2023, and its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Basis for Qualified Opinion

Described as Basis for Qualified Opinion and provides a description and quantification of the qualification. Includes an affirmative statement regarding the auditor's independence and ethical requirements.

The Group's investment in Cumulus Co., a foreign associate acquired during the year and accounted for by the equity method, is carried at $450,000 on the consolidated statement of financial position as at December 31, 2023, and Blue Sky Inc.'s share of Cumulus Co.'s net income of $90,000 is included in Blue Sky Inc.'s income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of Blue Sky Inc.'s investment in Cumulus Co. as at December 31, 2023 and Blue Sky Inc.'s share of Cumulus Co.'s net income for the year because we were denied access to the financial information, management, and the auditors of Cumulus Co. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in Canada, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Sentence modified to include a reference to the qualified opinion.

Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements

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

In preparing the consolidated financial statements, management is responsible for assessing the Group's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and

(*continued*)

using the going concern basis of accounting unless management either intends to liquidate the Group or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Group's financial reporting process.

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

Our objectives are to obtain reasonable assurance about whether the consolidated 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 Canadian generally accepted auditing standards 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 consolidated financial statements.

A further description of our responsibilities for the audit of the financial statements is located at W&S Partners website at wands.org. This description forms part of our auditor's report.

The engagement partner on the audit resulting in this independent auditor's report is Matthew White.

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FIGURE 14.4 **Sample audit report with a qualification due to a scope limitation (*continued*)**

Source: CPA Handbook, CAS 705

FIGURE 14.5 **Sample audit report with a disclaimer of opinion**

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INDEPENDENT AUDITOR'S REPORT

To the Shareholders of Celestial Inc.

Report on the Audit of the Financial Statements

Disclaimer of Opinion indicates the auditor does not express an opinion on the financial statements.

Disclaimer of Opinion

We have audited the financial statements of Celestial Inc. (the Company), which comprise the statement of financial position as at December 31, 2023, 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.

We do not express an opinion on the accompanying financial statements of the Company. Because of the significance of the matters described in the Basis for Disclaimer of Opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Described as Basis for Qualified Opinion and provides a description of the matter that caused the modified opinion.

Basis for Disclaimer of Opinion

Due to a fire at its office location after year end, management was unable to provide appropriate supporting documentation for the majority of the transactions selected for audit. We were unable to satisfy ourselves by alternative means concerning the assets, liabilities, revenues and expenditures reported by Celestial Inc. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of the assets, liabilities, revenues and expenditures making up the statement of financial position as at December 31, 2023, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended.

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

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.

(*continued*)

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 responsibility is to conduct an audit of the Company's financial statements in accordance with Canadian generally accepted auditing standards and to issue an auditor's report. However, because of the matters described in the Basis for Disclaimer of Opinion section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Auditor's responsibilities are revised to indicate the auditor was not able to obtain sufficient and appropriate evidence to provide a basis for an audit opinion.

We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in Canada, and we have fulfilled our other ethical responsibilities in accordance with these requirements.

The engagement partner on the audit resulting in this independent auditor's report is Nicholas Summers.

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FIGURE 14.5 Sample audit report with a disclaimer of opinion (*continued*)

Source: CPA Handbook, CAS 705

14.8.3 Material Misstatement of Financial Statements

The auditor may disagree with those charged with governance about matters such as the acceptability of accounting policies selected, the method of their application, or the adequacy of disclosures in the financial statements. Where these disagreements are material to the financial statements, a qualified or adverse opinion is expressed. Where the financial statements include a material misstatement that is not pervasive to the overall financial statements, a qualified opinion may be issued. When a qualified or adverse opinion is issued, the auditor may still include a KAM, if appropriate. For example, if management refuses to depreciate the capital assets as required by GAAP, but the rest of the financial statements are free from material misstatements, the auditor may issue a qualified opinion due to a GAAP departure. See **figure 14.6** for an example. If however, management refuses to consolidate a subsidiary under its control as required by GAAP, this will impact many of the revenue and expense accounts in the financial statements. In this case, the auditor may issue an adverse opinion. See **figure 14.7** for an example. Note again that the title of the opinion and the basis of the opinion is changed to reflect the type of report issued. The report also includes a description of the matter that caused the modified report.

FIGURE 14.6 Sample audit report with a qualification due to a GAAP departure

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INDEPENDENT AUDITOR'S REPORT

To the Shareholders of Celestial Inc.

Report on the Audit of the Financial Statements

Qualified Opinion

Qualified Opinion indicates that the opinion is modified.

We have audited the financial statements of Celestial Inc. (the Company), which comprise the statement of financial position as at December 31, 2023, and the statement of comprehensive

(*continued*)

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.

> Indicates "except for" the qualified opinion, the financial statements are not materially misstated.

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion section of our report, the accompanying financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 2023, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

> Basis for Qualified Opinion provides a description and quantification of the qualification.

Basis for Qualified Opinion

As discussed in Note 8 to the financial statements, no depreciation has been recorded in the financial statements, which in our opinion, is not in accordance with International Financial Reporting Standards. The depreciation expense for the year ended December 31, 2023, should be $100,000 calculated using the straight-line method and annual rates of 10% for the building and 25% for the equipment. Accordingly, the property, plant, and equipment should be reduced by accumulated depreciation of $100,000 and the loss for the year and accumulated deficit should be increased by $100,000.

> Sentence modified to include a reference to the qualified opinion.

We conducted our audit in accordance with Canadian generally accepted auditing standards. 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 ethical requirements that are relevant to our audit of the financial statements in Canada, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Responsibilities of Management and Those Charged with Governance for the Financial Statements (see figure 14.3)

Auditor's Responsibilities for the Audit of the Financial Statements (see figure 14.3)

The engagement partner on the audit resulting in this independent auditor's report is Nicholas Summers.

Toronto, Canada — "W&S Partners"

February X, 2024 — Chartered Professional Accountants
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FIGURE 14.6 **Sample audit report with a qualification due to a GAAP departure (*continued*)**

Source: CPA Handbook, CAS 705

FIGURE 14.7 **Sample audit report with an adverse opinion**

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INDEPENDENT AUDITOR'S REPORT

To the Shareholders of Blue Sky Inc.

Report on the Audit of the Consolidated Financial Statements

> Adverse Opinion indicates the auditor does not express an opinion on the financial statements.

Adverse Opinion

We have audited the consolidated financial statements of Blue Sky Inc. and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 2023, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion section of our report, the accompanying consolidated financial statements do not present fairly the consolidated financial position of the Group as at December 31, 2023, and its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

(*continued*)

Basis for Adverse Opinion

As explained in Note 10, the Group has not consolidated subsidiary Cumulus Company that the Group acquired during 2023 because it has not yet been able to determine the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under IFRSs, the Company should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had Cumulus Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

Basis for Adverse Opinion provides a description of the matter that caused the modified opinion.

We conducted our audit in accordance with Canadian generally accepted auditing standards. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in Canada, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.

Sentence includes reference to adverse opinion.

Key Audit Matters

Except for the matter described in the Basis for Adverse Opinion section, we have determined that there are no other key audit matters to communicate in our report.

Responsibilities of Management and Those Charged with Governance for the Consolidated Financial Statements (see figure 14.4)

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements (see figure 14.4)

The engagement partner on the audit resulting in this independent auditor's report is Matthew White.

Toronto, Canada "W&S Partners"

February X, 2024 Chartered Professional Accountants

Licensed Public Accountants

FIGURE 14.7 **Sample audit report with an adverse opinion (*continued*)**

Source: CPA Handbook, CAS 705

Table 14.1 outlines the circumstances in which a modification would be issued and the type of modification appropriate in the circumstances.

TABLE 14.1 **Types of modified audit report**

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**[a]
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

[a] Where the circumstances are so material and pervasive that the auditor has been unable to obtain sufficient appropriate audit evidence, or where a qualified opinion is inadequate to disclose the misleading or incomplete nature of the financial statements.

Cloud 9 Integrated Case

Sharon prepares the draft audit report for the partner. The partner will discuss the audit report with Cloud 9's management at their meetings. If management refuses to amend the financial statements for the material misstatements found during the audit, the audit report may need to be revised and a qualified report may be issued. It is possible that a subsequent event could still occur that would require an emphasis of matter. However, there have been no scope limitations.

Before You Go On

14.8.1 Provide an example of a common emphasis of matter included in audit reports.

14.8.2 Does the inclusion of an emphasis of matter in the audit report result in the report being qualified?

14.8.3 Describe one situation in which a scope limitation may be appropriate in the audit report.

14.9 Communication with Those Charged with Governance

LEARNING OBJECTIVE 9

Explain what reporting is required to management and those charged with governance.

Communication with those charged with governance is covered in CAS 260 *Communication with Those Charged with Governance*, which requires that the auditor communicate audit matters of governance interest arising from the audit of the financial statements with those charged with governance. Communication with those charged with governance, with management, and with third parties, when applicable, is also covered in several other auditing standards. For example, if the auditor has identified a fraud, or has information that indicates the existence of a fraud, they are required to communicate these matters to an appropriate level of management by CAS 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*. Similarly, when the auditor has identified material non-compliance with laws and regulations, they are required to communicate their findings to those charged with governance in accordance with CAS 250 *Consideration of Laws and Regulations in an Audit of Financial Statements*.

"Governance" is the term used to describe the role of people entrusted with the supervision, control, and direction of an entity. Those charged with governance are accountable for ensuring that the entity achieves its objectives, with regard to reliability of financial reporting, effectiveness and efficiency of operations, compliance with applicable laws, and reporting to interested parties. Those charged with governance include management only when it performs such functions.

"Audit matters of governance interest" are those that arise from the audit of the financial statements and, in the auditor's opinion, are both important and relevant to those charged with governance in overseeing the financial reporting and disclosure process. Audit matters of governance interest include only those matters that have come to the auditor's attention as a result of the performance of the audit. The auditor is not required to design audit procedures for the specific purpose of identifying matters of governance interest.

14.9.1 Audit Matters of Governance Interest to Be Communicated

The auditor meets with management and those charged with governance to discuss the results of the audit. The matters that they discuss are those that arise from the audit and that, in the auditor's opinion, are both important and relevant to those charged with governance. As previously stated, the auditor is not required to design audit procedures for the specific purpose of identifying matters of governance interest.

Matters of governance interest that the auditor may wish to discuss with those charged with governance include:

- the general approach and overall scope of the audit, including significant risks identified
- the selection of, or changes in, significant accounting policies and practices that have, or could have, a material effect on the entity's financial statements. (CAS 260 indicates the auditor considers the appropriateness of the accounting policies to the particular circumstances of the entity. They judge these against the objectives of relevance, reliability,

comparability, and understandability, but having regard for the need to balance the different objectives and the cost of providing information with the likely benefit to users of the entity's financial statements. They discuss the appropriateness of accounting estimates and judgements—for example, in relation to provisions, including the consistency of assumptions and degree of prudence reflected in the recorded amounts. The auditor considers the appropriateness of the judgements made in developing sensitive accounting policies and the overall neutrality, consistency, and clarity of the disclosures in the financial statements.)

- the potential effect on the financial statements of any material risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements
- misstatements, whether or not recorded by the entity, that have or could have a material effect on the entity's financial statements
- material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern
- disagreements with management about matters that, individually or in the aggregate, could be significant to the entity's financial statements or the audit report. (These communications include consideration of whether the matter has or has not been resolved and the significance of the matter.)
- expected modifications to the audit report. The auditor discusses any expected modifications to the audit report on the financial statements with those charged with governance to confirm that:
  - those charged with governance are aware of the proposed modification and the reasons for it before the report is finalized
  - there are no disputed facts with respect to the matter(s) giving rise to the proposed modification (or that matters of disagreement are confirmed as such)
  - those charged with governance have an opportunity, where appropriate, to provide further information and explanations with respect to the matter(s) giving rise to the proposed modification
  - if applicable, key audit matters
- any practical difficulties encountered in performing the audit
- any irregularities or suspected non-compliance with laws and regulations that came to the auditor's attention during the audit
- comments on the design and operation of the internal controls and suggestions for their improvement, particularly if the auditor has identified material weaknesses in internal control during the audit. (This is sometimes separately communicated in a management letter.)
- any other matters agreed upon in the terms of the audit engagement

The auditor also informs those charged with governance of those uncorrected misstatements aggregated by the auditor during the audit that were determined by management to be immaterial, both individually and in the aggregate, to the financial statements taken as a whole.

14.9.2 Documentation Considerations

The auditor retains a copy of the communication with those charged with governance in their working papers, together with details of any responses from management and/or those charged with governance and their intended action(s). If the communication takes the form of a presentation at a meeting or meetings, the auditor files a copy of the presentation material and also gives a copy of the material to management to prevent disputes at a later date. Depending on the nature, sensitivity, and significance of the matters communicated, the auditor may decide to confirm oral communications in writing.

As soon as practicable, the auditor should communicate deficiencies in internal controls to management or those charged with governance. The reporting of internal control deficiencies should always be documented; the most common form is a letter. However, depending on the circumstances, documentation in the form of a file note (minutes of meetings) may be appropriate as evidence of the discussion held on internal control deficiencies.

Cloud 9 Integrated Case

Sharon also prepares a draft letter to be used for communication with those charged with governance at Cloud 9. The letter is incomplete but will be finalized after the completion of subsequent events procedures and the final meetings between the partner and Cloud 9's management.

Before You Go On

14.9.1 Name five items of governance interest that would be communicated to those charged with governance.

14.9.2 Is communication with those charged with governance always in the form of a letter?

14.9.3 If communication is not always in the form of a letter, what other forms of communication could the auditor use?

14.10 Other Engagements

LEARNING OBJECTIVE 10

Understand the various types of other engagements that auditors may be asked to perform.

A practitioner in public practice may perform audit, review, and compilation engagements of financial information as well as a variety of tax engagements. However, clients may have other information needs. They may ask the practitioner to prepare or to provide an opinion on information other than general purpose financial statement information. This information may be financial or non-financial. Depending on the type of engagement, a particular Canadian Auditing Standard (CAS) or another Canadian standard may apply.

We will now briefly discuss some of the assurance standards and common special engagements an auditor may be asked to perform.

14.10.1 Reports Prepared in Accordance with a Special Purpose Framework

An assurance provider may be asked to provide assurance on financial information prepared on a basis of accounting other than GAAP, or in accordance with a special purpose framework. Examples of these types of reports include financial statements prepared in the following situations: in accordance with the terms of a contract, in accordance with the requirements of a regulation, or in applying a tax basis of accounting. If an audit level of assurance is required, then the engagement should be performed in accordance with CAS 800 *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*. If a review engagement is performed, then the auditor must ensure compliance with the standards of CSRE 2400 *Engagements to Review Historical Financial Statements*.

