THE INSTITUTE OF
CHARTERED ACCOUNTANTS
OF SRI LANKA

Small and Medium - Sized Entities
Audit Manual
Volume 2 – Practical Guidance

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Audit Manual

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The Institute of Chartered Accountants of Sri Lanka
30 A Malalasekera Mawatha
Colombo 7

Telephone: 2352000
Fax: 2352067

The Volume 1 and Volume 2 of the CA Sri Lanka Small and Medium-Sized Entities – Audit Manual is based on Guide to Using International Standards on Auditing in the Audits of Small and Medium-Sized Entities, Third Edition of the Small and Medium Practices Committee, published by the International Federation of Accountants (IFAC) in November 2011 and is used with permission of IFAC.

Disclaimer

Small and Medium-Sized Entities – Audit Manual is designed to assist practitioners in the implementation of the Sri Lanka Auditing Standards (SLAuSs) on the audit of small- and medium-sized entities, but is not intended to be a substitute for the SLAuSs themselves. Furthermore, a practitioner should utilize Small and Medium-Sized Entities – Audit Manual in light of his/her professional judgment and the facts and circumstances involved in each particular audit. The Institute of Chartered Accountants of Sri Lanka (CA Sri Lanka) disclaims any responsibility or liability that may occur, directly or indirectly, as a consequence of the use and application of this Audit Manual.

Small and Medium - Sized Entities – Audit Manual

Volume 2 – Practical Guidance

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1. How to Use the Audit Manual

The purpose of this Audit Manual is to provide practical guidance to practitioners conducting audit engagements for small- and medium-sized entities (SMEs). However, no material in the Audit Manual should be used as a substitute for:

- **Reading and understanding the SLAuSs**
  It is assumed that practitioners have read the text of the Sri Lanka Auditing Standards (SLAuSs). SLAuS 200.19 states that the auditor shall have an understanding of the entire text of a SLAuS, including its application and other explanatory material, to understand its objectives and to apply its requirements properly.
- **Use of professional judgment**
  In order to apply the SLAuSs effectively, professional judgment is required based on the particular facts and circumstances involved in the firm and each particular engagement.

While it is expected that small- and medium-sized practices (SMPs) will be a significant user group, this Audit Manual is intended to help all practitioners to implement SLAuSs on SME audits.

This Audit Manual can be used to:

- Develop a deeper understanding of an audit conducted in compliance with the SLAuSs;
- Develop a staff manual (supplemented as necessary for local requirements and a firm's procedure) to be used for day-to-day reference, and as a basis for training sessions and individual study and discussion; and
- Help ensure that staff adopt a consistent approach to planning and performing an audit.

This Audit Manual often refers to an audit team, which implies that more than one auditor is involved in conducting the audit engagement. However, the same general principles also apply to audit engagements performed exclusively by one person (the practitioner).

1.1 Chapter Content and Organization

Rather than just summarize each SLAuS in turn, the Audit Manual has been organized into three volumes as follows:

- Volume 1—Core Concepts
- Volume 2—Practical Guidance
- Volume 3—Templates

This is Volume 2 of the Audit Manual, which focuses on how to apply the concepts outlined in Volume 1. It follows the typical stages involved in performing an audit, starting with client acceptance, planning, and risk assessment, and then the risk response, evaluating audit evidence obtained, and forming an appropriate audit opinion.

Summary of Organization

Volume 1 & 2 have been organized in the following format:

- **Chapter Title**
- **Audit Process Chart—Extract**
  Most chapters contain an extract from the audit process chart (where applicable) to highlight the particular activities addressed in the chapter.
- **Chapter Content**
  This outlines the content and purpose of the chapter.
- **Relevant SLAuSs**
  Most chapters in this Audit Manual begin with some extracts from the SLAuSs that are relevant to the chapter content. These extracts include relevant requirements and, in some cases, the objectives (sometimes highlighted separately if/when a chapter focuses primarily on one particular SLAuS), selected definitions, and application material. The inclusion of these extracts is not meant to imply that other material in the SLAuS not specifically mentioned, or other SLAuSs that relate to the subject matter do not need to be considered. The extracts in the Audit Manual are based solely on the judgment of the authors as to what is relevant for the content of each particular chapter. For example, the requirements of SLAuS 200, 220, and 300 apply throughout the audit process, but have only been addressed specifically in one or two chapters.
- **Overview and Chapter Material**
  The overview in each chapter provides:
  – Extracts from applicable SLAuSs; and
  – An overview of what is addressed in the chapter.

  The overview is followed by a more detailed discussion of the subject matter, and practical step-by-step guidance/methodology on how to implement the relevant SLAuSs. This can include some cross-references to the applicable SLAuSs. While the Audit Manual focuses exclusively on the SLAuSs (other than the 800 series) that apply to audits of historical financial information, reference is also made to the Code of Ethics for Professional Accountants issued by the Institute of Chartered Accountants of Sri Lanka, and the Sri Lanka Standard on Quality Control 1 (SLSQC 1)*Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements.*

- **Consider Points**

  A number of Consider Points are included throughout the Audit Manual. These Consider Points provide practical guidance on audit matters that can easily be overlooked, or where practitioners may have difficulty understanding and implementing certain concepts.

- **Illustrative Case Studies**

  To demonstrate how the SLAuSs can be applied in practice, Volume 2 of the Audit Manual includes two case studies. At the end of many chapters within Volume 2, two possible approaches to documenting the application of the SLAuS requirements are discussed. Please refer to Volume 2, Chapter 2 of this Audit Manual for details about the case studies.

  The purpose of the case studies and the documentation presented are purely illustrative. The documentation provided is a small extract from a typical audit file, and it outlines just one possible way of complying with the SLAuS requirements. The data, analysis, and commentary provided represent only some of the circumstances and considerations that the auditor will need to address in a particular audit. As always, the auditor must exercise professional judgment.

  The first case study is based on a fictional entity called Dephta Furniture. This is a local, family-owned furniture manufacturer with 15 full-time employees. The entity has a simple governance structure, few levels of management, and straightforward transaction processing. The accounting function uses an off-the-shelf, standard software package. The second case study is based on another fictional entity called Kumar & Co. This is a micro-sized entity with two full-time staff plus the owner and one part-time bookkeeper.

1.3 Glossary of Terms

The Audit Manual uses many of the terms as defined in the CA Sri Lanka Code, Glossary of Terms, and SLAuSs. Both partners and staff must be aware of these definitions.

The Audit Manual also uses the following terms:

Anti-Fraud Controls

These are controls designed by management to prevent or detect misstatements resulting from fraud. With respect to management override, these controls may not prevent a fraud from occurring, but would act as a deterrent and make perpetrating a fraud more difficult to conceal. Typical examples are:

- Policies and procedures that provide additional accountability, such as signed approval for journal entries;
- Improved access controls for sensitive data and transactions;
- Silent alarms;
- Discrepancy and exception reports;
- Audit trails;
- Fraud contingency plans;
- Human resource procedures such as identifying/monitoring individuals with above-average fraud potential (for example, an excessively lavish lifestyle); and

- Mechanisms for reporting potential frauds anonymously.