When accepting this type of engagement, the assurance provider must understand the nature of the agreement or contract, and the form and content of the assurance report. The assurance provider should also obtain an understanding of what the financial statements will be used for and who the users will be. As this type of report is usually issued for a specific user with a specific purpose, these are not general purpose financial statements. As a result, the report often includes an emphasis of matter with a restriction on distribution. The report should also specifically indicate the basis of accounting used.

14.10.2 Reports on a Component of the Financial Statements

A report on a component of the financial statements is a report issued on a single financial statement line item. This is appropriate when a user wants some assurance over a particular financial statement account such as sales, accounts receivable, or inventory to meet a particular financial reporting need. For example, auditors are sometimes asked to prepare a report on gross sales. This is common in the retail industry because landlords often include a percentage rent clause in a tenant's lease agreement. This means that a portion of the rent may be based on the retailer's gross sales. To get some assurance that the sales are not materially misstated, the landlord may request an audit or a review of this information.

An audit report of this nature falls under CAS 805 *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement*, while a review engagement would again fall under the requirements of CSRE 2400 *Engagements to Review Historical Financial Statements* with modification to suit the needs of the engagement. When performing this type of engagement, the practitioner must consider the related financial statement items that may have a material impact on the specific account being reported on. For example, if the auditor is reporting on sales, then the accounts receivable and allowance for doubtful accounts should be considered. The practitioner should also consider if disclosures are needed so the users can understand the reported items. Again, the report issued should indicate the basis of accounting.

14.10.3 Review Engagements

Earlier in this text, we introduced review engagements. Recall that a review engagement is a limited assurance engagement that may be requested when a client requires some assurance over the financial statements but does not require an audit level of assurance. Reviews of historical financial information are quite common in Canada for private entities where third-party users want some assurance over the financial information, but an audit level of assurance is not needed. Review engagements of historical financial information fall under CSRE 2400.

Engagement Acceptance

As with an audit, the first stage of a review engagement is the client acceptance or continuance decision. For a review engagement, this involves assessing if there is a rational purpose for the review engagement, if the financial reporting framework is acceptable, and if the ethical standards of the profession are met. The practitioner must also review the threats to independence and make certain that safeguards are put in place to limit or remove any identified threats. The practitioner should therefore assess independence before the client acceptance or continuance decision is made. Once the acceptance and continuance procedures are complete and the practitioner decides to accept the engagement, an engagement letter should be prepared. If this is a repeat engagement, the practitioner should consider updating the engagement letter if significant terms or conditions have changed.

Engagement Planning

In planning the engagement, the practitioner is required to determine materiality for the overall financial statements. The determination and calculation of materiality is similar for both audit and review engagements, in that materiality is based on the users. However, performance materiality is not required for a review engagement. In planning the engagement, the practitioner should also obtain an understanding of the entity. This provides the basis for the practitioner to assess where the risk of material misstatement exists. To adequately understand the business, the practitioner should obtain information regarding:

- the industry and the regulatory environment
- the entity's operations, including its ownership and governance structure
- the entity's objectives and strategies
- the entity's accounting systems and records
- the entity's selection of accounting principles.

With an understanding of where the risk of material misstatement exists, the practitioner can then plan the appropriate procedures to respond to those risks and to address all material balances. The procedures performed usually involve analytics and inquiry. Often the analytics performed include examining ratios and year-over-year fluctuations and making inquiries of management. Key questions include why significant fluctuations have or have not taken place as well as what are management's processes regarding cut-off. For example, W&S Partners is performing a review engagement of Todd's Toy Manufacturers Ltd. The following is a sample of questions the audit team is planning to ask the controller:

- Accounts receivable: Why was there a significant increase in accounts receivable? Are all accounts collectible? The balance from Mario Co. is over 90 days old—why is this collectible? Accounts receivable turnover has decreased—why? Are there situations where credit terms have been modified?
- Inventory: Was an inventory count done at year end? How was the count performed? Is there any inventory on consignment?
- Accounts payable: How was a good cut-off obtained? Are all payables recorded? Why have payables increased?

When conducting the engagement, if the practitioner becomes aware that items may be materially misstated, the practitioner should plan to do more work in these areas. Similar to an audit, all misstatements should be accumulated and discussed with management. Before finalizing the engagement, the practitioner is to reconcile the numbers to the financial statements and ask management specific questions about the following:

- Management estimates
- Related parties
- Significant or unusual transactions at the end of the year
- Subsequent events
- Suspected or actual fraud or illegal activity during the year
- Non-compliance with laws and regulations
- Going concern
- Non-monetary transactions

Engagement Completion

Once the work is completed and adequately documented, the practitioner can then assess the evidence and determine the appropriate report to issue. The review engagement report may be unmodified or modified. If the auditor concludes the financial statements are materially misstated, a qualified or adverse conclusion may be issued. If there is a scope limitation, a qualified or disclaimer of conclusion may be issued. As with an audit, the practitioner should use professional scepticism and professional judgement throughout the engagement and when assessing the evidence. The review engagement report should not be dated until after those responsible for governance have taken responsibility for the financial statements. This often is documented by management signing a management representation letter. A sample of an Independent Review Engagement Report was provided in an earlier chapter.

14.10.4 Review Engagements on Interim Financial Statements

All publicly reportable entities are required to file quarterly financial statements with the appropriate regulator. For entities listed on a Canadian stock exchange, a review of the interim financial information is not required, whereas for entities listed on a stock exchange in the United States, it is required. Even though an interim review is not required for Canadian-listed companies, some may elect to have their interim financial statements reviewed. If this is the case, the engagement falls under the requirements of CSAE 7060 *Auditor Review of Interim Financial Statements*. The purpose of this engagement is to report to the audit committee whether any material modifications should be made to the interim financial statements for the financial statements to be in accordance with the applicable financial reporting framework. Therefore, the report issued is limited in distribution to the audit committee.

14.10.5 Assurance Engagements

As noted, besides audits and reviews of historical financial information, there are a variety of other reports a practitioner may be asked to produce. Other standards apply when an engagement is performed on information other than historical financial information and assurance is provided. Recall that an assurance engagement is an engagement where a practitioner is engaged to gather sufficient, appropriate evidence to express a written conclusion about a subject matter. When a practitioner performs an assurance engagement (other than an audit or review of historical financial information), the engagement will fall under CSAE 3000 *Attestation Engagements Other than Audits or Reviews of Historical Financial Information* and CSAE 3001 *Direct Engagements*. These standards provide general principles that apply to assurance engagements.

While we have defined assurance engagements, there are generally two categories discussed in the assurance standards:

1. The first type is referred to as an **assurance engagement** and it is defined by CSAE 3000 as an engagement that involves the practitioner providing an opinion after evaluating a subject matter against an explicit statement made by management (or other party). For these engagements, management determines the criteria and the practitioner assesses the acceptability of the criteria and then evaluates the subject matter against it. An example of an assurance engagement is a report on compliance with a lease agreement.
2. The other assurance engagement is defined under CSAE 3001 as a **direct engagement** where a practitioner evaluates a subject matter against applicable criteria. In a direct engagement, there is no explicit statement made by management. Therefore, the practitioner develops the criteria; however, management should agree it is acceptable. An example of a direct engagement is a performance audit, which is concerned with the economy, efficiency, and effectiveness of an organization's activities.

assurance engagement an engagement that involves the practitioner providing an opinion after evaluating a subject matter against an explicit statement made by management (or other party)

direct engagement an engagement that evaluates a subject matter against applicable criteria

Both of these engagements can be reasonable assurance or limited assurance engagements. A **reasonable assurance engagement** is an engagement with a high level of assurance where the practitioner provides an opinion on the subject matter. This is an audit level of assurance. A **limited assurance engagement** is one in which a practitioner concludes on the subject matter, in that nothing has come to their attention to believe the information is materially misstated. In a limited assurance engagement, some assurance is provided, but less assurance than an audit level of assurance. This is considered a review level of assurance.

Both CSAE 3000 and CSAE 3001 provide guidance on engagement acceptance, engagement performance, and engagement reporting, which we will now discuss.

reasonable assurance engagement an engagement with a high level of assurance where the practitioner provides an opinion on the subject matter

limited assurance engagement an engagement in which a practitioner concludes on the subject matter, in that nothing has come to their attention to believe the information is materially misstated

Engagement Acceptance

With respect to engagement acceptance, the practitioner should conduct client acceptance procedures similar to those required for audit and review engagements. Because independence is required, it should be assessed as part of the client acceptance procedures. However, the practitioner also needs to assess whether the firm has the knowledge needed to conduct the engagement. Because assurance engagements under these standards do not involve historical financial information, the subject matter may be outside the firm's expertise and so the practitioner needs to ensure the firm has the knowledge needed to conduct the engagement. Also, unlike financial statement engagements where GAAP are the criteria, these assurance engagements may not have explicit criteria. Therefore, the practitioner needs to ensure that acceptable criteria exist and that management agrees the criteria are acceptable. This should be documented in the engagement letter, which should be obtained prior to the start of the engagement.

Engagement Performance

As with all engagements, an assurance engagement should be well-planned and the practitioner should use professional scepticism and professional judgement when assessing and gathering evidence. Some of the first procedures to be performed include determining materiality (referred to as significant deviation for direct engagements), and identifying where the risk of material misstatement exists. The practitioner should then plan procedures to reduce the identified risks to an acceptable level. When an audit level of assurance is required, the practitioner is required to gain an understanding of the internal controls over the information to be audited. When a limited assurance engagement is required, the practitioner should gain an understanding of the processes used to prepare the information. All work performed should be documented, and the working paper file should include sufficient, appropriate evidence to support the report issued.

Engagement Completion

When completing the engagement, the practitioner should obtain a management representation letter, and perform subsequent events procedures. The practitioner should assess any misstatements in terms of materiality to come to the appropriate opinion or conclusion. Similar to an audit or review engagement, the report could include an emphasis of matter, or it may be modified.

With respect to the report, the following is a list of what is to be included in an assurance report per CSAE 3000:

- A title indicating it is an independent assurance report
- Identification of the subject matter, and the level of assurance obtained
- Identification of the criteria
- Where appropriate, a description of any significant inherent limitations associated with the measurement or evaluation of the underlying subject matter against the applicable criteria
- When the criteria are designed for a specific purpose, a statement alerting readers to this fact and therefore advising that subject matter information may not be suitable for another purpose
- Identification of the responsible party and their responsibilities as well as those of the practitioner
- An explanation that the engagement was performed in accordance with assurance standards, quality control, and ethical requirements
- A summary of the work performed as a basis to support the conclusion and the conclusion itself
- The date of the report and the signature of the practitioner

A limited engagement report should also include wording indicating the level of work performed is not the same as with a reasonable assurance engagement and therefore, the level of assurance is lower than if a reasonable assurance engagement had been performed.

14.10.6 Compliance Engagements

There are some assurance engagements where along with the general assurance standards discussed, specific standards apply. Engagements where a practitioner is engaged to report on compliance is one of them. A compliance engagement is an engagement where a practitioner reports on whether management is in compliance with an agreement. For example, a practitioner could be asked to provide a compliance report on whether a tenant is in compliance with a lease agreement, or if a borrower is in compliance with its bank covenants. While these examples relate to financial measures, a compliance engagement can also relate to non-financial measures. For example, a non-financial compliance report would be a report on the number of full-time students that attend a school to help determine government funding.

Compliance engagements are covered under CSAE 3530 *Attestation Engagements to Report on Compliance* or CSAE 3531 *Direct Engagements to Report on Compliance*. If a practitioner is asked to report on a statement by management regarding compliance with an agreement, the engagement would fall under CSAE 3530. If the practitioner is asked to report directly on compliance with an agreement, this would fall under CSAE 3531. It is important to note that when performing these compliance engagements, a practitioner must also meet the requirements of CSAE 3000 and 3001, including client acceptance, and engagement performance requirements. In addition, the practitioner needs to understand and possibly interpret key terms of the agreement.

When sufficient and appropriate evidence is obtained, the practitioner concludes on the compliance with the agreement and issues the appropriate report. The reporting requirements of CSAE 3000 and CSAE 3001 are very similar to the requirements of the compliance standards.

14.10.7 Reporting on Controls

Recall that sometimes entities use service organizations to perform certain functions that can have a material impact on the financial statements. For example, an entity may outsource its payroll function to a third-party payroll service provider. If such organizations are being audited, CAS 402 *Audit Considerations Relating to an Entity Using a Service Organization* requires the auditor to obtain an understanding of the relevant internal controls of the service provider to the extent they may impact the financial statements under audit. One way for an auditor to do this is to obtain a report on the controls of the service organization. This type of report would be prepared under this standard, CSAE 3416 *Reporting on Controls at a Service Organization*. This type of report provides users with assurance over the effectiveness of the processes and controls of the service provider for the reporting period. A report issued under this standard must also comply with CSAE 3000.

14.10.8 Reports on Supplementary Matters

CSRS 4460 *Reports on Supplementary Matters Arising from an Audit or a Review Engagement* applies where a practitioner has been engaged to perform an audit or review and the practitioner is also asked to report on a supplementary matter to a third party and the engagement is not covered under any other standard. Often this involves the completion of a form or questionnaire. For example, a practitioner performs an audit or review for a not-for-profit entity and they are also asked to complete a form regarding program costs for a funding agency. The completion of the form regarding program costs is a supplementary matter because it is not a part of the financial statement audit. A report prepared under CSRS 4460 is not an assurance report.

14.10.9 Reports on the Results of Applying Specified Procedures to Financial Information Other Than Financial Statements

This report is issued when the auditor has performed agreed-upon procedures relating to the entity's financial information other than the financial statements. The auditor performs specific procedures requested by the client over specific financial information and then reports the factual results of these procedures. As a result, no assurance is provided. For example, a government agency may provide expense reimbursement to a housing agency to subsidize low-income families. The government may want to ensure the organization is recording the expenditures accurately, and ask an auditor to agree invoice amounts to the amounts recorded in the general ledger. The auditor then issues a report on the results of applying these specified procedures, stating the number of invoices reviewed and how many were recorded correctly. This type of engagement is covered by Section 9100 *Reports on the Results of Applying Specified Auditing Procedures to Financial Information Other than Financial Statements*. At the time of writing this textbook, Canadian standard setters had committed to replacing this standard with the International Standard on Agreed Upon Procedures Engagements. The adoption date of this new Canadian standard was scheduled for January 1, 2022.

14.10.10 Reports on the Application of Accounting Principles

This report is covered under Section 7600 *Reports on the Application of Accounting Principles*. This refers to a report on the application of accounting principles to either a specific transaction or to the financial statements overall. It only applies to actual transactions and it does not relate to hypothetical transactions. The auditor should understand the form and substance of the transaction, ensure it is in accordance with GAAP, and if needed consult with other professionals, specifically the incumbent accountant. All relevant facts, circumstances, and assumptions should be obtained in writing.

14.10.11 Reports Used in an Offering Document or Designated Document

offering document
a document that offers securities in exchange for cash, debt, other securities, or other assets

designated document
a document filed with a security regulator, such as audited financial statements, and a document that includes or refers to the audited financial statements, such as an annual report

Businesses can decide to issue shares on a stock exchange to raise funds. This involves what is called an **offering document**, defined in the CPA Handbook as a document that offers securities in exchange for cash, debt, other securities, or other assets. Sometimes a client will want to include audited or reviewed financial statements, or other documents the practitioner has prepared, in the offering document. Section 7150 *Auditor's Consent to the Use of a Report of the Auditor Included in an Offering Document* sets out the auditor's responsibilities in responding to these requests. Similarly, an audited set of financial statements may be included in a designated document. A **designated document** is defined by the CPA Handbook as a document filed with a security regulator, such as audited financial statements, or a document that includes or refers to the audited financial statements, such as an annual report. Section 7170 *Auditor's Consent to the Use of the Auditor's Report in Connection with a Designated Document* sets out the auditor's responsibilities in these situations, which includes ensuring the financial statements are accurately reproduced, and ensuring the information between the designated document and the financial statements is consistent.

Before You Go On

14.10.1 Provide three examples of when an auditor may issue an audit report on a special purpose framework.

14.10.2 What is a report on a component of the financial statements?

14.10.3 Does the auditor provide any assurance when they perform agreed-upon procedures relating to the entity's financial information other than the financial statements?

Summary

1 Explain the procedures performed as part of the engagement wrap-up, including gathering and evaluating audit evidence.

During the engagement wrap-up, the auditor reviews planned audit procedures to ensure they are completed, finalizes any open items (including review notes and to-do items), ensures that all necessary documentation is in the working paper files and removes any unnecessary documentation, reconsiders their risk assessment and fraud risk, reconsiders materiality, performs analytical procedures, assesses misstatements, and performs subsequent events procedures.

2 Understand the considerations when assessing the going concern assumption used in the preparation of the financial statements.

The auditor is required to consider whether the going concern assumption is the correct basis upon which the financial statements have been prepared. That is, is the entity viewed by the auditor, management, and those charged with governance as continuing into the foreseeable future with neither the intention nor the need to liquidate, to cease trading, or to seek protection from creditors?

3 Understand the purpose of and the procedures performed in the review for contingent liabilities and commitments.

It is the auditor's responsibility to perform procedures to verify that there are no unrecorded or undisclosed lawsuits or claims that could result in the financial statements being materially misstated.

4 Compare the two types of (material) subsequent events to determine what effect they have on the financial statements (if any).

There are two types of subsequent events. Type 1 subsequent events are those that provide additional evidence with respect to conditions that existed at year end. These are required to be adjusted for in the financial statements. Type 2 subsequent events are those that provide evidence with respect to conditions that developed subsequent to year end; these are not required to be recorded in the financial statements, but are considered for inclusion as a disclosure note.

5 Analyze misstatements and explain the difference between quantitative and qualitative considerations when evaluating misstatements.

Quantitative and qualitative considerations of misstatements include the risk of undetected errors remaining, the effect of the misstatements on compliance with covenants or agreements, whether the misstatements are errors or judgemental misstatements, whether any prior-period unadjusted misstatements exist and could affect the current period's results, the likelihood that these differences will become material in the future, the sensitivity of the misstatements, the significance of the misstatements for the known users of the financial statements, the effect of offsetting differences in financial statement captions, and the dollar amount (quantity) of the misstatements.

6 Evaluate conclusions obtained during the performance of the audit and explain how these conclusions link to the overall opinion formed on the financial statements.

The final phase of the audit is to assess all of the audit evidence obtained and determine whether it is sufficient and appropriate to reduce the risk of material misstatement in the financial statements to an acceptably low level. Based on the evidence gathered, the audit opinion on the financial statements will be determined.

7 Describe the components of an audit report.

The audit report includes a title, an addressee, an audit opinion, a basis of opinion, possibly key audit matters, other matters, management's and the auditor's responsibility for the financial statements, the name of the engagement partner, the auditor's signature, the date of the report, and the auditor's address. KAMs are the matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements.

8 Identify the types of modifications to an audit report.

The overall conclusion reached at the end of the audit can be unmodified, unmodified with an emphasis of matter, modified with a qualification, modified with an adverse opinion, or modified with a disclaimer of opinion.

9 Explain what reporting is required to management and those charged with governance.

All audit matters of governance interest—that is, items that are important and relevant to those charged with governance in overseeing the financial reporting and disclosure process—should be reported to management and those charged with governance by the auditor. This is a required communication that can be provided verbally or in writing, with written communications (or evidence of such communications) preferred.

10 Understand the various types of other engagements that auditors may be asked to perform.

A practitioner may be asked to perform engagements other than those involving financial information and tax engagements. These other engagements include reports prepared in accordance with a special purpose framework or a basis of accounting other than GAAP; reports on a single financial statement line item, such as inventory or gross sales; assurance reports; reports on compliance with contractual agreements, such as covenants; reviews of interim financial statements, such as for companies listed on a stock exchange in the United States; reports on applying specified procedures to financial information other than financial statements, such as reports on the accuracy of expenditures; and reports on the application of accounting principles either to a specific, actual transaction or to the financial statements overall as well as reports on supplementary matters.

Key Terms

Self-Test Questions

Answers to the Self-Test Questions are available in *WileyPLUS*.

14.1 At the conclusion of the audit, the wrap-up process involves:

a. review of proper and complete execution of planned audit procedures.

b. determination that all necessary matters have been appropriately considered.

c. revisiting open review notes, to-do items, and open audit procedures.

d. all of the above.

14.2 If an auditor finds any misstatements or deviations in planned procedures:

a. the auditor should consider the reason for the misstatement or deviation.

b. the auditor should not revise the risk assessment.

c. the auditor should not alter any planned procedures.

d. the auditor does not have to consider the need to perform further audit procedures.

14.3 The going concern assumption means:

a. the entity is facing difficulties continuing as a going concern.

b. the entity is viewed as continuing in business for the foreseeable future with no need for liquidation.

c. assets and liabilities are stated at liquidation values.

d. the auditor is concerned about whether the entity is going to change locations.

14.4 Subsequent events are:

a. events subsequent to the start of the financial year.

b. events subsequent to the appointment of the auditor.

c. events subsequent to the end of the financial year.

d. events subsequent to the going concern assumption.

14.5 The following is a valid type of subsequent event:

a. an event that provides additional evidence with respect to conditions that existed at year end.

b. an event that occurred after the start of the year but before the end of the year.

c. legal action that was settled in the last month of the financial year.

d. all of the above.

14.6 If an auditor becomes aware after the date of the auditor's report but before the financial statements are issued of a fact that may materially affect the financial statements, the auditor should:

a. consider whether the financial statements need changing.

b. discuss the matter with management.

c. take the action appropriate in the circumstances.

d. all of the above.

14.7 The following is an example of an event that provides evidence with respect to conditions that developed subsequent to year end:

a. bankruptcy of a customer subsequent to year end, which would be considered when evaluating the adequacy of the allowance for uncollectible accounts.

b. loss of plant as a result of fire or flood after year end.

c. deterioration in financial results after year end, which may indicate doubt about the going concern assumption in the preparation of the financial statements.

d. an amount received with respect to an insurance claim that was in the course of negotiation at year end.

14.8 Management's responsibility for the financial statements includes:

a. selecting internal control tests.

b. selecting samples for audit testing.

c. selecting and applying appropriate accounting policies.

d. selecting experts to assist with testing asset valuations.

14.9 Emphasis of matter is used without an accompanying qualification of the audit report when:

a. a significant uncertainty exists that should be brought to the reader's attention.

b. an extreme limitation of the scope of the engagement exists.

c. there is a disagreement with those charged with governance regarding the selection of accounting policies.

d. all of the above.

14.10 Communication with those charged with governance:

a. means that the auditor should write to the board of directors about any matters of governance interest arising from the audit of the financial statements.

b. is done at the start of the audit.

c. is done through the audit report.

d. requires the auditor to write to the CEO at the conclusion of the audit.

Review Questions

14.1 List and describe the elements in the engagement wrap-up process. Why are they important?

14.2 What is the accounting assumption of "going concern"? Why is it of interest to auditors?

14.3 What procedures must the auditor perform to search for contingent liabilities?

14.4 Explain the difference between the two types of subsequent events. Discuss the auditor's responsibility for detecting subsequent events (a) prior to the completion of fieldwork, (b) prior to signing the audit report, and (c) between the date of the audit report and the issuance of the financial statements.

14.5 What options does an auditor have when material errors are found? Do these options vary for current-year misstatements and prior-year misstatements?

14.6 Why do audit reports contain paragraphs outlining (a) management's responsibility for the financial statements and (b) the auditor's responsibility for the financial statements? What is contained in these paragraphs?

14.7 What is "modified wording" in an audit report? What are the different types of modified wording and when are they used?

14.8 Explain the difference between limitation of scope and disagreement with those charged with governance.

14.9 CAS 260 stresses the importance of communication with "those charged with governance." Who are these people and why is it important that the auditor communicate with them (and not others)?

14.10 What matters does an auditor communicate at the end of an audit to those charged with governance? Why are these matters important?

Professional Application Questions

Basic Moderate Challenging

14.1 Audit wrap-up Basic LO 1

Lucy Huang has just finished her first audit assignment. She is now assisting her audit manager, Tom Lucas, in wrapping up the engagement. He has asked Lucy to make a list of all uncleared review notes, to-do items, and audit procedures, and to note for each whether the matter requires more attention, has been resolved (but is not yet noted on file), or is no longer relevant because of other events.

Tom has also asked Lucy to go through the files and remove all unnecessary documentation, drafts, and review notes. Lucy is very nervous about this task because she believes her inexperience will mean that she will not be able to distinguish "unnecessary" from "necessary." She has heard that in a famous case in the United States an audit firm was prosecuted because it shredded files that should have been kept.

Required

a. What additional attention would open matters require?

b. Explain why documents in a client's audit files would be "unnecessary." Give examples.

14.2 Going concern Basic LO 2

Phil Nanere is the partner in charge of the audit for a new client, Western Wonderland (WW). The client engaged Phil's audit firm in November 2022, in preparation for the 2023 audit. From January 30, 2023, onwards, WW has consistently paid its suppliers late, well in excess of the suppliers' agreed credit terms. This has resulted in some suppliers demanding cash on delivery from WW. Phil is also aware from his review of correspondence between WW and its bank that the company has been experiencing cash flow problems since 2020.

Required

Identify any significant events or conditions that individually or collectively may cast significant doubt on WW's ability to continue as a going concern.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, December 2010. Provided courtesy of Chartered Accountants Australia and New Zealand.

14.3 Assessing going concern Moderate LO 2, 7

Manitoba Metal Fabricators (MMF) is a company that makes steel components for the construction industry. It specializes in extreme precision manufacturing where tolerances are measured in distances of less than one millimetre. Its products are used in revolving restaurants, automatic doors, and similar construction components. In the past, the majority of its sales have been to international construction companies, particularly in the Middle East. Construction has slowed down in the Middle East, and the extremely expensive buildings requiring high-precision steel components are becoming less popular. In addition, some of the technology used by MMF has been copied by companies in southeast Asia, resulting in extreme price competition in this sector of the construction industry for the first time.

MMF is highly leveraged. Two years ago the company borrowed a large sum of money to fund the purchase of new premises and the latest laser-cutting equipment. The loan is due for renewal three months after year end. One week before the audit report is to be signed, the bank has still not agreed to renew the loan and MMF's management has begun negotiations with another bank.

Required

a. Identify the factors that would raise questions about the going concern assumption for MMF. Are there any mitigating factors?

b. What reporting options are available to the auditor of MMF? Discuss. Refer to CAS 570 in your answer.

14.4 Audit documentation for going concern **Basic** **LO 1, 2, 5, 7**

Springsteen Ltd. is a new audit client for the 2023 financial year. Springsteen's financial statements for the 2022 year, the last with the previous auditor, were prepared on the assumption of a going concern. An unmodified audit opinion with a going concern heading was included in the auditor's report because of a going concern issue. The issue identified by the auditor was that Springsteen was due to refinance a material amount of debt shortly after the prior year end. You are aware that Eastcoast Bank appeared unwilling to extend further financing, and Springsteen had taken no steps to secure other financing. Springsteen did not disclose any information about the debt refinancing matter in its financial statements.

It is August 2023 and the first audit for Springsteen Ltd. with your audit firm for the 2022–23 year is almost complete. Prior to reaching your final conclusions, you are reviewing the working papers for the year ended June 30, 2023. The material bank loan with Eastcoast Bank was extended in September 2022 for another 12 months.

Required

a. Given the history of the bank loan, outline two types of documentation you would expect to see included in the audit file to provide audit evidence that this year's financial statements can be prepared on a going concern basis.

b. Was the opinion in the auditor's report appropriate? Explain.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, May 2010. Provided courtesy of Chartered Accountants Australia and New Zealand.

14.5 Subsequent events procedures **Moderate** **LO 4**

Mitch Ziegel and Rosie Punter are discussing the audit plan for a large manufacturing company. The company has two main manufacturing plants plus several warehouse and distribution centres (one in each province). The company has a large investment in trade receivables and there are additional concerns this year about whether the tough economic conditions have affected the collectibility of the trade receivables. The agenda for the board of directors' monthly meeting includes an item to discuss the effect of the economic slowdown on customers. The board is also negotiating a takeover with a competing company. The discussions have been ongoing for some time and one month before year end the board of the other company indicated it would like more progress to be made on this deal. Another matter concerning senior management at the manufacturing company is a threatened labour dispute by the largest union representing workers at the distribution centres. A number of safety issues have been identified for the company, explaining the union's demands for better working conditions and a pay increase. The company management is disputing most of the safety concerns.

Mitch and Rosie are reviewing the draft plan to ensure that adequate procedures are included to meet their obligations for detecting subsequent events during the period from year end to the date of signing the audit report. Mitch is the engagement partner on the audit and Rosie is an audit manager. Rosie admits to Mitch that she has always had trouble distinguishing the two types of subsequent events in IAS 10 and therefore has some trouble applying CAS 560. She also admits to Mitch that she has never been involved in an audit where there was a subsequent event arising after the date of the audit report, so she doesn't know what the auditor is supposed to do in these circumstances.

Required

a. Explain the difference between the two types of subsequent events. Give an example of each and explain the type of adjustment (if any) to the financial statements that would be required.

b. List some audit procedures that should be in the audit plan for this company for the detection of subsequent events occurring prior to the date of the audit report.

c. Explain the auditor's responsibilities for subsequent events that arise after the date of the audit report (before the date the financial statements are issued). What is the difference in the auditor's responsibilities between these events and those arising before the date of the audit report?

14.6 Reporting subsequent events **Moderate** **LO 4**

Brad Gokool is reviewing the results of the subsequent events audit procedures. Brad is writing a report for his audit partner based on these results and will be attending a meeting tomorrow with the partner and representatives of the company to discuss them. The issue will be whether the financial statements should be amended or additional notes should be included for these subsequent events.