Entity-Level Controls

Entity-level controls address pervasive risks. They contribute to the "tone at the top" of an organization and establish expectations for the control environment. They are often less tangible than controls that operate at the transaction level, but have a pervasive and significant impact and influence over all other internal controls. As such, they form the all-important foundation upon which other internal controls (if any) are built. Examples of entity-level controls include management's commitment to ethical behavior, attitudes toward internal control, hiring and competence of staff employed, and anti-fraud and period-end financial reporting. These controls will have an impact on all other business processes within the entity.

Management

The person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance—for example, executive members of a governance board, or an owner-manager.

Those Charged With Governance (TCWG)

The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities, in some jurisdictions, those charged with governance may include management personnel—for example, executive members of a governance board of a private or public sector entity, or an owner-manager.

Owner-Manager

This refers to the proprietor of an entity involved in the running of the entity on a day-to-day basis. In most instances, the owner-manager will also be the person charged with governance of the entity.

Small- and Medium-Sized Practice (SMP)

An accounting practice/firm that exhibits the following characteristics:

- Its clients are mostly small- and medium-sized entities (SMEs);
- External sources are used to supplement limited in-house technical resources; and
- It employs a limited number of professional staff.

What constitutes an SMP will vary from one jurisdiction to another.

1.4 Acronyms Used in the Audit Manual

AR	Accounts receivable
Assertions (combined)	C = Completeness E = Existence A = Accuracy and cutoff V = Valuation
CAATs	Computer-assisted audit techniques
CU	Currency units (standard currency unit is referred to as "Rs")
F/S	Financial statements
HR	Human resources
IAASB	International Auditing and Assurance Standards Board
IC	Internal Control. The five major components of internal control are as follows: CA = Control activities CE = Control environment IS = Information systems MO = Monitoring RA = Risk assessment
Code	CA Sri Lanka Code of Ethics for Professional Accountants
SLFRSs	Sri Lanka Accounting Standards (SLFRSs/LKASs)
SLAuSs	Sri Lanka Auditing Standards
SLSAEs	Sri Lanka Standards on Assurance Engagements
SLAPSs	Sri Lanka Auditing Practice Statements
SLSQC	Sri Lanka Standard on Quality Control
SLSREs	Sri Lanka Standards on Review Engagements
SLSRSs	Sri Lanka Standards on Related Services
IT	Information technology
PC	Personal computer
R&D	Research and development
RMM	Risks of material misstatement
RAPs	Risk assessment procedures
SME	Small- and medium-sized entity
SMP	Small- and medium-sized practice
TOC	Tests of controls
TCWG	Those charged with governance
WP	Work papers, working papers

2. Introduction to the Case Studies

To illustrate how the various aspects of the audit process can be documented in practice, two case studies have been developed based on one fictional medium-sized entity and one fictional entity that is very small. The first scenario (Case Study A) is a furniture company called Dephta Furniture, Inc. that employs 15 people. The second scenario (Case Study B) is Kumar & Co., a small entity with two people. Kumar & Co. primarily supplies goods to Dephta Furniture, Inc. Both organizations have decided to use the SLFRS reporting framework.

Readers are cautioned that these case studies are purely illustrative. The documentation provided is a small extract from a typical audit file, and it illustrates just one possible way of complying with the SLAuS requirements. The data, analysis, and commentary provided represent only some of the circumstances and considerations that the auditor will need to address in a particular audit. As always, the auditor must exercise professional judgment.

Case Study A—Dephta Furniture, Inc.

Background

Dephta Furniture, Inc. is a family-owned furniture manufacturing company. It produces various kinds of wooden household furniture, both ready-made and custom-built. Dephta has an excellent reputation for producing quality products.

The company has three major product lines: bedroom sets, dining-room sets, and tables of all sorts. Standard pieces of furniture can also be customized for specific needs. To tap into the power of the Internet, the company recently set up a web site where people can buy furniture directly and pay by credit card. During the last period, the company shipped custom orders as far as 900 kilometers away.

The manufacturing facility is located on an acre of land adjacent to Suraj Dephta's house. An addition on the west side of Suraj's home acts as Dephta Furniture's shop. Major decisions are often made around the dining room table (which is the first table Suraj and his father built together). He likes the symbolism of sharing a meal on the product that produces his family's money for food.

Industry Trends

Until recently, Dephta had been growing rapidly. However, the furniture industry is currently experiencing challenging times due to:

- A declining economy due to a world-wide recession;

- Potential customers limiting their spending on discretionary goods, including furniture;
- Competition;
- Pressure to reduce prices to attract sales; and
- Some furniture parts manufacturers going out of business, thereby causing some production delays.

Governance

The company was started in 1952 by Suraj's father, Jeewan Dephta. Jeewan first made wooden spindles and banisters with one lathe in a small workshop next to the family home.

The company does not have a formal governance structure. Jeewan and Suraj prepare a business plan each period, then meet once a month with a successful local businessman, Ravi Jain, to review their progress against the plan. They also pay Ravi to comment on the practicality of their new dreams and ideas for the business, review the operating results, and provide advice on how to deal with any specific issues that have arisen.

Ravi's daughter, Parvin (a lawyer by training), usually accompanies her father to the meetings with Suraj and Jeewan. Parvin offers some legal advice, but her true passion lies in marketing and promotion. It was Parvin's idea that Dephta Furniture should expand its boundaries and start selling its products on the Internet. She also pushed for expansion outside their local region and even to neighboring countries. Perhaps by accessing additional markets, sales levels can be maintained despite the current economic downturn.

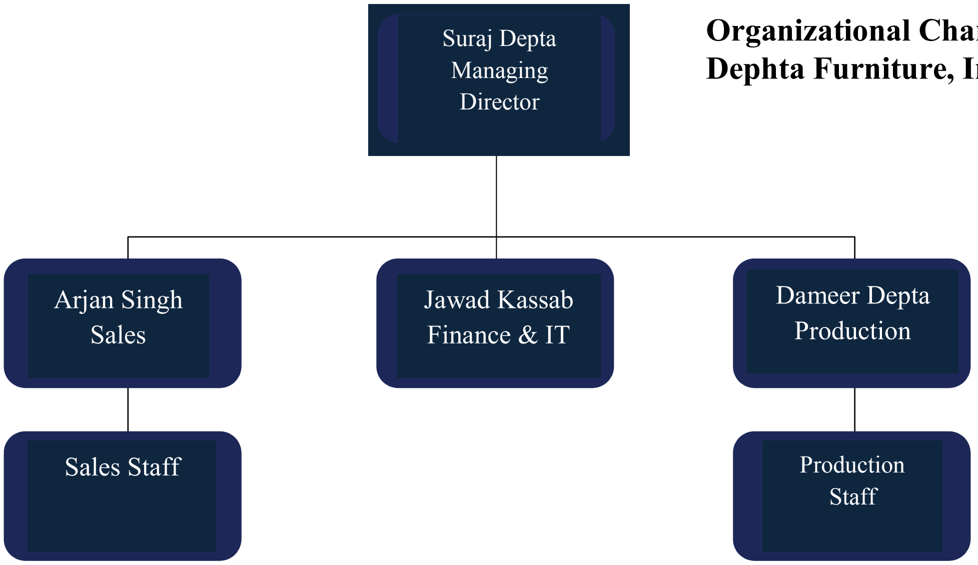
Personnel

Dephta Furniture, Inc. has a full-time staff of 15 employees. Six of these employees are related in some way to the family. Most of the family members work in the production area (as needed) in addition to the roles outlined in the exhibit below. During busy periods, two to four temporary workers may be employed as necessary. A few of the temporary workers return regularly but, because of the lack of job security, turnover is quite high.

As managing director, Suraj Dephta oversees all aspects of the business. Arjan Singh is in charge of sales and he is assisted by two full-time salespeople. Dameer, Suraj's brother, looks after production, which includes ordering raw materials and managing the inventory. Because the facility's space is limited, Suraj and Dameer are never too far away from the production process, and they share the task of supervising the two staff members.

Jawad Kassab (a cousin of Suraj) is in charge of the finance function and information technology (IT), and has two staff in his group.

Organizational Chart
Dephta Furniture, Inc.



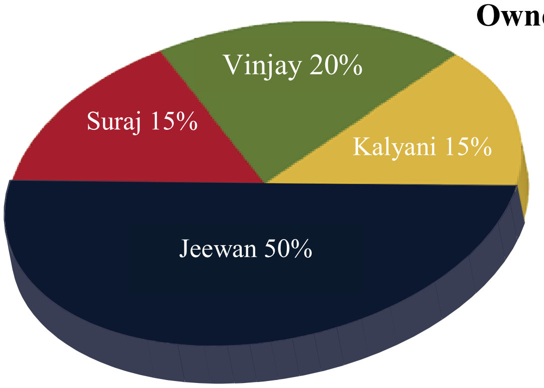
Ownership

Jeewan is the principal shareholder with a 50% interest in the company. He has plans to start transferring the shares to his son, Suraj, as long as Suraj continues to manage the company on a full-time basis and the company remains profitable as a result.

Suraj and his sister, Kalyani, each hold a 15% interest.

The remaining 20% is held by a family friend, Vinjay Sharma. Vinjay is a wealthy investor who has provided much of the capital needed to grow the company.

Ownership of Dephta Furniture, Inc.



Kalyani is a well-known singer who travels extensively. She is not involved in the operations of the company and totally relies on her father and brother to look after her interests.

In June of each period, Jeewan organizes a more formal business meeting. The shareholders meet in the morning (primarily to review the financial statements) and, later in the afternoon, hold a party for all staff. Suraj uses this occasion to tell the staff how well the business is doing and what the plans are for the future.

Operations

The company started out manufacturing chairs, tables, and spindles for railings and banisters, and has since expanded into making simple household furniture such as dressers, wardrobes, and cabinets. Dephta Furniture has grown considerably through strategies such as:

- Providing quality products at fair prices to local customers;
- Accepting larger furniture orders from national retailers. These large orders come with a firm delivery deadline (there are major penalties for late delivery) and the profit margins are much tighter than those for custom-made furniture;
- Being the first company in the region to sell (limited products) over the Internet; and
- Manufacturing parts such as spindles and round table legs for other local furniture manufacturers. This has enabled the company to purchase expensive lathes and specialized tools that other companies cannot afford.

Dephta also sells scrap furniture and wood (pieces rejected in the quality control process) at the factory for cash only.

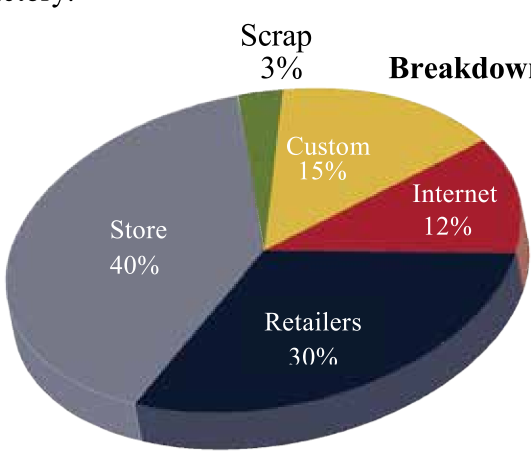
Exporting furniture to neighboring countries is also being considered. Suraj recognizes that this will mean higher shipping costs, dealing with customs, foreign currency exchange risk, and the potential for damage during transport. Although selling to neighboring countries means higher costs, it seems to be a small price to pay to access potential new customers. Also, Parvin knows many people in local government and thinks she can help to facilitate the extra paperwork involved.

Sales

The sales breakdown is approximately:

• Standard furniture (from catalog) from sales that are negotiated in person at the store:	40%
• Sales to furniture retailers:	30%
• Made-to-order (custom-built) furniture:	15%
• Internet sales:	12%
• Scrap sales from factory:	3%

Breakdown of Sales



Arjan Singh is a great dealmaker. He is very persistent when negotiating with customers and usually gets the sale, although the profit margins can be slim. Despite the economic downturn, he recently bought a beautiful family home overlooking the valley.

- **Notes on the sales system**
  - Sales contracts are prepared for retail and specialized orders. Deposits of 15% of the order are required on all custom orders, which are recorded as sales revenue when received. Two of the large retailers require Dephta to keep 30 days of inventory on hand so that orders can be shipped quickly to the stores when needed. These contracts also have provisions for inventory to be returned to Dephta if it doesn't sell within a specified time period.
  - Sales orders are manually filled at the time of sale, except for furniture sold directly from the shop or other small items on hand. All orders over Rs.500 or where the sale price is below the minimum sale price must be approved by Arjan. Invoices are prepared when the items are shipped and sent to the customer.
  - For all sales out of the shop, invoices are prepared at the time of sale and entered into the accounting system, which automatically numbers each sales transaction and provides an order receipt upon request.
  - A summary of the day's Internet sales is downloaded from the web site. Details of the items ordered are prepared and given to the production department. An invoice is prepared at the same time and recorded into revenue, as the item has already been paid for on the customer's credit card. The invoice marked "paid in full" accompanies all Internet orders that have been shipped.
  - Arjan rarely performs credit checks on customers. He knows most of them. In the past, customers paid cash upon delivery; currently, credit is granted to match the terms that Dephta Furniture's competitors are providing. As a result, Dephta Furniture requires a line of credit from the bank. Each period, the number of bad debts seems to be growing.
  - At the end of each month, Suraj reviews the sales and accounts receivable listing. He ensures that there are no obvious mistakes, and personally calls every customer whose account is over 90 days.
  - Each member of the sales staff (including Arjan) receives a commission of 15% on each sale in addition to a minimum base salary. To motivate the salespeople, their base salary is well below the salaries of most of the other employees. The computer system tracks sales made by each salesperson. Jawad prints a report each month and prepares a listing of commissions that will be paid on the following week's payroll. Either Suraj or Dameer reviews the listing of commissions and the sales to ensure that the staff are paid the correct amount. Arjan receives by far the most sales commissions.

Information Technology

The system consists of six PCs and a server used to host the Internet site. The internal system is mainly used for email, order taking, and accounting.

The company runs weekly back-ups of the accounting system on an external hard drive that is kept in the safe next to the computer room. Firewall protection and password protection have all been added in the last two periods. Last period, two PCs were stolen from the office. Access to the offices is now better secured, the PCs are chained to desks, and the server is locked in a separate and specially cooled office.