Many of the items are not material and Brad will recommend that no action be taken with respect to these. However, there are several items that Brad believes are material and should be discussed at the meeting. These are:

- The board is planning to issue shares in a private placement on August 15.
- The share issue is to fund the purchase of a 60-percent stake in another company. The negotiations are in the final stages and although the contract is not yet signed, it will be signed by August 15.
- A statement of claim was lodged in court in the week after year end claiming damages for illness allegedly caused by chemicals used at a subsidiary company's manufacturing plant in the 1990s. This is the tenth such claim lodged and the client has denied responsibility in all cases because it was unreasonable to believe at that time that these chemicals had adverse health effects. The claimant has new scientific evidence that counters this defence.
- The review of subsequent cash receipts has revealed that several of the accounts receivable that were considered doubtful have now been paid. However, the audit procedures have shown that a large customer with a significant receivable balance considered safe on June 30 unexpectedly declared bankruptcy on July 20.
- The year end for the company is June 30 and the audit report is due to be signed on August 20.

Required

For each item above:

a. What type of subsequent event is it?

b. What is the appropriate treatment in the financial statements?

14.7 Events after balance sheet date **Basic** **LO 4**

Martin Rorke is reviewing the results of the review of subsequent cash receipts. There are several receipts listed from customers that were considered doubtful at the end of the year (June 30). Martin is also reviewing evidence that shows that another customer that had a large balance at year end was unexpectedly declared bankrupt on July 10.

Required

How should this information be reflected in the financial statements?

14.8 Disclosure of subsequent events **Challenging** **LO 4**

In connection with your examination of the financial statements of Martinson Inc. for the year ended December 31, your post–balance sheet date audit procedures disclosed the following items on the following dates:

1. January 5: The funds for a $50,000 loan to the corporation made by Marc Martinson on December 18 were obtained by him with a loan on his personal life insurance policy. The loan was recorded in the account "Loan payable to officers." The source of the funds obtained by Marc was not disclosed in the company records.
2. January 9: The mineral content of a shipment of ore en route on December 31 was determined to be 80 percent. The shipment was recorded at year end at an estimated content of 50 percent by a debit to "Raw material inventory" and a credit to "Accounts payable" in the amount of $41,200. The final liability to the vendor is based on the actual mineral content of the shipment.
3. January 31: As a result of reduced sales, production was curtailed in mid-January and some workers were laid off. On February 5, all the remaining workers went on strike. To date, the strike is unsettled.
4. February 20: A contract was signed whereby Whitworth Enterprises purchased from Martinson Inc. all of its capital assets, inventories, and the right to conduct business under the name "Martinson Inc. Division." The transfer's effective date will be March 1. The sale price was $800,000.

Required

Assume that the above items came to your attention prior to completion of your audit work on February 28. For each of the above items, discuss the disclosure that you would recommend for the item.

14.9 Approaches to reporting contingent liabilities **Moderate** **LO 3, 4**

Hatami and Partners completed the fieldwork for the December 31, 2023, audit of Harbinger Corporation on March 1, 2024. The financial statements and auditor's report were issued and mailed to shareholders on March 15, 2024.

Required

In each of the two situations below, select from the list of possible actions the choices that would be appropriate for an auditor to make under those circumstances. Assume both situations are material. Explain why.

Situations

1. On January 5, 2024, a lawsuit was filed against Harbinger for a copyright infringement action that allegedly took place in early 2023. In the opinion of Harbinger's lawyers, there is a reasonable (but not probable) danger of a significant loss to Harbinger.
2. On February 15, 2024, Harbinger settled a lawsuit out of court that had originated in 2023 and is currently listed as a contingent liability.

Possible actions

a. Adjust the December 31, 2023, financial statements.

b. Disclose the information in a footnote in the December 31, 2023, financial statements.

c. Request that the client revise and reissue the December 31, 2023, financial statements. The revision should involve an adjustment to the December 31, 2023, financial statements.

d. Request that the client revise and reissue the December 31, 2023, financial statements. The revision should involve the addition of a footnote, but no adjustment, to the December 31, 2023, financial statements.

e. No action is required.

14.10 Misstatements and the audit report **Challenging** **LO 5, 6, 7, 8**

Katrina Lukacs is the engagement partner of the audit of Champion Securities, an investment company. Most of Champion's assets and liabilities are financial and their valuation is critical to the assessment of the company's solvency and profitability. Katrina has employed two outside experts to value the financial assets and liabilities because they are extremely complex to value, particularly the energy market derivatives and the instruments traded in foreign markets. In addition, the valuations are highly dependent on market conditions and the specific and detailed requirements of the recently revised accounting standards.

Throughout this year's audit, Katrina has had difficulties with the CEO of Champion Securities. He is vehemently opposed to any asset writedowns she has suggested. The CEO has the backing of the chair of the board and Katrina has been unable to get the CEO to listen to her concerns about the valuations of the financial assets and liabilities the company has made. In past years, Katrina has had an amicable relationship with both the CEO and the chair, and the audits have run very smoothly. Katrina has now realized that this harmonious relationship was mainly due to the boom in the market. It was unlikely that there would be arguments about writing up the value of the company's assets during these good times.

Katrina, with the help of the experts, has prepared a summary of the relevant items, detailing the revised values for the assets and liabilities and the associated effects on income and retained earnings. The CEO has dismissed this summary and the audit recommendations with the comment, "The market has hit bottom and is recovering. There is no need to show these writedowns because by the time the financial statements are published the values will be back to where they were before the market fell. It is all a waste of time. In fact, I think you are just being difficult to deal with. I think we need an auditor who is a bit more realistic."

Required

a. Discuss the ethical issues Katrina faces and explain what she needs to do to comply with the code of professional conduct independence requirements.

b. Explain Katrina's audit report options.

c. Recommend a course of action for Katrina.

14.11 Misstatements and the audit report **Challenging** **LO 5, 6, 7, 8**

The staff at Nguyen and Partners have completed the necessary audit work for Manitoba Metal Fabricators. The partner responsible for the audit is now reviewing the audit file. She has come across the Schedule of Unadjusted Differences and is considering the type of audit report to issue. Referring to figure 14.2, answer the following:

Required

a. If overall materiality for the engagement were set at $30,000, what type of audit report would be issued? Why?

b. If overall materiality for the engagement were set at $100,000, what type of audit report would be issued? Why?

c. Why would the Schedule of Unadjusted Differences include a line relating to entries from the prior year? How might unrecorded entries from the prior year impact the current year's financial statement balances?

14.12 Audit reports and other communication at the end of an audit **Moderate** **LO 5, 7, 8, 9**

Steven Erasmus has had difficulties throughout the audit of Kingston Catering Inc. The company is a long-standing client of the audit firm and there have been no problems in the past. However, four months into the start of the financial year, the company's computer systems failed. Subsequent diagnostic tests revealed that a particularly nasty virus had infected the computer system and corrupted all the processed data. The IT manager called in an IT specialist for advice as soon as the problem was discovered. The specialist installed a new computer system and additional security programs and the IT manager is confident that the problem will not recur.

The processed data had been backed up and stored in a secure location, but when a restoration was attempted it was discovered that the virus had also corrupted the backups. The Kingston Catering staff tried to reconstruct the computer files based on paper records, but the reconstruction was incomplete because some paper documents had been inadvertently destroyed.

Steven is particularly concerned about sales and trade receivables. Kingston Catering has many "one-time" customers as well as several large accounts. The first four months of the year corresponded with the busiest time of the year for the company. Staff attended many corporate and private functions during this time and made numerous sales of catering equipment to wholesale and retail customers. Or at least they think they did, and they believe that they collected all the accounts. Steven is not so sure. He thinks the chaos caused by the computer virus meant that deliveries were being made in a rush without the completion of the appropriate paperwork and the attempts to collect accounts were ineffectual as customers took advantage of the situation to claim that they had either already paid or had returned goods for credit. Other customers simply "fell off" the system and were never billed.

Required

a. Discuss Steven's audit report options and recommend the appropriate wording for the audit report.

b. What matters would Steven include in the letter to those charged with governance at Kingston Catering?

Questions 14.13 and 14.14 are based on the following case.

Fabrication Holdings Ltd. (FH) has been a client of KFP Partners for many years. You are an audit senior and have been assigned to the FH audit for the first time for the financial year end, December 31, 2023.

FH's financial statements for the year ended December 31, 2023, show land and buildings at fair value of $20.8 million. As part of your subsequent events procedures, you become aware that FH sold the property in January 2024 when an independent third party made an unexpected offer of $24.5 million. The difference between the sale price and the amount stated in the financial statements (which has not been adjusted) is material. You have not yet signed the audit report.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam,* May 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

14.13 Subsequent events **Moderate** **LO 4**

Required

Analyze the events surrounding the sale of FH's land and buildings. Is it a subsequent event? If so, which type?

14.14 Audit reports and subsequent events **Moderate** **LO 7, 8**

Required

Based on your answer to question 14.13, explain what type of audit opinion you would issue. Why?

Questions 14.15 and 14.16 are based on the following case.

Fellowes and Associates Chartered Professional Accountants is a successful mid-tier accounting firm with a large range of clients across Canada. In April 2023, Fellowes and Associates gained a new client, Health Care Holdings Group (HCHG), which owns 100 percent of the following entities:

- Shady Oaks Centre, a private treatment centre
- Gardens Nursing Home Ltd., a private nursing home
- Total Laser Care Limited, a private clinic that specializes in the laser treatment of skin defects

The year end for all HCHG entities is June 30.

You are the audit partner reviewing the audit work papers for HCHG for the year ended June 30, 2023. Today is July 13, 2023, and the audit report is due to be signed in three weeks' time.

During your review, you note that the fixed-term borrowings of HCHG totalling $75 million are approaching maturity and HCHG does not seem to have renegotiated any terms of refinancing. You are aware, from your experience with other clients, that banks are reluctant to extend financing on the same terms in the current market. The financing of HCHG was historically managed by the group's treasurer, who left the group six months ago and has not been replaced.

HCHG's financial controller, who has been with the group for nine months, has advised you that he has been busy renegotiating with some of HCHG's key suppliers, who recently requested cash on delivery for all orders, rather than extending the normal credit terms.

You are also aware that a fire that occurred in the Shady Oaks cafeteria last week was not adequately covered by insurance. Fortunately, no one was seriously injured in the fire, but the cafeteria was so badly damaged that it had to be closed. When you are discussing this matter with HCHG's law firm, they reveal that the centre is unlikely to have adequate professional indemnity insurance to meet the current demands of several malpractice cases that have been brought against it in the past 12 months.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, December 2008 and March 2009. Provided courtesy of Chartered Accountants Australia and New Zealand.

14.15 Final review issues—subsequent events **Moderate** **LO 4**

Required

a. Explain your responsibilities with respect to the Shady Oaks cafeteria fire.

b. How will this event be handled in the HCHG financial statements and the audit report?

14.16 Final review issues—going concern and reporting **Challenging** **LO 2, 7, 8**

Required

a. Are there any going concern issues for HCHG? Explain. If so, what are the mitigating circumstances?

b. How will you recommend that the issues be handled in the financial statements and the audit report?

14.17 Types of audit reports and modifications **Basic** **LO 8**

Required

For each of the following situations, indicate what type of modification/audit report is most appropriate.

a. There is a scope limitation and it is material. However, the overall financial statements are still presented fairly.

b. There is a departure from GAAP and it is pervasively material.

c. The auditor lacks independence in fact, but not necessarily in appearance.

d. The uncorrected misstatements are immaterial.

14.18 Assurance report over gross sales **Basic** **LO 10**

Beautiful Shoes Inc. is a high-end ladies' shoe store. It has recently expanded its operations and signed a long-term lease in a popular shopping centre. The owner, Beverly Hung, is concerned because the lease agreement requires that she submit to the landlord a percentage of her gross sales at the end of the calendar year. The lease indicates she must also provide a report on the gross sales. This report should have an assurance report attached. Beverly has no idea what this means or how she will come up with such a report. She has asked you, her CPA, to explain what may be required.

Required

Explain to Beverly what is needed to satisfy the requirements of the new lease agreement.

[1]**14.19** Special engagement reporting **Moderate** **LO 10**

You, a recently designated CPA, have agreed to serve on a committee that is organizing a sports adventure race as a fundraiser for Far West Camp, a camp for teenagers from all economic backgrounds. Far West Camp has obtained support from two sponsors that have specified criteria that must be met before they will contribute. They have also asked for an independent opinion that their criteria have been fulfilled. The following is a list of the sponsors and their stated criteria.

Sponsor	Contribution Criteria
Sports Wear Unlimited to provide $10 per participant	Confirmation of the number of participants
Department of Tourism to provide a grant for publicity	Independent confirmation that the funds are spent on eligible activities, and that there is no direct benefit to individuals involved in organizing the race or operating the camp. Final approval for the grant is expected in the next couple of weeks.

The chair of the committee has asked you to explain to the committee what it can do to satisfy the sponsors' requests.

Required

Explain to the committee chair the various report options for both sponsors.

Source: Adapted from the Uniform Final Exam (UFE), The Institutes of Chartered Accountants of Canada and Bermuda, 2008, Day 3, Problem 3.

14.20 Review engagements **Challenging** **LO 2, 4, 10**

Epic Travel is a travel agency in Saskatoon, Saskatchewan. The company sells travel services to the public. Since its inception by Cyril Kang, 10 years ago, Epic Travel has had a review engagement performed by the CPA firm Doug and Green. Doug and Green is getting ready to perform the review engagement for the April 30, 2023, year end. While the company has had a history of profitability, the last year proved challenging. In February 2023, a global pandemic shook the world and it resulted in all travel being suspended. In response, the agency temporarily closed its doors for the last three months of the year. To help with cash flow, in March 2023, the company laid off most of its employees. In May 2023, before the completion of the review engagement, Epic Travel took advantage of a government program that allowed it to obtain a government loan and a portion would be forgivable provided it rehired some of its employees.

Doug and Green has completed the client acceptance procedures. The balance sheet for Epic Travel is presented below. In discussions with Cyril, the practitioner notes that the subsidiary reported on the balance sheet is a restaurant not likely to survive the economic slowdown caused by the global pandemic. The goodwill on the balance sheet is the result of the purchase of the restaurant for a sum greater than the fair value of its assets a few years ago. The firm has determined that materiality for the engagement is $25,000.

[1] Adapted with permission of the Chartered Professional Accountants of Canada, Toronto, Canada. Any changes to the original material are the sole responsibility of the publisher and have not been reviewed or endorsed by the Chartered Professional Accountants of Canada.