Internet sales are managed by Jawad. The company has an agreement with the bank to process the credit cards before any order is approved for shipping, and pays the bank 7% on each order processed. The application program for Internet sales provides the details of each sale, including the customer's name, address, and the items ordered. Internet transactions are downloaded daily from the website, and sales orders are prepared and forwarded to the production department.

Human Resources and Payroll

All hiring decisions are made by Dameer and Suraj. Like his father, Suraj is committed to hiring competent people and expects loyalty from his employees.

Employees are paid in cash at the beginning of each week. One of Jawad’s staff, Karla Winston, is responsible for payroll. She has a list of employees, and calculates the payroll and deductions based on time-card summaries that Dameer provides to her. Suraj reviews payroll each Monday morning before instructing Karla to hand the envelopes to employees. All employees sign a list when they pick up their envelope. The company does not keep formal employee records.

Purchasing and Production

Dameer is responsible for purchasing and production. Because the inventory system is not very sophisticated, he tends to over-order some items, which often results in inventory sitting in the warehouse gathering dust. This is considered better than under-ordering supplies, which results in production delays.

- **Notes on the purchasing function**
  - At least two quotes must be obtained before purchases over Rs. 5,000 are approved. The exception is wood supplied by the local lumber mill, where Dephta has negotiated a five-year exclusive supply contract.
  - The company prepares purchase orders for all inventory or capital purchases over Rs.1,000.
  - Dameer approves all new vendors and supplies the details to Jawad. Jawad then sets up the vendors in the system and enters details of invoices received.

Accounting and Finance

Jawad studied accounting at university and is well versed in accounting and financial matters. When he joined Dephta two years ago, he quickly introduced the “Sound Accounting” software package by Onion Corp. with its integrated accounts payable, accounts receivable, and capital assets modules.

- **Notes on the accounting and finance function**
  - At present, the company does not have a perpetual inventory system. Inventory is counted twice a period, once at period end and once halfway through the period. This ensures that profit margins on sales can be accurately calculated at least twice a period.
  - Jawad has been frustrated by the lack of controls over inventory. He had suggested to Suraj that inventory be counted at least four times per period to ensure that margins are reviewed throughout the period. Suraj had overridden his recommendation, stating that it would be too disruptive to count inventory so often and could cause the company to miss deadlines.
  - Although Dephta has been profitable, the gross margins have been inconsistent. Jawad does not have an explanation as to why inventory costs are not tracked by product line.
  - Suraj gets very annoyed at having to pay any form of income tax, and usually pressures Jawad to ensure that accruals are “more than adequate.”

Note: The following income statement and balance sheet were prepared by management. Notes to the financial statements or a cash-flow statement have not been included.

Appendix A

Dephta Furniture, Inc.
Income Statement
(in Currency Units (Rs.))

	For the year ended December 31		
	20X2	**20X1**	**20X0**
Sales	1,437,317	1,034,322	857,400
Cost of goods sold	879,933	689,732	528,653
Gross profit	557,384	344,590	328,747
Distribution costs	64,657	41,351	39,450
Administrative expenses	323,283	206,754	197,248
Finance cost	19,471	19,279	15,829
Depreciation	23,499	21,054	10,343
	430,910	288,438	262,870
Profit before tax	126,474	56,152	65,877
Income taxes	31,619	14,038	16,469
Net income	94,855	42,114	49,408

Appendix B

Dephta Furniture, Inc.
Balance Sheet
(in Currency Units (Rs.))

	As at December 31		
	20X2	**20X1**	**20X0**
ASSETS			
Current assets			
Cash and cash equivalents	22,246	32,522	22,947
Trade and other receivables	177,203	110,517	82,216
Inventories	156,468	110,806	69,707
Prepayments and other	12,789	10,876	23,877
	368,706	264,721	198,747
Non-current assets			
Property, plant and equipment	195,821	175,450	103,430
	564,527	440,171	302,177
EQUITY AND LIABILITIES			
Current liabilities			
Bank indebtedness	123,016	107,549	55,876
Trade and other payables	113,641	107,188	50,549
Income tax payable	31,618	14,038	16,470
Current portion of interest- bearing loan	10,000	10,000	10,000
	278,275	238,775	132,895
Non-current liabilities			
Interest-bearing loan	70,000	80,000	90,000
Capital and reserves			
Issued capital	18,643	18,643	18,643
Accumulated profits	197,609	102,753	60,639
	564,527	440,171	302,177

Case Study B—Kumar & Co.

Background

Kumar & Co. was started in 1990 by Rajesh (Raj) Kumar. It is an incorporated company, but consists of only two production personnel, Rajesh as the owner-manager, and some part-time bookkeeping assistance.

As a young boy, Raj learned the woodcrafting trade from his father, Sanjay. When Sanjay first took young Raj under his wing, he saw that Raj also had a natural talent for woodworking, and that made him proud.

After his father died in 1976, Raj decided to invest his small savings in opening his own furniture shop, which he called Kumar & Co.

Business Proposition

Raj's business was initially focused on producing small wooden household furniture. However, soon after starting the business, his cousin Suraj (of Dephta Furniture) approached him with a business proposition. Suraj asked that Raj dedicate most of his time and attention to creating spindles and table legs for furniture the Dephta factory produced. The price Dephta was willing to pay for his products allowed him a greater profit margin than he could get with any of his other handiwork. Raj agreed.

To encourage Raj to focus his business on serving Dephta's supply needs, Dephta purchased a 15% ownership stake in Kumar. This helped Kumar purchase new lathes and tools to improve production efficiency.

Industry Trends

The furniture industry is currently facing a challenging economy. Kumar & Co. has experienced healthy and steady growth, but if the demand for products from Dephta declines, Kumar's sales will also be hurt. Raj still takes some custom furniture orders, but Dephta constitutes approximately 90% of his business.

Production

Kumar & Co. is an owner-managed company, with Raj owning 85% of the shares. There are two full-time production personnel in addition to Raj. He is used to long workdays, and works most weekends, simply to keep up with the orders from Dephta.

In the current period, though, Raj is rarely in the office or workshop. He does the minimum required to meet demands, but has not been nearly as involved in approving orders, supply purchases, or record-keeping as he once was. Apparently he is dealing with some issues at home.

At the beginning of the period, Kumar obtained new bank financing to buy necessary raw materials and to replace some aging equipment. The loan came with bank covenants that must be maintained or the funds could be recalled.

Raj deals directly with Dephta personnel on orders and logs them in a notebook. The accountant then creates invoices and receives payments. He personally organizes shipping and maintains an order/shipping log.

Raj maintains good records and keeps the following information updated:

- Order/shipping log: date order was placed, amount, type, pricing, date promised, method of delivery, quantity sold/shipped, date shipped, and if paid;
- Sales log: customer name, date shipped, order details (product type, quantity, type of wood, special

requests, etc.), price, amount paid; and

- Purchases log: segregated between materials and other items.

Raj matches the shipping log to the sales log each week to ensure that no shipments are missed.

Accounting

Kumar & Co.'s part-time bookkeeper, Ruby, has been working with Raj for over 10 years and is very competent. She maintains the accounting records and creates the monthly and annual financial statements. However, she feels that Raj takes her services for granted. He has not increased her salary in the last three years. Ruby has two children whom she wants to go to college, but is worried about how the tuition will be paid.

Appendix A

Kumar & Co.
Income Statement—Prepared by Management
(in Currency Units (Rs.))

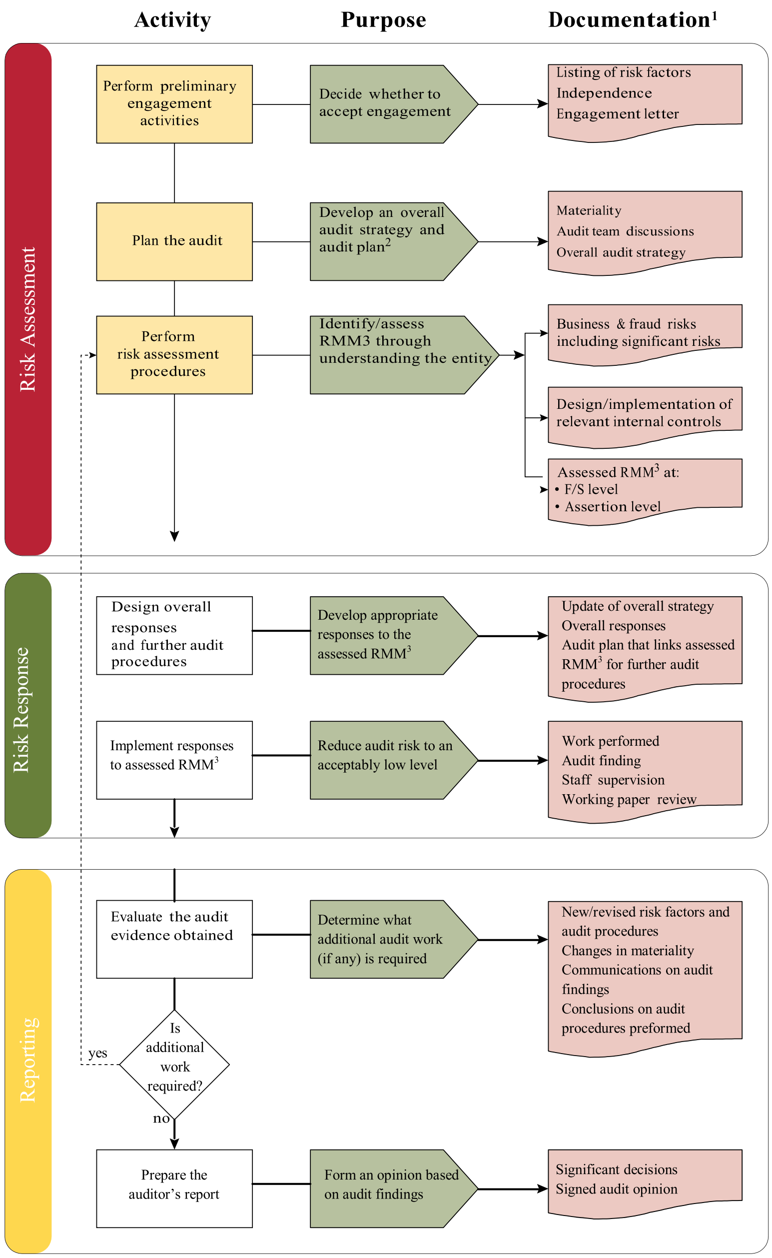
	For the year ended December 31		
	20X2	**20X1**	**20X0**
Sales	231,540	263,430	212,818
Cost of goods sold	118,600	122,732	100,220
Gross profit	112,940	140,698	112,598
Distribution costs	13,002	19,450	12,890
Administrative expenses	71,532	91,318	68,101
Finance cost	6,480	0	0
Depreciation	11,541	6,871	5,020
	102,555	117,639	86,011
Profit before tax	10,385	23,059	26,587
Income taxes	5,765	6,420	8,988
Net income	4,620	16,639	17,599

Appendix B

Kumar & Co.
Balance Sheet—Prepared by Management
(in Currency Units (Rs.))

	As at December 31		
	20X2	**20X1**	**20X0**
ASSETS			
Current assets			
Cash and cash equivalents	1,255	10,822	6,455
Trade and other receivables	67,750	65,110	34,100
Inventories	34,613	15,445	12,607
	103,618	91,377	53,162
Property, plant and equipment	54,430	22,468	20,216
	158,048	113,845	73,378
EQUITY AND LIABILITIES			
Current liabilities			
Trade and other payables	53,100	48,820	36,500
Current portion of interest- bearing loan	4,000	0	0
	57,100	48,820	36,500
Non-current liabilities			
Interest-bearing loan	31,000	0	0
Capital and reserves			
Issued capital	10,580	10,580	10,580
Accumulated profits	59,368	54,445	26,298
	158,048	113,845	73,378

3. Risk Assessment — Overview



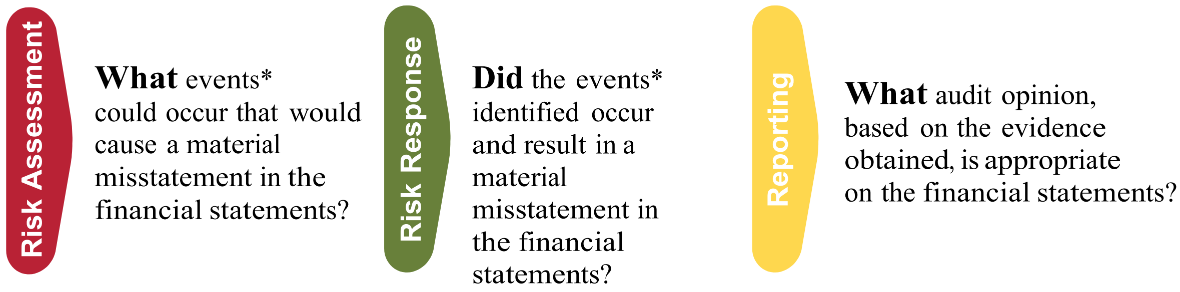
Notes:
1. Refer to SLAuS 230 for a more complete list of documentation required.
2. Planning (SLAuS 300) is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

For the purposes of this Audit Manual the audit approach has been divided into three distinct phases—risk assessment, risk response, and reporting. The exhibit on the previous page summarizes the major activities involved in the risk assessment phase, along with their purpose and the resulting documentation. Additional information on each of these activities is outlined in the following chapters.

Paragraph #	SLAuS Objective(s)
315.3	The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

A simpler way of describing the three elements is illustrated below.