Epic Travel Co. Balance Sheet April 30, 2023		
	2023	**2022**
Assets		
Current assets:		
Cash	$ 65,000	$ 50,000
Accounts receivable	785,000	955,500
Prepaid expenses	20,000	25,500
	870,000	1,031,000
Advances to subsidiary company	100,000	100,000
Property, plant, and equipment	200,000	650,000
Goodwill	300,000	300,000
	$ 1,470,000	$ 2,081,000
Liabilities and Shareholders' Equity		
Current liabilities:		
Accounts payable and accrued liabilities	$ 760,000	$ 560,000
Client deposits	85,000	295,000
	845,000	855,000
Long-term debt	495,000	405,000
	1,340,000	1,260,000
Shareholders' Equity		
Share capital	10,000	10,000
Retained earnings	120,000	811,000
	$ 1,470,000	$ 2,081,000

Required

a. Based on the information and the balance sheet provided, identify the material and high-risk areas.

b. What questions should the practitioner plan to ask Cyril Kang regarding the high-risk areas?

c. Discuss the impact of the global pandemic on the review engagement. Your response should consider the going concern assumption and subsequent events.

Case

[2]**14.21** Integrative Case Study—Ball Construction Corporation **Challenging**

You are the audit senior of Ball Construction Corporation (BCC), a small public company that enters into construction contracts with individuals and developers and builds to their specifications. BCC is a Canadian company, but recently opened a branch in the southwestern United States.

It is September 2023 and the audit fieldwork for this year's audit engagement has just been completed. You are in the process of finalizing the audit file. The following is documented in the audit file:

[2] Adapted with permission of the Chartered Professional Accountants of Canada, Toronto, Canada. Any changes to the original material are the sole responsibility of the publisher and have not been reviewed or endorsed by the Chartered Professional Accountants of Canada.

Risk assessment

Although BCC's audit is recurring and we are familiar with its operations and systems, we determined that the audit risk for this year has increased from medium to high. There are three main reasons for the change:

- Recent declines and instability in the U.S. housing market have created a high-credit-risk situation.
- BCC's controller left in March 2023, and the position had not been filled by year end.
- The bank increased the interest rate on the company's operating line during the year, suggesting that it views BCC as a higher risk than before.

Audit approach

No information systems issues were noted in prior years. While we identified isolated control weaknesses in this year's review of the systems, overall the controls appear reliable. We will use a combined approach, and, because of the increased risk, we will increase the amount of substantive work.

Materiality

Planning materiality was set at $242,000.

1. Internal control

a. When the controller left, the finance department staff took on additional duties. We noted that, during the latter part of the year, the same individual was creating purchase orders, entering invoices into the system, and preparing the cheque runs. The CFO said the situation was unavoidable, and noted that the accounting manager reviewed the cheque runs and prepared the bank reconciliations.

b. We noted that many journal entries had not been approved. The CFO said that he trained most of the employees responsible for the entries, so he knows what the entries are for. He also said, "Our management review of reports and financial statements would uncover any incorrect entries."

c. The CFO relies on senior management to review, approve, and sign reports generated by the finance department, such as the costing report by project. Testing of a sample of reports indicated that most reports had been appropriately approved. However, some reports were found on a construction manager's desk. When asked about them, she explained, "I'm so busy managing my current jobs that I haven't had time yet to look them over." The signed reports were given to the audit team the next day and the audit testing was completed.

2. Accounts receivable and allowance for doubtful accounts

We sent confirmations to a sample of accounts receivable and noted the following issues based on the responses received:

- One confirmation was returned stating that a receivable balance, related to a $1,542,000 contract, was overstated based on the progress report. Upon examination of the relevant report, we noted that a transposition error had occurred (86 percent completion was used when it should have been 68 percent). This represents a known error of $277,560. The CFO agreed that it was an error but was satisfied that this was an isolated issue and would normally have been caught by the supervisor's review. The CFO does not want to adjust for this error.
- The CFO was quite adamant that no adjustments be made to the financial statements, declaring that "the statements fairly and accurately represent the financial situation of BCC."

Required

a. What type of audit report should be prepared, assuming the CFO does not change his position? Discuss.

b. Prepare the draft management letter.

Source: Adapted from the Uniform Final Exam (UFE), The Institutes of Chartered Accountants of Canada and Bermuda, Paper 2, 2008.

Case Study—Cloud 9

Answer the following questions based on the information presented for Cloud 9 in Appendix A of this book and the current and earlier chapters. You should also consider your answers to the case study questions in earlier chapters.

Required

Based on everything you know about the audit of Cloud 9, finalize the audit by preparing the audit report and the letter to those charged with governance of the company.

Research Question 14.1

The global financial crisis of 2007–08 led to increasing legal action against auditors as company managers searched for scapegoats and potential places to recover their losses. The tough economic times also likely caused companies that would otherwise have survived to fail, exposing bad management and poor-quality auditing.

Required

Conduct a literature search for reports of threatened and actual legal action against auditors as a result of that global financial crisis. In your search, include articles raising questions about auditors and the quality of their work even though legal action may not have commenced.

Write a summary of your findings and comment on the merits of the cases against auditors. Is there any evidence of poor-quality auditing?

Appendix A: Cloud 9 Ltd.

W&S Partners is a Canadian accounting firm with offices located in each of the major cities. W&S Partners has just won the December 31, 2023, statutory audit work for Cloud 9 Ltd. The audit team assigned to the client is Partner, Jo Wadley; Audit Manager, Sharon Gallagher; Audit Seniors, Josh Thomas and Suzie Pickering; IT Audit Manager, Mark Batten; and Audit Juniors, including Ian Harper, Weijing Fei, and you.

Prior-year audits were conducted by Ellis & Associates. As part of the change of auditors process, Jo Wadley met with R. J. Ellis (Managing Partner, Ellis & Associates) to discuss acceptance of Cloud 9 Ltd. as a client and to inquire about access to Ellis & Associates' work papers. In the discussion, R. J. Ellis stated that there were no issues that W&S Partners should be aware of before accepting the client or commencing the work.

Cloud 9 Ltd. Company Background

Originally founded in 2000 by Ron McLellan, the Toronto-based company was a manufacturer and retailer of customized basketball shoes. In 2013, Cloud 9 Inc. (a publicly listed Canadian company) purchased the original company from Ron McLellan and renamed it Cloud 9 Ltd. As part of the sale agreement, Ron McLellan was appointed to the Cloud 9 Ltd. board of directors.

The parent company, Cloud 9 Inc., has wholly owned subsidiaries in the United Kingdom, Germany, United States, China, and Brazil, and has built a reputation around the fact that its shoes are comfortable and durable. The company promotes itself using its now well-known tagline, "Our shoes are so comfortable, it's like walking on Cloud 9." Currently, Cloud 9 Ltd. is primarily a wholesaler of athletic shoes to its main customers: David Jones, Meyer Sports, Foot Locker, and Rebel Sports.

Cloud 9 Ltd. receives the majority of its inventory from the production plant in China, with the remainder coming from the United States. All inventory is purchased free on board (FOB) shipping point, which means Cloud 9 Ltd. takes ownership of the products once the international courier accepts the goods for delivery. The inventory is sent to the main warehouse in Richmond, B.C., which is linked to retailers through an electronic inventory system. When retail inventory levels get low, the company ensures that deliveries are made using its own transport trucks, thus ensuring control throughout the entire process.

In February 2021, Cloud 9 Ltd. launched its new product line, which included the Heavenly 456 walking shoe. Advertising campaigns and media coverage have been very successful and sales for this style of shoe have steadily increased. For Cloud 9 Ltd., the Heavenly 456 now makes up 20 percent of total sales.

A specific marketing campaign was initiated in 2023 to promote and build the Cloud 9 brand in Canada. The Canadian company was granted permission from its parent entity to sponsor a new soccer team, the Thompson Thunders, for the 2023 season. Under this sponsorship agreement, Cloud 9 Ltd. is to provide all the athletic footwear for the team, and have sole merchandising rights. The agreement also includes general advertising rights at the stadium.

In a separate contractual arrangement, Cloud 9 Ltd. has signed Kevin McDonald, the captain of the Thompson Thunders, as spokesperson for the brand. This arrangement allows Cloud 9 Ltd. to use Kevin's image to promote and build the brand in Canada.

To further establish the brand, the first Cloud 9 retail store was opened in Toronto on June 1, 2023. The store operates on a just-in-time inventory system linked with the main warehouse in Richmond. However, the management team reports that there have been a few hiccups in determining ideal inventory quantities for the store to allow optimum availability of merchandise to the customers. There have also been some thefts of merchandise from the store and in order to reduce inventory loss by theft, the company has installed closed-circuit television cameras.

Personnel

Cloud 9 Ltd. has 52 full-time employees. In the retail store, the company employs part-time staff, with casual employees enhancing staff levels in the busier retail period.

To administer the company's finances, Cloud 9 Ltd. employs Finance Director David Collier, Financial Controller Carla Johnson, and Business Systems Manager Justin Reeves. These three employees are entitled to participate in the employee share purchase plan and receive stock options in Cloud 9 Inc. if revenue targets are met.

Financial Information

Responding to pressure from its parent company, Cloud 9 Ltd. set a goal of increasing its revenue by 3 percent for the 2023 fiscal year. One of the critical success factors for the company achieving this 3-percent increase is to grow its share of the North American footwear market. However, with the new store opening and the subsequent increase in costs, as well as the costs related to the sponsorship deals, the management team is projecting a loss for the year.

In addition, to build customer loyalty and promote sales in the retail store, Cloud 9 Ltd. introduced a loyalty program whereby customers earn one point for every $10 that they spend. Customers can then redeem points by going online to receive coupons that can be exchanged for merchandise in the store.

On October 1, 2022, the company took out an additional loan of $2 million with Ontario Bank to help fund the store costs and to purchase additional delivery trucks and vans. This loan is repayable over five years. The company's other debt relates to loans issued five years ago from a company that is majority-owned by one of the directors.

All inventory is purchased in U.S. dollars, which the company translates into Canadian dollars. The company provides a 12-month warranty on all footwear. Historical claims have been 2 percent of total sales.

The prior-year income statement and balance sheet are included below.

CLOUD 9 LTD.
Income Statement
Year ended December 31, 2022

	2022	2021
Revenue	$ 33,987,595	$ 31,901,288
Cost of goods sold	16,393,394	14,355,579
Gross profit	17,594,201	17,545,709
Other expenses	16,476,833	16,293,621
Income from operations	1,117,368	1,252,088
Other income	312,447	212,990
Income before taxes	1,429,815	1,465,078
Income tax expense	378,074	452,064
Net income	$ 1,051,741	$ 1,013,014

CLOUD 9 LTD. **Balance Sheet** As at December 31, 2022		
	2022	**2021**
Assets		
Current assets		
Cash	$ 1,753,765	$ 534,938
Accounts receivable	9,361,402	9,608,742
Inventory	6,163,242	6,796,990
Prepaid expenses	666,054	1,135,416
Total current assets	17,944,463	18,076,086
Due from parent company	482,306	482,306
Plant and equipment	852,965	301,667
Deferred tax asset	277,559	326,218
Total assets	$ 19,557,293	$ 19,186,277
Liabilities and Shareholders' Equity		
Current liabilities		
Accounts payable	$ 1,709,580	$ 3,402,045
Accrued liabilities	1,860,627	3,077,879
Current tax liability	207,893	12,391
Total current liabilities	3,778,100	6,492,315
Long-term debt	9,560,224	7,560,224
Deferred taxes	170,284	136,794
Total liabilities	13,508,608	14,189,333
Shareholders' equity		
Share capital	5,448,026	5,448,026
Retained earnings	600,659	(451,082)
Total liabilities and shareholders' equity	$ 19,557,293	$ 19,186,277

Following are the December 2023 trial balance for Cloud 9 Ltd., a draft statement of income for 2023, a transcript of a meeting with Carla Johnson (Cloud 9 Ltd. financial controller), and sales and cash control testing support.

CLOUD 9 LTD.
Trial Balance

	December 31, 2023		December 31, 2022	
	DR	**CR**	**DR**	**CR**
Cash—operating account	184,679		551,583	
Cash—savings account	60,000		1,200,000	
Petty cash	1,786		2,182	
Cash—store locations	500			
Trade receivables—stores	217,649			
Trade receivables—wholesale	10,604,933		9,879,175	
Allowance for doubtful accounts		468,197		637,167
Miscellaneous receivables	44,789		49,372	
HST receivable	31,457		70,022	
Inventory	5,788,922		6,057,752	
Goods in transit	453,002		629,235	
Allowance for inventory obsolescence		417,788		523,745
Amounts receivable from parent	482,306		482,306	
Prepaid rent	300,450		211,699	
Prepaid insurance	765,702		417,603	
Other prepaid expenses	45,876		36,752	
Furniture and equipment	1,768,954		1,098,290	
Accumulated depreciation—furniture and equipment		1,283,848		757,958
Leasehold improvements	1,324,875		722,302	
Accumulated depreciation—leasehold improvements		360,650		209,669
Deferred tax assets	271,659		277,559	
Trade payables		2,179,603		1,215,219
Accrued bonuses		300,000		250,000
Sales commissions payable		423,786		398,074
Other accrued expenses		715,103		943,972
Intercompany payables		593,457		494,361
Accrued vacation payable		156,548		182,984
Loyalty program provision		62,456		
Current income tax payable		159,866		207,893
Warranty liability		91,456		85,597
Long-term debt		8,872,482		9,560,224
Deferred income taxes		198,647		170,284
Share capital		5,448,026		5,448,026
Retained earnings		600,659	451,082	
Revenue—stores		854,376		
Revenue—wholesale		36,340,556		33,987,595

(*continued*)

(*continued*)

CLOUD 9 LTD.
Trial Balance

	December 31, 2023		December 31, 2022	
	DR	**CR**	**DR**	**CR**
Interest from bank		60,576		28,642
Foreign exchange gain/loss		47,289		29,568
Gain on disposals				7,714
Other revenue		251,453		246,523
Cost of goods sold—stores	640,781			
Cost of goods sold—wholesale	16,453,395		16,393,394	
Salaries and employee benefits	5,044,460		4,842,343	
Storage—rent expense, store	166,667		—	
Storage—rent expense, warehouse	2,959,257		2,959,257	
Distribution expenses	2,038,255		2,008,015	
Telephone	59,537		—	
Computer and IT costs	252,469		450,907	
Advertising and promotion—print	1,685,812		1,046,668	
Trade shows	327,687		384,934	
Advertising and promotion—TV	841,901		496,996	
Advertising and promotion—sponsorships	1,713,008		—	
Rent expense—office	309,170		309,170	
Bad debt expense	75,712		120,000	
Depreciation—furniture and equipment	701,187		339,852	
Depreciation—leasehold improvements	201,309		96,326	
Entertainment	220,576		320,703	
Professional fees	318,205		458,903	
Insurance expense	2,153,461		1,597,463	
Recruitment	352,436		343,720	
Interest expense—loan from bank	1,017,583		701,576	
Income tax expense	6,415		378,074	
	59,886,822	**59,886,822**	**55,385,215**	**55,385,215**

Draft Income Statement
December 31, 2023

Revenue	$ 37,194,932
Cost of goods sold	17,094,176
Gross profit	20,100,756
Other expenses	20,438,692
Loss from operations	(337,936)
Other income	359,318
Net income before taxes	21,382
Income tax expense	6,415
Net income	$ 14,967

TRANSCRIPT OF MEETING WITH CARLA JOHNSON

Present: Carla Johnson, Financial Controller, Cloud 9 Ltd.
Josh Thomas, Audit Senior, W&S Partners

JT: Thanks for seeing me, Carla.