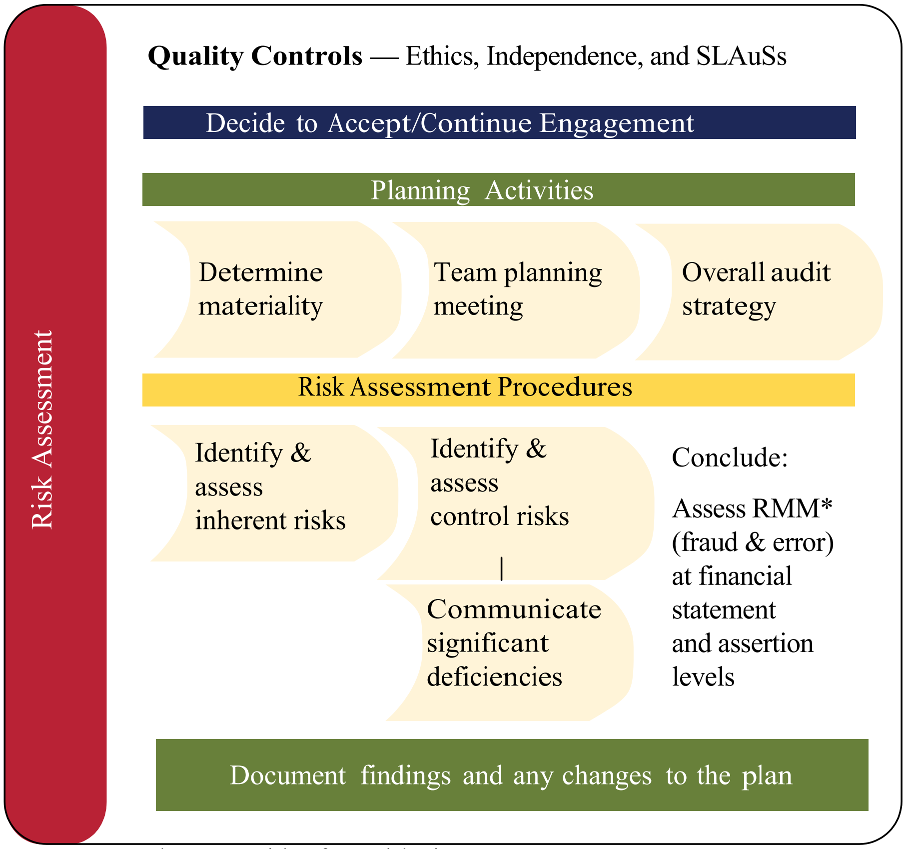
Exhibit 3.0-1



* An "event" is simply a business or fraud risk factor (see descriptions in Volume 1, Chapter 4, Exhibit 4.2-2) including those risk factors resulting from the absence of internal control to mitigate the potential for material misstatements in the financial statements.

The major steps involved in the risk assessment phase of the audit, in the order they would normally be performed, are outlined in the following exhibit.

Exhibit 3.0-2



* RMM = Risks of Material Misstatement

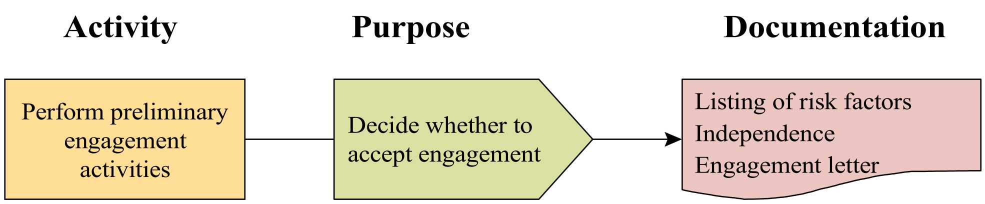
The core concepts that are addressed in the risk assessment phase are set out below.

Core Concepts Risk Assessment Phase	Volume and Chapters
Internal Control	V1 - 5
Financial Statement Assertions	V1 - 6
Materiality and Audit Risk	V1 - 7
Risk Assessment Procedures	V1 - 8

4. Engagement Acceptance and Continuance

Chapter Content	Relevant SLAuSs/SLSQC 1
Guidance on procedures required to: • Identify and assess risk factors relevant to deciding whether to accept or decline the audit engagement; and • Agree upon and document the terms of the engagement.	210, 220, 300 and SLSQC 1

Exhibit 4.0-1



The major steps in the engagement acceptance/continuance process are outlined below.

Exhibit 4.0-2

Process to accept/continue with an audit engagement

1 For further information, refer to Volume 2, Chapter 4.3.

Paragraph #	SLAuS Objective(s)
210.3	The objective of the auditor is to accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed, through: (a) Establishing whether the preconditions for an audit are present; and (b) Confirming that there is a common understanding between the auditor and management and, where appropriate, those charged with governance of the terms of the audit engagement.

Paragraph #	Relevant Extracts from SLAuSs/SLSQC 1
SLSQC 1.26	The firm shall establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide the firm with reasonable assurance that it will only undertake or continue relationships and engagements where the firm: (a) Is competent to perform the engagement and has the capabilities, including time and resources, to do so; (Ref: Para. A18, A23) (b) Can comply with relevant ethical requirements; and (c) Has considered the integrity of the client, and does not have information that would lead it to conclude that the client lacks integrity. (Ref: Para. A19-A20, A23)
SLSQC 1.27	Such policies and procedures shall require: (a) The firm to obtain such information as it considers necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client. (Ref: Para. A21, A23) (b) If a potential conflict of interest is identified in accepting an engagement from a new or an existing client, the firm to determine whether it is appropriate to accept the engagement. (c) If issues have been identified, and the firm decides to accept or continue the client relationship or a specific engagement, the firm to document how the issues were resolved.
SLSQC 1.28	The firm shall establish policies and procedures on continuing an engagement and the client relationship, addressing the circumstances where the firm obtains information that would have caused it to decline the engagement had that information been available earlier. Such policies and procedures shall include consideration of: (a) The professional and legal responsibilities that apply to the circumstances, including whether there is a requirement for the firm to report to the person or persons who made the appointment or, in some cases, to regulatory authorities; and (b) The possibility of withdrawing from the engagement or from both the engagement and the client relationship. (Ref: Para. A22-A23)
210.4	For purposes of the SLAuSs, the following term has the meaning attributed below: Preconditions for an audit—The use by management of an acceptable financial reporting framework in the preparation of the financial statements and the agreement of management and, where appropriate, those charged with governance to the premise on which an audit is conducted.
220.12	The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate. (Ref: Para. A8-A9)

Paragraph #	Relevant Extracts from SLAuSs/SLSQC 1
220.13	If the engagement partner obtains information that would have caused the firm to decline the audit engagement had that information been available earlier, the engagement partner shall communicate that information promptly to the firm, so that the firm and the engagement partner can take the necessary action. (Ref: Para. A9)
300.13	The auditor shall undertake the following activities prior to starting an initial audit: (a) Performing procedures required by SLAuS 220 regarding the acceptance of the client relationship and the specific audit engagement; and (b) Communicating with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements. (Ref: Para. A20)

4.1 Overview

One of the most important decisions that a firm can make is determining what engagements to accept or which client relationships to retain. A poor decision can lead to unbillable time, unpaid fees, additional stress on partners and staff, loss of reputation, and, worst of all, potential lawsuits.

SLSQC 1 and SLAuS 220 require firms to develop, implement, and document their quality control procedures in regard to their client acceptance and retention policies. Ideally, these policies and procedures should address the level of risk (risk tolerance) and the client characteristics (such as poor management integrity, a high-risk industry, or a publicly-traded company) that would not be acceptable to the firm.

Before a firm decides to accept or retain an engagement, the auditor is required to:

- Establish the acceptability of the proposed financial reporting framework;
- Assess whether the firm can comply with relevant ethical requirements;
- Obtain the agreement of management that it acknowledges and understands its responsibility for:
  - The preparation of the financial statements in accordance with the applicable financial reporting framework,
  - Such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error, and
  - To provide the auditor with access to all relevant information and any additional information that the auditor may request, plus unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence; and
- Perform engagement acceptance or continuance procedures. These procedures would be similar to the risk assessment procedures outlined in Volume 1, Chapter 8. The results (assuming the engagement is accepted) can later be used as part of the risk assessment.