CJ: You're welcome, Josh. What can I do for you?

JT: I need to ask you some questions about Cloud 9's process for recording wholesale revenue transactions, including the trade receivables and cash receipts aspects. After I understand the process, I'll need to select a sample transaction to confirm my understanding of the process as you have explained.

CJ: Well, I can tell you what should be happening, but you may want to go and speak to the sales manager or warehouse managers to confirm that they do what the company policy and procedures say.

JT: Good point, I'll make appointments to see them. Thanks. So let's start at the beginning—how does a sales transaction get initiated?

CJ: We've got a pretty complex inventory management software system called Swift. It was designed by some of our tech guys in the United States. It tracks and does everything!

JT: Sounds impressive!

CJ: Anyway, the customers—let's say the Sport Mart store in Toronto—complete a purchase order online through a site that is linked to Swift.

JT: How do the customers decide the quantity and know the price?

CJ: Swift is linked (don't ask me how) and sends an alert when the inventory balance of our products gets below the predetermined limit they set with us. They can select the quantity based on their needs, but the prices are set in the system. They get sent price lists from the sales manager so they know the current prices.

JT: How often are prices changed?

CJ: Depends on the market, really. They don't change too frequently.

JT: What if you don't have the products?

CJ: The system doesn't allow them to place an order greater than our current inventory levels. If they need more, they need to fill out a separate request form that gets emailed to our warehouse manager so she can place the order with China.

JT: OK, so they complete a purchase order. Then what?

CJ: The submitted purchase order goes through a credit check and then becomes a sales order. That's all done behind the scenes in the system. We really don't see anything on our side until the sales order stage.

JT: Guess that saves a lot of time and trees!

CJ: Yeah, there's so much that we rely on the system to do for us, it's scary. If we were hit by an electrical storm, we'd be in trouble.

JT: What happens to the sales orders—how do they get filled?

CJ: Every day, the warehouse manager downloads the outstanding sales orders to these little hand-held computer/scanner thingies. It's very Star Trek. Warehouse personnel use these to select the items off the shelves onto pallets. The pallets are taken to a staging area where each product is then scanned. This establishes the shipping document in Swift, which then gets printed for the delivery.

JT: Are the shipping documents approved before the goods go out the door? How do you know that what got sent is what was ordered?

CJ: Swift matches the quantities and products on the shipping document to the sales order. Once they match, the approval box is activated and the shipping supervisor can enter his pass code. This officially approves the shipping document and it gets printed.

JT: **How many orders do you fill in a day? It sounds like a lot for one person to do.**

CJ: We probably complete about 50 orders a day. Shoes aren't perishable items, you know, so it's not like we are sending products to every store, every day. We're trying out the "pit crew" concept, where there's two shipping supervisors with about four to five warehouse employees in their crew team. So they are in the staging area with them and do it right there with the hand-held devices. They like to have little contests to see who can do it the fastest. You should go down there; it's quite a lively group. David encourages it and it's been great for productivity and morale.

JT: **Sounds like a great working environment. Better than being stuck in a broom closet sifting through invoices!**

CJ: Ah, the life of an auditor. I remember the good old days . . .

JT: **And the goods are sent out on your own trucks?**

CJ: That's right. We've bought our own trucks and vans rather than relying on couriers. The drivers pick up their loads in the morning and bring back anything undelivered. Because shoes are an easy product to off-load, we have to be careful about theft. So nothing can be left in the back of a truck at the end of the day. It comes back here and gets locked up in the shipping cage until it can be delivered again.

JT: **Why would goods be undelivered?**

CJ: Sometimes the drivers get behind or the store is closed unexpectedly. So there are occasions when all the goods won't get delivered in the day.

JT: **OK, so once the goods are delivered to the customer, how do you bill them?**

CJ: The drivers have the customers sign for the goods and then give us the signed copy. We go into the billing system and pull up the draft invoice that was generated when the shipping document was approved. We match the quantities in the invoice against the shipping document and confirm customer sign-off. This way, we only bill for those goods that were actually received by the customer. At 4 p.m., we do a batch run for the day. The copy is stapled to the signed shipping document and put on file. The running of the batch run posts the invoices to the sales journal and accounts receivable subledger.

JT: **Does finance ever go back to the sales order?**

CJ: No. Since a shipping document can't get generated unless it agrees to the sales order, we don't go back that far into the process. Why, do you think we have to?

JT: **I wouldn't say so at this stage. But you'd have to be sure to have some tight controls around Swift, given that it seems to do everything.**

CJ: Like I said, it does everything.

JT: **What is the cash receipts process?**

CJ: We get most payments via EFT, so my AR clerk downloads the previous day's receipts from online banking. She then goes into the subledger to post the receipts against the customer accounts. When she's finished posting each entry, she runs a batch report of all postings and reconciles it back to the bank statement. I review that reconciliation and sign off.

JT: **Are bank reconciliations done in a timely manner?**

CJ: I do bank recs each month for the operating and savings accounts. David reviews and approves them. Keep in mind what I just explained is for the wholesale transactions. We have separate procedures for the store regarding daily cash balance reconciliations to the deposits in the operating bank account.

JT: **Yes, our graduate will be handling the store side of the sales to cash receipts process. They will probably come and talk to you in a day or two. Well, I think that should do it for now. I may have some follow-up questions for you as I start getting my head around all of this.**

CJ: Door's always open.

JT: **Thanks for your time.**

CLOUD 9 LTD.
SALES INVOICE

TO: David Jones
23 Main St, Shop 43
Toronto, ON

October 13, 2023

132811
Swift Purchase order reference: P00132811
Shipping reference: D00132811

Code	Description	Qty	Price per unit	Total price
786541	Heavenly 456 — Women 9	5	$114.74	$573.70
786540	Heavenly 456 — Women 8	3	$114.74	$344.22
	Total			$917.92
	HST			$119.33
	TOTAL			**$1,037.25**

Payment due on November 27, 2023

CLOUD 9 LTD.
SHIPPING DOCUMENT

TO: David Jones
123 Main St, Shop 43
Toronto, ON

October 12, 2023

D00132811
Swift Purchase order reference: P00132811
Authorized: YES

Code	Description	Qty
786541	Heavenly 456 — Women 9	5
786540	Heavenly 456 — Women 8	3

Driver: R. Williams

I declare that all goods were received and no damage noted.

Customer Signature: Sally Rose. 10/12/23

CLOUD 9 LTD.
SALES INVOICE

TO: Rebel Sports — World Square
680 George Street, Shop 12
Barrie, ON

October 27, 2023

133410
Swift Purchase order reference: P00133410
Shipping reference: D00133410

Code	Description	Qty	Price per unit	Total price
587241	Maximum Speed — Men 12	4	$123.56	$494.24
786540	Heavenly 456 — Women 8	2	$114.74	$229.48
	Total			$723.72
	HST			$94.08
	TOTAL			**$817.80**

Payment due on December 11, 2023

CLOUD 9 LTD.
SHIPPING DOCUMENT

TO: Rebel Sports — World Square
680 George Street, Shop 12
Barrie, ON

D00133410
Swift Purchase order reference: P00133410
Authorized: YES

October 25, 2023

Code	Description	Qty
587241	Maximum Speed — Men 12	4
786540	Heavenly 456 — Women 8	2

Driver: R. Williams

I declare that all goods were received and no damage noted.

Customer Signature: Jenna Hennesey 10/26/23

CLOUD 9 LTD.
SALES INVOICE

TO: Meyer Sports — Burnaby
328 Elizabeth Ave
Burnaby, BC

134063
Swift Purchase order reference: P00134063
Shipping reference: D00134063

November 4, 2023

Code	Description	Qty	Price per unit	Total price
649852	Olympic — Women 6	4	$109.21	$436.84
475125	Thunder 75 — Men 14	2	$157.68	$315.36
	Total			$752.20
	GST and PST			$90.26
	TOTAL			**$842.46**

Payment due on December 19, 2023

CLOUD 9 LTD.
SHIPPING DOCUMENT

TO: Meyer Sports — Burnaby
328 Elizabeth Ave
Burnaby, BC

D00134063
Swift Purchase order reference: P00134063
Authorized: YES

November 3, 2023

Code	Description	Qty
649852	Olympic — Women 6	4
475125	Thunder 75 — Men 14	3

Driver: Ted McGinty

I declare that all goods were received and no damage noted.

Customer Signature: Julie Brown 11/3/23

CLOUD 9 LTD.
SALES INVOICE

TO: Cross Country Sports
769 First Avenue
St. John's, NL

134104
Swift Purchase order reference: P00134104
Shipping reference: D00134104

November 6, 2023

Code	Description	Qty	Price per unit	Total price
786541	Heavenly 456 — Women 9	2	$114.74	$229.48
	Total			$229.48
	HST			$34.42
	TOTAL			**$263.90**

Payment due on December 21, 2023

CLOUD 9 LTD.
SHIPPING DOCUMENT

TO: Cross Country Sports
769 First Avenue
St. John's, NL

D00134104
Swift Purchase order reference: P00134104
Authorized: YES

November 5, 2023

Code	Description	Qty
786541	Heavenly 456 — Women 9	2

Driver: D. Bredbenner

I declare that all goods were received and no damage noted.

Customer Signature: ______________________

CLOUD 9 LTD.
SALES INVOICE

TO: Wide Road Specialty Retailer
74 Shore Highway
Fredericton, NB

135215
Swift Purchase order reference: P00135215
Shipping reference: D00135215

December 12, 2023

Code	Description	Qty	Price per unit	Total price
587240	Maximum Speed — Men 10	3	$123.56	$370.68
475123	Thunder 75 — Men 12	3	$157.68	$473.04
347586	Heat Seeker — Men 15	2	$174.21	$348.42
	Total			$1,192.14
	HST			$178.82
	TOTAL			**$1,370.96**

Payment due on January 26, 2024

CLOUD 9 LTD.
SHIPPING DOCUMENT

TO: Wide Road Specialty Retailer
74 Shore Highway
Fredericton, NB

D00135215
Swift Purchase order reference: P00135215
Authorized: YES

December 11, 2023

Code	Description	Qty
587240	Maximum Speed — Men 10	3
475123	Thunder 75 — Men 12	3
347586	Heat Seeker — Men 15	2

Driver: R. Jones

I declare that all goods were received and no damage noted.

Customer Signature: Sharon J Jones 12/11/23

CLOUD 9 LTD.
SALES INVOICE

TO: Foot Locker — Pitt St. Mall
435 Pitt St., Shop 4
London, ON

135947
Swift Purchase order reference: P00135947
Shipping reference: D00135947

December 20, 2023

Code	Description	Qty	Price per unit	Total price
649852	Olympic — Women 6	2	$109.21	$218.42
786540	Heavenly 456 — Women 8	5	$114.74	$573.70
786539	Heavenly 456 — Women 7.5	2	$114.74	$229.48
	Total			$1,021.60
	HST			$132.81
	TOTAL			**$1,154.41**

Payment due on February 3, 2024

CLOUD 9 LTD.
SHIPPING DOCUMENT

TO: Foot Locker — Pitt St. Mall
435 Pitt St., Shop 4
London, ON

D00135947
Swift Purchase order reference: P00135947
Authorized: YES

December 18, 2023

Code	Description	Qty
649852	Olympic — Women 6	2
786540	Heavenly 456 — Women 8	5
786539	Heavenly 456 — Women 7.5	2

Driver: R. Williams

I declare that all goods were received and no damage noted.

Customer Signature: Tom Connolly 12/18/23

CLOUD 9 LTD.
System 01 version 1.9
Daily Reconciliation of AR Posting to Bank Report
as at September 19, 2023

Description	**Source**	**Amount**
Cash receipts posted to accounts receivable	Subledger	10,577.23
Total bank deposits	Bank statement	10,577.23
Difference		0.00
		OKAY

Prepared: Jessica Williams 9/19/23

Approved: Carla Johnson 9/19/23

ONBank

CLOUD 9 LTD.
Online Banking
EFT payments for September 19, 2023
Passcode accepted:
Carla Johnson

EFT 427	David Jones	$7,856.46
EFT 428	Cross Country Sports	$2,720.77
Total		$10,577.23

CLOUD 9 LTD.
System 01 version 1.9
Daily Reconciliation of AR Posting to Bank Report
as at October 8, 2023

Description	**Source**	**Amount**
Cash receipts posted to accounts receivable	Subledger	8,765.49
Total bank deposits	Bank statement	8,765.49
Difference		0.00
		OKAY

Prepared: Jessica Williams 10/8/23

Approved: Carla Johnson 10/8/23

ONBank

CLOUD 9 LTD.
Online Banking
EFT payments for October 8, 2023
Passcode accepted:
Carla Johnson

EFT 445	Rebel Sports	$2,963.54
EFT 446	Foot Locker	$1,964.71
EFT 447	Meyer Sports	$3,837.24
Total		$8,765.49

CLOUD 9 LTD.
System 01 version 1.9
Daily Reconciliation of AR Posting to Bank Report
as at October 23, 2023

Description	**Source**	**Amount**
Cash receipts posted to accounts receivable	Subledger	5,490.61
Total bank deposits	Bank statement	5,490.61
Difference		0.00
		OKAY

Prepared: Jessica Williams 10/23/23

Approved: Carla Johnson 10/23/23

ONBank

CLOUD 9 LTD.
Online Banking
EFT payments for October 23, 2023
Passcode accepted:
Carla Johnson

EFT 501	David Jones	$1,237.89
EFT 502	Cross Country Sports	$4,252.72
Total		$5,490.61

CLOUD 9 LTD.
System 01 version 1.9
Daily Reconciliation of AR Posting to Bank Report
as at November 12, 2023

Description	**Source**	**Amount**
Cash receipts posted to accounts receivable	Subledger	9,302.20
Total bank deposits	Bank statement	9,302.20
Difference		0.00
		OKAY

Prepared: Jessica Williams 11/12/23

Approved: Carla Johnson 11/12/23

ONBank

CLOUD 9 LTD.
Online Banking
EFT payments for November 12, 2023
Passcode accepted:
Carla Johnson

EFT 534	David Jones	$2,179.52
EFT 535	Dick's Sports	$1,095.48
EFT 536	Running Shop — Calgary	$2,304.00
EFT 537	Meyer Sports	$2,612.72
EFT 538	Foot Locker	$1,110.48
Total		$9,302.20

CLOUD 9 LTD.
System 01 version 1.9
Daily Reconciliation of AR Posting to Bank Report
as at December 3, 2023

Description	Source	Amount
Cash receipts posted to accounts receivable	Subledger	12,567.33
Total bank deposits	Bank statement	12,567.33
Difference		0.00
		OKAY