The initial and subsequent years' assessments of the engagement risk help to ensure that the firm is:

- Independent, and that no conflicts of interest exist;
- Competent to perform the work with the required resources and time availability;
- Willing to accept the risks involved in performing the audit. This would include an assessment of management's integrity and attitudes toward internal control, industry trends, availability of appropriate audit evidence, and other factors such as the ability of the client to pay the fees involved; and
- Not aware of any new information about an existing client that would have caused the firm to decline the engagement if it had been known earlier.

CONSIDER POINT

There may be some very small entities requiring an audit where the owner-manager runs the entity, has few (if any) formal documented controls in place, and can therefore override just about everything. In these situations, the auditor has to determine whether the absence of control activities or of other components of control may make it impossible to obtain sufficient appropriate audit evidence. If this is the case, the auditor would exercise professional judgment in determining whether the engagement should be declined or a modified opinion provided.

Factors to consider include:

- The entity's control environment. For example: is the owner-manager trustworthy, competent, and does he/she have a good attitude toward internal control?
- Is it possible to develop an overall response and further audit procedures that would respond appropriately to the assessed risk factors? For example, can substantive procedures be used to determine that all revenues and liabilities are properly recorded in the accounting records?

4.2 Engagement Acceptance

The first step in the client acceptance or continuance process is to assess the auditing firm's ability to perform the engagement, and the risks involved. The following exhibit outlines some possible lines of inquiry.

Exhibit 4.2-1

Consider	Line of Inquiry
The Firm's Quality Control Requirements	What policies and procedures are in place to provide reasonable assurance that the firm will only undertake or continue relationships where: • The firm can comply with the SLAuS requirements; and • The engagement risks involved are within the firm's tolerance for risk?
What Work Is Required?	• What is the nature and scope of the audit? • What accounting framework will be used? • How will the auditor's report and financial statements be used? • What is the deadline (if any) for completing the audit?

Consider	Line of Inquiry
Does the Firm Have the Competence, Resources, and Time Required?	• Does the firm have sufficient personnel with the necessary competence and capabilities? • Do the selected firm personnel have: – Knowledge of relevant industries or subject matters, – Experience with relevant regulatory or reporting requirements, or – Ability to gain the necessary skills and knowledge effectively? • Are experts available, if needed? • Where applicable, are there qualified persons available to perform the engagement quality control review? • Can the firm and the available staff (in light of timing requirements for other clients) complete the engagement within the reporting deadline?
Is the Firm Independent?	• Can the firm and the engagement team comply with ethical and independence requirements? • Where conflicts of interest, lack of independence, or other threats have been identified: – Has appropriate action been taken to eliminate those threats or reduce them to an acceptable level by applying safeguards, or – Have steps been taken to withdraw from the engagement? • If the entity being audited is a component of a larger group, the group engagement team may request certain work to be performed on the financial information of the component. In such cases, the group engagement would first obtain an understanding of the following: – Whether the component auditor understands and will comply with the ethical (including independence) requirements that are relevant to the group audit, – The component auditor's professional competence, – Whether the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence, and – Whether the component auditor operates in a regulatory environment that actively oversees auditors.

Consider	Line of Inquiry
Are the Risks Involved Acceptable?	• For new engagements, has the firm communicated (as required by SLAuS 300.13) with the predecessor auditor to determine if there are any reasons for not accepting the engagement? • Has the firm conducted an Internet search and had discussions with firm personnel and other third parties (such as bankers) to identify any reasons why the firm should not accept the engagement? • What are the values (“tone at the top”) and future goals of the entity? • How competent are the entity’s senior management and staff? • Are there difficult or time-consuming issues to address (accounting policies, estimates, compliance with legislation, etc.)? • What changes have taken place this period that will impact the engagement (business trends and initiatives, personnel changes, financial reporting, IT systems, purchase/sale of assets, regulations, etc.)? • Is there a high level of public scrutiny and media interest? • Is the entity in good financial health and does it have the ability to pay the firm’s professional fees? • Will the entity provide help to the firm in obtaining information and preparing schedules, analysis of balances, providing data files, etc.?
Can the Client Be Trusted?	• Are there any scope limitations, such as unrealistic deadlines or an inability to obtain the required audit evidence? • Is there any reason (or recent event) that casts doubt on the integrity of the principal owners, senior management, and those charged with governance of the entity? Consider the entity’s operations, including business practices, the business’ reputation, and history of any ethical or regulatory infringements. • Are there any indications that the entity might be involved in money laundering or other criminal activities? • What is the identity and business reputation of related parties? • Does management have a poor attitude toward internal control and an aggressive attitude toward interpretation of accounting standards? Consider corporate culture, organizational structure, risk tolerance, complexity of transactions, etc.

Background Checks

To ensure that the information obtained from the entity is accurate, consider what third-party information could be obtained to validate key aspects of the risk assessment. This simple step could avert problems later on. Examples include information from sources such as previous financial statements, income tax returns, credit reports, and possibly (after receiving permission from the prospective client) discussions with key advisors such as bankers, etc.

CONSIDER POINT

Before contacting third parties and collecting information on a prospective client, take steps to ensure that all partners and staff are aware of:

- The firm's policies to protect confidential information maintained on clients;
- Requirements of any privacy legislation; and
- Requirements of the applicable code of ethics.

Once a decision has been reached to accept or continue with the client engagement, the next step is to:

- Establish whether the preconditions for an audit are present; and
- Confirm a common understanding between the auditor and management (and where appropriate, those charged with governance) of the terms of the audit engagement.

4.3 Pre-Conditions for an Audit

Paragraph #	Relevant Extracts from SLAuSs
210.6	In order to establish whether the preconditions for an audit are present, the auditor shall: (a) Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable; and (Ref: Para. A2-A10) (b) Obtain the agreement of management that it acknowledges and understands its responsibility: (Ref: Para A11-A14, A20) (i) For the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation; (Ref: Para. A15) (ii) 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 (Ref: Para. A16-A19) (iii) To provide the auditor with: a. 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; b. Additional information that the auditor may request from management for the purpose of the audit; and c. Unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence.

Exhibit 4.3-1

Consider	Line of Inquiry
Are the Audit Preconditions Present?	Is the financial reporting framework (such as SLFRSs) to be used in preparing the financial statements acceptable? Factors to consider include: • The nature of the entity (business, public sector, or not-for-profit); • The purpose of the financial statements (common purpose or for specific users); • The nature of the financial statements (complete set of financial statements or a single financial statement); and • Whether law or regulation prescribes the applicable financial reporting framework. Does management agree to and acknowledge/understand its responsibility for: • Preparing the financial statements in accordance with the applicable financial reporting framework, including (where relevant) their fair presentation; • 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 • Providing the auditor with: − Access to all relevant information such as records, documentation, and other matters, − Additional information requested from management for the purpose of the audit (such as written representations), and − Unrestricted access to persons within the entity to obtain the necessary audit evidence?
Is There a Scope Limitation?	Has management or those charged with governance imposed any type of limitation on the scope of the audit? This could include unrealistic deadlines, not accepting certain firm's staff to perform the work, and denial of access to a facility, key personnel, or relevant documents. If such a limitation would result in a disclaimer of opinion, the firm would decline the engagement, unless the firm is required by law or regulation to proceed with the engagement.