Prepared: Jessica Williams 12/3/23

Approved: Carla Johnson 12/3/23

ONBank

CLOUD 9 LTD.
Online Banking
EFT payments for December 3, 2023
Passcode accepted:
Carla Johnson

EFT 576	Meyer Sports	$3,684.53
EFT 577	Foot Locker	$2,087.45
EFT 578	Rebel Sports	$1,832.12
EFT 579	Rebel Sports	$1,971.03
EFT 580	David Jones	$2,992.20
Total		$12,567.33

CLOUD 9 LTD.
System 01 version 1.9
Daily Reconciliation of AR Posting to Bank Report
as at December 19, 2023

Description	**Source**	**Amount**
Cash receipts posted to accounts receivable	Subledger	13,874.85
Total bank deposits	Bank statement	13,874.85
Difference		0.00
		OKAY

Prepared: Jessica Williams 12/19/23

Approved: Carla Johnson 12/19/23

ONBank

CLOUD 9 LTD.
Online Banking
EFT payments for December 19, 2023
Passcode accepted:
Carla Johnson

EFT 635	Wide Road Specialty Retailer	$6,130.61
EFT 636	Cross Country Sports	$1,456.18
EFT 637	Foot Locker	$6,288.06
Total		$13,874.85

Glossary

accounting estimates items for which an exact amount is not known and the recorded amount includes estimation uncertainty, p. 3-19.

accounts payable master file a computer file containing details of suppliers, transactions with suppliers, and the balance owing, p. 11-9.

accounts receivable master file a computer file containing customer details such as contact information, address, and approved credit limit, p. 10-7.

accounts receivable subsidiary ledger a ledger recording the details of transactions by customer and balances owing by invoice, p. 10-8.

accounts receivable trial balance a listing of individual customer balances at a particular date on the accounts receivable master file or accounts receivable sub-ledger, p. 10-25.

accuracy assertion that amounts and other data relating to recorded transactions and events have been recorded appropriately and related disclosures have been appropriately measured and described, p. 5-4, 6-20.

accuracy, valuation, and allocation assertion that assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded and the related disclosures are appropriately measured and described, p. 5-6, 6-21.

acid-test (quick) ratio liquid assets to current liabilities, p. 4-27.

adverse opinion opinion provided when the auditor concludes that there is a pervasive material misstatement in the financial statements, p. 1-21.

advocacy threat the threat that can occur when a firm or its staff acts on behalf of its assurance client, p. 2-11.

aged trial balance an accounts receivable trial balance in which customer balances are analyzed by the period since each sales transaction was entered, p. 10-25.

analytical procedures an evaluation of financial information by studying plausible relationships among both financial and non-financial data, p. 4-22, 5-25, 8-12.

applicable financial reporting framework the financial framework chosen by management to prepare a company's financial statements. For example, an applicable framework for a reporting issuer would be International Financial Reporting Standards (IFRS). An applicable framework for a private enterprise could be Accounting Standards for Private Enterprises (ASPE), or it could be IFRS, p. 1-5.

application controls manual or automated controls that apply to the processing of transactions by individual applications, p. 3-23.

assertion statement made by management regarding the recognition, measurement, presentation, and disclosure of items included in the financial statements, p. 1-5, 4-4, 5-4.

assurance engagement an engagement performed by an auditor or consultant to enhance the reliability of the subject matter, p. 1-4, 14-35.

attribute sampling a sampling technique used to reach a conclusion about a population in terms of a rate (frequency) of occurrence, p. 7-26.

audit committee a sub-committee of the board of directors. The audit committee enhances auditor independence and ensures that the financial statements are fairly presented and that the external auditor has access to all records and other evidence required to form their opinion, p. 2-18.

audit data analytics (ADAs) the examination of large datasets, usually using computer software, to identify exceptions, outliers, trends, and other useful information, p. 5-25, 9-4.

audit evidence information used by the auditor to support the audit opinion, p. 1-5.

audit file the file where the evidence and documentation of the work performed are kept as a permanent record to support the opinion issued, p. 1-5.

audit plan the list or description of audit procedures to be performed, p. 1-5, 6-3.

audit program a detailed listing of the audit procedures to be performed, with enough detail to enable the auditor to understand the nature, timing, and extent of testing required, p. 8-6.

audit risk the risk that an auditor expresses an inappropriate audit opinion when the financial statements are materially misstated, p. 1-5, 4-3, 6-18, 7-4, 8-3.

audit sampling the application of audit procedures to less than 100 percent of items within a population, p. 6-3.

audit strategy a strategy that sets the scope, timing, and direction of the audit and provides the basis for developing a detailed audit plan, p. 3-4, 4-17, 6-18.

authorized price list a list of selling prices for each product, p. 10-8.

bank confirmation a letter sent directly by an auditor to their client's bank requesting information such as the amount of cash held in the bank (or overdraft), details of any loans with the bank, and interest rates charged, p. 5-9, 13-12.

bank reconciliations schedules agreeing the balance of cash at the bank per the entity's records with the balance shown per the bank. The most common reconciling items are deposits in transit and outstanding cheques, p. 13-6.

bank transfer schedule a schedule prepared by the auditor listing bank transfers for a few days either side of the end of the reporting period, and the dates recorded in the records and the bank statement, p. 13-11.

block selection the selection of items that are grouped together within the population of items available, p. 6-9.

board of directors the group that represents the shareholders and oversees the activities of a company and its management, p. 2-10.

capital asset sub-ledger a file containing plant and equipment information such as description, supplier, serial number, and location, as well as cost and depreciation charges that reconcile with the control account in the general ledger, p. 12-25.

cash count audit procedure of counting cash on hand and agreeing the balance with the accounting records, p. 13-16.

cash cut-off tests audit procedures verifying the agreement of cash receipts recorded in the accounting records at close of business with the physical movement of cash, p. 13-9.

cash receipts cut-off test a substantive procedure designed to obtain reasonable assurance that cash receipts are recorded in the accounting period in which they are received, p. 10-27.

cash receipts journal a journal recording cash receipt transactions for posting to the ledgers, p. 10-10.

cheque register a listing of all cheques issued, p. 11-10.

classification transactions, events, assets, liabilities, and equity interests have been recorded in the proper accounts, p. 5-5, 6-20.

closing procedures processes used by a client when finalizing the books for an accounting period, p. 3-5.

combined audit strategy strategy used when the auditor obtains a detailed understanding of their client's system of internal controls and plans to rely on that system to identify, prevent, and detect material misstatements, p. 4-18.

common-size analysis a comparison of account balances with a single line item, p. 4-25.

compilation engagement engagement that provides no assurance, where the practitioner compiles the financial information in accordance with a basis of accounting disclosed in the financial statements, p. 1-17.

compilation engagement report the communication issued when the practitioner performs a compilation engagement, p. 1-19.

completeness all transactions, events, assets, liabilities, equity items, and disclosures that should have been recorded and disclosed have been recorded and disclosed, p. 5-4, 6-20.

compliance audit an audit to determine whether the entity has conformed with regulations, rules, or processes, p. 1-12.

component auditor an auditor who, at the request of the group engagement team, performs work on financial information related to a component for the group audit, p. 5-23.

comprehensive audit an audit that encompasses a range of audit and audit-related activities, such as a financial statement audit, performance audit, and compliance audit, p. 1-13.

computational evidence evidence gathered by an auditor checking the mathematical accuracy of the numbers that appear in the financial statements, p. 5-17.

confidentiality the obligation that all members of the profession refrain from disclosing information that is learned as a result of their employment to people outside of their workplace, p. 2-4.

confirmation of accounts payable written inquiry of suppliers, requesting confirmation of the balance owed or a statement listing invoices owing at the confirmation date, p. 11-30.

consulting firms non-audit firms that provide assurance services on non-financial information, such as corporate social responsibility and environmental disclosures, p. 1-13.

control activities policies and procedures that help ensure that management directives are carried out. Control activities are a component of internal control, p. 7-12.

control environment the attitudes, awareness, and actions of management and those charged with governance concerning the entity's internal control and its importance in the entity, p. 7-7.

control exception an observed condition that provides evidence that the control being tested did not operate as intended, p. 7-26.

control risk the risk that a client's system of internal controls will not prevent or detect a material misstatement, p. 4-4, 6-18, 7-10, 8-4.

corporate governance the rules, systems, and processes within companies used to guide and control, p. 2-13, 3-5.

corporate social responsibility (CSR) a range of activities undertaken voluntarily by a corporation; CSR disclosures include environmental, employee, and social reporting, p. 1-13.

current file file that contains client information that is relevant for the duration of one audit, p. 5-29.

current ratio current assets to current liabilities, p. 4-27.

customer order a document indicating the goods requested by a customer that provides evidence of authenticity, p. 10-6.

cut-off transactions and events have been recorded in the correct accounting period, p. 5-5, 6-20.

cyclical inventory counts periodic inventory counts that count, over a year, all or most inventory items, p. 12-7.

dashboard the display of multiple visuals to monitor business performance, p. 9-5.

data analytics the analysis of data to draw conclusions about them, p. 9-3.

data cleansing identifying and correcting missing, incorrect, and duplicate fields, and reformatting data in a consistent format, p. 9-10.

data errors inaccurate, duplicate, incomplete, and inconsistent data, p. 9-10.

data life cycle the life span of data, from when they are collected, maintained, used, stored, and then finally destroyed, p. 9-12.

data visualization the results of an ADA presented as an image, chart, or table, p. 9-4.

debt to equity ratio liabilities to equity, p. 4-28.

dependent variable the item to be predicted or the account being audited in a regression analysis, p. 9-24.

deposit slip a listing of cash, coins, and individual cheques for deposit with the bank, endorsed by the bank teller, a copy of which is retained by the entity, p. 10-10.

descriptive analytic a data analytic performed to understand past data, p. 9-3.

designated document a document filed with a security regulator, such as audited financial statements, and a document that includes or refers to the audited financial statements, such as an annual report, p. 14-38.

detection risk the risk that the auditors' procedures will not be effective in detecting a material misstatement should there be one, p. 4-5, 7-10, 8-4.

diagnostic analytic a data analytic performed to understand why something happened, p. 9-3.

direct engagement an engagement that evaluates a subject matter against applicable criteria, p. 14-35.

disclaimer of opinion opinion provided when the impact of a scope limitation is so extreme that an auditor is unable to obtain sufficient appropriate evidence to base an opinion on, p. 1-21.

documentary evidence information that provides evidence about details recorded in a client's list of transactions (for example, invoices and bank statements), p. 5-13.

dual purpose tests procedures that provide evidence for both tests of controls and substantive procedures, p. 8-10.

due care the obligation to act diligently and comply with both technical and professional standards, p. 2-4.

earnings per share (EPS) profit to weighted average ordinary shares issued, p. 4-21.

electronic evidence data held on a client's computer, files sent by email to the auditor, and items scanned and faxed, p. 5-18.

embedded audit facility procedures written directly into the program of a specific computer application allowing the auditor intervention to capture or process data for audit purposes, p. 10-18.

emphasis of matter what results when an auditor issues an unmodified audit opinion when there is a significant issue that is adequately disclosed and there is a need to draw the user's attention to it in the audit report, p. 1-20.

engagement letter letter that sets out the terms of the audit engagement, to avoid any misunderstandings between the auditor and their client, p. 2-26.

entity-level controls the collective assessment of the client's control environment, risk assessment process, information system, control activities, and monitoring of controls, p. 7-7.

error an unintentional misstatement in the financial statements, including the omission of an amount or a disclosure, p. 14-15.

estimation uncertainty the lack of precision with an estimate or related disclosure, p. 3-19.

evidence information gathered by the auditor that is used when forming an opinion on the fair presentation of a client's financial statements, p. 5-7.

executive directors employees of the company who also hold a position on the board of directors, p. 2-17.

existence recorded assets, liabilities, and equity interests exist, p. 5-5, 6-21.

expert someone with the skills, knowledge, and experience required to aid the auditor when gathering sufficient appropriate evidence, p. 5-21.

extent of audit testing the amount of audit evidence gathered when testing controls and conducting detailed substantive procedures, p. 6-24.

external confirmation evidence obtained as a direct written response to the auditor from a third party, in paper form, or by electronic or other medium, p. 5-9.

externally generated evidence information created by a third party (for example, supplier statements, bank statements), p. 5-20.

fair presentation the consistent and faithful application of accounting standards when preparing the financial statements, p. 1-10.

false positives items that are erroneously identified as exceptions or anomalies, p. 9-19.

familiarity threat the threat that can occur when a close relationship exists or develops between the assurance firm (staff) and the client (staff), p. 2-12.

financial statement audit an audit that provides reasonable assurance about whether the financial statements are prepared in all material respects in accordance with the financial reporting framework, p. 1-10.

financial statements a structured representation of historical financial information, including the required disclosures, p. 1-5.

finished goods manufactured inventory that is available for sale, p. 12-5.

fraud an intentional act through the use of deception to obtain an unjust or illegal advantage, p. 3-5.

general information technology controls the entity's IT processes that support the continued proper operation of the IT environment, p. 3-23.

generalized audit software software auditors use under a variety of data organization and processing methods, p. 10-18.

going concern the viability of a company to remain in business for the foreseeable future, p. 3-5, 14-8.

gross profit margin gross profit to net sales, p. 4-26.

group engagement partner the auditor responsible for signing the audit report, p. 5-23.

haphazard selection the selection of a sample without use of a methodical technique, p. 6-9.

imprest bank account bank account funded with a sum sufficient to meet the payment of special-purpose cheques such as wages or dividends, p. 13-7.

imprest petty cash fund petty cash fund maintained at a constant level via replenishment with the value of receipts paid out of the fund, p. 13-6.

independence the ability to act with integrity and objectivity, p. 2-9.

independent auditor's report the auditor's formal expression of opinion on whether the financial statements are in accordance with the applicable financial reporting framework, p. 1-5.

independent directors non-executive directors without any business or other ties to the company, p. 2-14.

independent variable the predictor in a regression analysis, p. 9-24.

information risk the risk that users will rely on incorrect information to make a decision, p. 1-7.

information technology the use of computers to store and process data and other information, p. 3-22.

inherent risk the susceptibility of the financial statements to a material misstatement without considering the internal controls, p. 4-4, 6-18, 7-10, 8-4.

inherent risk factors conditions that make a material misstatement more likely, p. 4-7.

inquiry an evidence-gathering procedure that involves asking questions verbally or in written form to gain an understanding of various matters throughout the audit, p. 5-25.

inspection an evidence-gathering procedure that involves checking documents and physical assets, p. 5-18.

integrated test facility a type of test of controls that requires using a fictitious entity and entering fictitious transactions for that entity with the regular transactions, and then comparing the result with the expected output, p. 10-18.

integrity the obligation that all members of the accounting profession be straightforward and honest, p. 2-4.

internal audit an independent service within an entity that generally evaluates and improves risk management, internal control procedures, and elements of the governance process, p. 1-13.

internal auditors employees of the company who evaluate and make recommendations to improve risk management, internal control procedures, and elements of the governance process, p. 2-18.

internal control The processes implemented and maintained by management to help the entity achieve its objectives, p. 1-5.

internally generated evidence information created by the client (for example, customer invoices, purchase orders), p. 5-19.

intimidation threat the threat that can occur when a member of the assurance team feels threatened by client staff or directors, p. 2-12.

inventory count sheets prepared (usually pre-numbered) sheets for recording inventory description and quantity as counted, p. 12-8.

inventory master file a file containing details of inventory items, their movement, and the quantity on hand, p. 12-6.

inventory tags three-part, tie-on tags for recording the inventory count of each item, p. 12-8.

inventory transfer requisition a document authorizing the requisitioning of materials and labour for the purpose of manufacturing, p. 12-6.

inventory turnover cost of sales to average inventory, p. 4-27.

investment subsidiary ledger (investment register) a subsidiary ledger recording individual investments in shares and bonds. Entries show purchases and sales, the cost of each bundle purchased, and the quantity and the cost of the balance owed, p. 13-22.

judgemental misstatement a misstatement that arises as a result of a difference in the application of judgement by the client and the auditor, such as the use of an estimate the auditor considers unreasonable or the application of an inappropriate accounting policy. A judgemental misstatement is not the same as an error, p. 14-16.

judgemental selection the selection of items that an auditor believes should be included in the sample for testing, p. 6-10.

key performance indicators (KPIs) measurements, agreed to beforehand, that can be quantified and that reflect the success factors of an organization, p. 4-21.

kiting an irregularity overstating the cash balance by intentionally recording a bank transfer as a deposit in the receiving bank while failing to show a deduction from the bank account on which the transfer is drawn, p. 13-11.

lapping an irregularity concealing the misappropriation of cash by using subsequent cash receipts to conceal the original misappropriation, p. 13-17.

legal letter a letter sent to a client's lawyer asking them to confirm the details of legal matters outstanding identified by management, p. 5-14.

limited assurance the level of assurance obtained where engagement risk is reduced to an acceptable level and the evidence gathered is at least sufficient for the practitioner to conclude and provide a level of assurance that is likely to enhance the intended users' confidence about the financial statements, p. 1-17.

limited assurance engagement an engagement in which a practitioner concludes on the subject matter, in that nothing has come to their attention to believe the information is materially misstated, p. 14-35.

linear regression a regression analysis that presents one dependent and one independent variable as a mathematical equation, p. 9-24.

liquidity the ability of a company to pay its debts when they fall due, p. 4-22.

listed entity an entity whose shares or debt are listed on a stock exchange, p. 1-10.

management letter a document prepared by the audit team and provided to the client that discusses internal control weaknesses and other matters discovered during the course of the audit, p. 7-38.

management representation letter a letter from the client's management to the auditor acknowledging management's responsibility for the preparation of the financial statements and details of any verbal representations made by management during the course of the audit, p. 5-14.

material an amount or disclosure that is significant enough to make a difference to a user, p. 1-5.

materiality information that impacts the decision-making process of the users of the financial statements, p. 3-4, 4-12, 14-5.

misstatement a difference between the reported amount, classification, presentation, or disclosure of a financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud, p. 8-22, 14-15.

monthly customer statement a listing sent to each customer of transactions with that customer that have occurred since the date of the previous statement, which shows the closing balance due, p. 10-8.

multiple regression a regression analysis that presents more than one independent variable, p. 9-24.

nature of audit testing the purpose of the test and the procedure used, p. 6-22.

negative confirmation a letter sent directly by an auditor to a third party, who is asked to respond to the auditor on the matter(s) included in the letter only if they disagree with the information provided, p. 5-11.

negligence failure to exercise due care, p. 2-19.

no assurance what results when a practitioner completes a set of tasks requested by the client and reports factually on the results of that work to the client, p. 1-17.

non-executive directors board members who are not employees of the company. Their involvement on the board is limited to preparing for and attending board meetings and relevant board committee meetings, p. 2-17.

non-sampling risk the risk that the auditor reaches an inappropriate conclusion for any reason not related to sampling risk, p. 6-6.

non-statistical sampling any sample selection method that does not have the characteristics of statistical sampling, p. 6-7.

notable items unexpected trends, outliers, and exceptions that require follow-up when performing an audit data analytic, p. 9-16.

objectivity the obligation that all members of the profession not allow their personal feelings or prejudices to influence their professional judgement, p. 2-4.

observation an evidence-gathering procedure that involves watching a procedure being carried out by another party, p. 5-25.

occurrence assertion that transactions and events that have been recorded or disclosed have occurred and pertain to the entity, p. 5-4, 6-20.

offering document a document that offers securities in exchange for cash, debt, other securities, or other assets, p. 14-38.

payable confirmation a letter sent directly by an auditor to their client's vendor or supplier requesting information about amounts owed by the client to the vendor or supplier, p. 5-9.

payroll register a document that contains details of wages paid, withholding taxes, and a cumulative record of wages paid per employee, per department, and in total, p. 11-13.

payroll transaction file a file recording details of hours worked, wage rates, and wages paid per employee, p. 11-13.

performance audit an assessment of the economy, efficiency, and effectiveness of an organization's operations, p. 1-12.

performance materiality an amount less than materiality, which is set to reduce the likelihood that a misstatement in a particular class of transactions, account balances, or disclosures, in aggregate, does not exceed materiality for the financial statements as a whole, p. 4-15.

permanent file file that contains client information that is relevant for more than one audit, p. 5-28.

perpetual inventory records records of the movement of inventory items and the quantity on hand, p. 12-6.

personnel authorization form a form issued by the personnel department indicating the job classification and wage rate for all approved positions, p. 11-12.

personnel file a file maintained by the personnel department recording details of individual employees, such as the job classification, wage rate, and date of hiring, p. 11-13.

personnel master file a computer file containing details of employees, such as approved wage rate and date of hiring, p. 11-13.

physical evidence a client's tangible assets, such as its inventory and fixed assets, p. 5-18.

positive confirmation a letter sent directly by an auditor to a third party, who is asked to respond to the auditor on the matter(s) included in the letter in all circumstances (that is, whether they agree or disagree with the information included in the auditor's letter), p. 5-11.

predictive analytic a data analytic performed to make predictions into the future considering a variety of scenarios, p. 9-3.

prescriptive analytic a data analytic performed to examine a variety of solutions to determine the best outcome, p. 9-3.

presentation assertion that transactions, events, assets, liabilities, and equity items are appropriately aggregated or disaggregated, clearly described, and related disclosures are relevant and understandable, p. 5-5, 6-20.

price-earnings (PE) ratio market price per share to earnings per share, p. 4-21.

professional behaviour the obligation that all members must maintain the reputation of the profession and its ability to serve the public interest, p. 2-4.

professional competence the obligation that all members of the accounting profession maintain their knowledge and skill at a required level, p. 2-4.

professional judgement the exercise of the auditor's professional characteristics, such as their expertise, experience, knowledge, and training, p. 7-39, 8-3, 14-6.

professional scepticism an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence, p. 3-13.

profit margin profit to net sales, p. 4-26.

profitability the ability of a company to earn a profit, p. 4-21.

projected error extrapolation of the errors detected when testing a sample to the population from which the sample was drawn, p. 6-17.

purchase journal a computer file listing details of all purchase transactions, p. 11-9.

purchase order a form showing the description of the goods, the quantity ordered, and other relevant data. This is signed by the purchasing officer as evidence of the approval of the purchase, p. 11-7.

purchase requisition a form issued by authorized personnel detailing the goods and services required, p. 11-6.

qualified opinion an "except for" opinion provided where there is a material scope limitation or a material (significant) misstatement not pervasive to the overall financial statements, p. 1-21.

quantitative materiality information that exceeds an auditor's preliminary materiality assessment, p. 4-13.

random selection the process whereby a sample is selected free from bias and each item in a population has an equal chance of selection, p. 6-8.

rate of deviation when testing controls, the proportion of items tested that did not conform to the client's prescribed control procedure, p. 6-12.

raw materials materials purchased from suppliers to be used in the manufacture of finished goods, p. 12-5.

reasonable assurance assurance that provides high but not absolute assurance on the reliability of the subject matter, p. 1-14.

reasonable assurance engagement an engagement with a high level of assurance where the practitioner provides an opinion on the subject matter, p. 14-35.

recalculation an evidence-gathering procedure that involves checking the mathematical accuracy of client records, p. 5-25.

receivable confirmation a letter sent directly by an auditor to their client's credit customers requesting information about amounts owed to the client by the debtor, p. 5-11.

receivables turnover net credit sales to average net receivables, p. 4-28.

receiving report a form issued by the receiving department detailing the description and quantity of the goods delivered by the supplier, p. 11-8.

regression analysis representing past data as a mathematical formula that can be used as a predictive substantive analytical procedure, p. 9-7.

relevance extent to which information is logically connected to an assertion, p. 5-8, 9-10.

relevant assertion an assertion identified as at risk of material misstatement before considering any controls, p. 4-4.

reliability extent to which information reflects the true state of the information, p. 5-8, 9-10.

remittance advice a form accompanying cash or cheques paid by a customer, indicating the customer's details and the items being paid, p. 10-10, 11-10.

re-performance an evidence-gathering procedure that involves redoing processes conducted by the client, p. 5-25.

reporting issuer a public company with a market capitalization and a book value of total assets greater than $10 million, p. 2-12.

reporting phase the audit stage involving evaluating the results of the detailed testing in light of the auditor's understanding of their client and forming an opinion on the fair presentation of the client's financial statements, p. 3-4.

return on assets (ROA) profit to average assets, p. 4-27.

return on equity (ROE) profit to average equity, p. 4-27.

review engagement engagement in which the practitioner does adequate work to provide limited assurance, p. 1-17.

rights and obligations recorded assets are owned by the entity and recorded liabilities represent commitments of the entity, p. 5-6, 6-21.

risk assessment phase the audit stage involving gaining an understanding of the client, identifying risk factors, developing an audit strategy, and assessing materiality, p. 3-4.

risk assessment process the entity's process for identifying and responding to business risks, p. 7-10.

risk response phase the audit stage involving detailed testing of controls and substantive testing of transactions and accounts, p. 3-4, 4-23.

roll-forward procedures procedures performed during the period between an interim date and year end (the roll-forward period) to provide sufficient and appropriate audit evidence to base conclusions on as at year end when substantive procedures are performed at an interim date, p. 8-9.

sales cut-off test a substantive procedure designed to obtain reasonable assurance that sales and accounts receivable are recorded in the accounting period in which the transactions occurred, and that the corresponding entries for inventories and cost of sales are made in the same period, p. 10-27.

sales invoice a form detailing the goods or services supplied to a customer and the amount owing, p. 10-7.

sales journal a journal listing completed sales transactions, p. 10-8.

sales order a form showing the description of the goods, the quantity ordered, and other relevant data, which serves as the basis for the internal processing of the customer order, p. 10-6.

sales return cut-off test a substantive procedure designed to obtain reasonable assurance that sales returns are accounted for in the period in which the original sales transactions took place, p. 10-27.

sales transactions file a computer file listing details of all sales transactions, p. 10-8.

sampling risk the risk that the sample chosen by the auditor is not representative of the population available for testing and, as a consequence, the auditor arrives at an inappropriate conclusion, p. 6-4.

self-interest threat the threat that can occur when an accounting firm or its staff has a financial interest in an assurance client, p. 2-10.

self-review threat the threat that can occur when the assurance team needs to form an opinion on their own work or work performed by others in their firm, p. 2-11.

shareholders owners of the company, p. 2-17.

shipping document a form authorizing the release of goods from inventory and the delivery of the goods to the customer, p. 10-7.

significant account any account with a relevant assertion, p. 4-4, 8-3.

significant risk an identified risk of material misstatement assessed at the upper end of the spectrum of inherent risk or identified as a significant risk in other auditing standards, p. 4-4.

specific materiality information that is relevant when some areas of the financial statements are expected to influence the economic decisions made by users of the financial statements, p. 4-15.

spectrum of inherent risk the scale on which the inherent risk can vary, p. 4-4.

statistical sampling an approach to sampling where random selection is used to select a sample and probability theory is used to evaluate the sample results, p. 6-7.

stratification the process of dividing a population into groups of sampling units with similar characteristics, p. 6-8.

structured data data that reside in a fixed field within a record or file, p. 9-9.

subsequent events both events occurring between year end and the date of the audit report, and facts discovered after the date of the audit report, p. 14-12.

subsequent period's bank statement the first bank statement issued after the end of the reporting period, which is used by the auditor to verify the existence of outstanding deposits and uncleared cheques listed on the bank reconciliation as at the end of the reporting period, p. 13-14.

substantive audit strategy strategy used when the auditor does not plan to rely on the client's controls and increases the reliance on detailed substantive procedures that involve intensive testing of year-end account balances and transactions from throughout the year, p. 4-18.

substantive procedures (substantive testing or **tests of details)** audit procedures designed to detect material misstatements at the assertion level, p. 6-20, 7-28, 8-6.

sufficient appropriate evidence quantity (sufficiency) and quality (appropriateness) of audit evidence gathered, p. 3-5, 5-7, 14-7.

supplier's invoice a form issued by the supplier detailing the goods or services supplied and the amount owing, p. 11-8.

system of internal control the system designed, implemented, and maintained by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations, p. 7-4.

systematic selection the selection of a sample for testing by dividing the number of items in a population by the sample size, giving a sampling interval (n) and then selecting every nth item in the population, p. 6-9.

systems control audit review file an embedded audit facility that enables auditors to specify parameters of interest, such as transactions meeting specified criteria, which are then recorded in a special audit file for subsequent review by the auditors, p. 10-18.

technical competence the skills, training, and ability of the internal audit team, p. 2-19.

termination notice a form issued by the personnel department to document the termination of an employee, p. 11-13.

test data approach a method of testing controls in a computerized information system environment, where the auditor prepares fictitious transactions and tests the fictitious data using the entity's software. The output is then compared with the expected output, p. 10-18.

tests of controls (control testing) the audit procedures designed to evaluate the operating effectiveness of controls in preventing or detecting and correcting material misstatements at the assertion level, p. 6-19, 7-17.

tests of details of balances tests that support the correctness of an account ending balance, p. 8-11.

tests of details of transactions tests predominantly designed to verify a balance or a transaction back to supporting documentation; therefore, they usually include vouching and tracing, p. 8-10.

third parties anyone other than the client and its shareholders who uses the financial statements to make a decision, p. 2-21.

those charged with governance generally the board of directors, and may include management of an entity, p. 1-13, 14-10.

times interest earned profit before income taxes and interest expense to interest expense, p. 4-28.

timing of audit testing the stage of the audit when procedures are performed and the date, such as within or outside the accounting period, that audit evidence relates to, p. 6-23.

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