Where management does not agree to and acknowledge its responsibilities as set out in SLAuS 210.6(b) above, or the financial reporting framework is not acceptable, the auditor is required by SLAuS 210.8 to decline the engagement unless required by law or regulation.

4.4 Agreeing the Terms of Engagement

Paragraph #	Relevant Extracts from SLAuSs
210.7	If management or those charged with governance impose a limitation on the scope of the auditor's work in the terms of a proposed audit engagement such that the auditor believes the limitation will result in the auditor disclaiming an opinion on the financial statements, the auditor shall not accept such a limited engagement as an audit engagement, unless required by law or regulation to do so.
210.9	The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate. (Ref: Para. A21)

Paragraph #	Relevant Extracts from SLAuSs
210.10	Subject to paragraph 11, the agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written agreement and shall include: (Ref: Para. A22-A25) (a) The objective and scope of the audit of the financial statements; (b) The responsibilities of the auditor; (c) The responsibilities of management; (d) Identification of the applicable financial reporting framework for the preparation of the financial statements; and (e) Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.
210.11	If law or regulation prescribes in sufficient detail the terms of the audit engagement referred to in paragraph 10, the auditor need not record them in a written agreement, except for the fact that such law or regulation applies and that management acknowledges and understands its responsibilities as set out in paragraph 6(b). (Ref: Para. A22, A26-A27)
210.12	If law or regulation prescribes responsibilities of management similar to those described in paragraph 6(b), the auditor may determine that the law or regulation includes responsibilities that, in the auditor's judgment, are equivalent in effect to those set out in that paragraph. For such responsibilities that are equivalent, the auditor may use the wording of the law or regulation to describe them in the written agreement. For those responsibilities that are not prescribed by law or regulation such that their effect is equivalent, the written agreement shall use the description in paragraph 6(b). (Ref: Para. A26)
210.13	On recurring audits, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement. (Ref: Para. A28)
210.14	The auditor shall not agree to a change in the terms of the audit engagement where there is no reasonable justification for doing so. (Ref: Para. A29-A31)
210.15	If, prior to completing the audit engagement, the auditor is requested to change the audit engagement to an engagement that conveys a lower level of assurance, the auditor shall determine whether there is reasonable justification for doing so. (Ref: Para. A32-A33)
210.16	If the terms of the audit engagement are changed, the auditor and management shall agree on and record the new terms of the engagement in an engagement letter or other suitable form of written agreement.
210.17	If the auditor is unable to agree to a change of the terms of the audit engagement and is not permitted by management to continue the original audit engagement, the auditor shall: (a) Withdraw from the audit engagement where withdrawal is possible under applicable law or regulation; and (b) Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators

Note: Paragraphs 18-22 of SLAuS 210 contain some additional considerations in engagement acceptance, such as where financial reporting standards are supplemented by law or regulation and where the financial reporting framework is prescribed by law or regulation.

To ensure a clear understanding between management and the auditor on the terms of engagement, an engagement letter (or other suitable form of written agreement) is prepared and agreed upon with the appropriate representative of senior management. To avoid any potential for misunderstanding, the engagement letter would be finalized and signed before the engagement work commences.

Even in countries where the audit objective, scope, and obligations are established by law, an engagement letter may still be useful to inform clients about their specific roles and responsibilities.

A sample of an engagement letter based on the example contained in SLAuS 210 is provided in the case study materials that follow.

The engagement letter would address the matters set out below.

Exhibit 4.4-1

Terms	Description
The Objective, Accounting Framework, Scope, and Form of Auditor's Report Resulting from the Audit of the Financial Statements	• The accounting framework to be used. • Objective of the audit of financial statements and the anticipated form of auditor's report or other communication. Also, the circumstances in which a report may differ from its expected form and content. • The scope of the audit, including reference to applicable legislation, regulations, SLAuSs, and ethical and other pronouncements of professional bodies to which the auditor adheres. • Other parties to whom a report is required to be made (e.g., a regulator).
The Responsibilities of the Auditor	• To conduct the audit in accordance with Sri Lanka Auditing Standards (SLAuSs). • Recognition that, due to the inherent limitations of an audit and the 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 SLAuSs.
The Responsibilities of Management	• For the preparation of the financial statements in accordance with the applicable financial framework, and for designing and implementing 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. • Accept the terms of the engagement as outlined in the engagement letter. • Provide unrestricted access to any records, documentation, and other information requested in connection with the audit. • Provide unrestricted access to persons within the entity • Confirm auditor's expectation of receiving written confirmation from management concerning representations made in connection with the audit. • Agreement of management to inform the auditor of facts that may affect the financial statements, of which management may become aware during the period from the date of the auditor's report to the date the financial statements are issued.

Other matters that could be included in the engagement letter are outlined below.

Exhibit 4.4-2

Terms	Description
How the Audit Will Be Conducted, Any Dispute Resolution, Obligations, and Fee Arrangements	Address arrangements regarding: • The planning and performance of the audit, including the composition of the audit team and details of what (if any) draft financial statements or other working papers are to be prepared by the client, along with the dates on which the auditor requires these; • Involvement of other auditors and experts; • Involvement of the predecessor auditor, if any, with respect to opening balances; and • Other matters: – Any restrictions of the auditor's liability where such possibility exists, – The basis on which fees are computed and any billing arrangements, – Any obligations by the firm to provide audit working papers to other parties, and – Reference to any further agreements between the auditor and the client, or other letters or reports the auditor expects to issue to the client. Client to confirm the terms of the engagement by acknowledging receipt of the engagement letter.

Updating the Engagement Letter

When no changes have occurred, the auditor is required to assess whether there is a need to remind the entity of the existing terms of the audit engagement. The terms of engagement may be reconfirmed at the time of the auditor's reappointment without the need to obtain a new letter each year.

The engagement letter is required to be revised when the circumstances change. Matters that may constitute a change in circumstance include:

- Any revised or special terms of the engagement;
- A recent change in senior management;
- A significant change in ownership;
- A significant change in the nature or size of the entity's business;
- A change in legal or regulatory requirements;
- A change in the financial reporting framework adopted in the preparation of the financial statements;
- A change in other reporting requirements; and
- Some indication that management misunderstands the objective and scope of the audit.

A Change in the Terms of the Audit Engagement

If management requests changes to the terms of the audit engagement, the auditor would consider whether there is reasonable justification for the request, and the implications for the scope of the audit engagement. A reasonable justification could include a change in the client's circumstances or a misunderstanding of the nature of the original service requested.

A change would not be reasonable if it is motivated by issues raised during the audit. This could include audit information that does not support management representations, an inability to obtain certain audit information (which would effectively limit the scope of the audit), or evidence that is otherwise unsatisfactory. An example might be where the auditor is unable to obtain sufficient appropriate audit evidence regarding inventory balances, and the entity asks for the audit engagement to be changed to a review engagement to avoid a qualified opinion or a disclaimer of opinion.

If the change in terms is reasonable, a revised engagement letter or other suitable form of written agreement would be obtained. If, however, the auditor is unable to agree to the proposed change in terms and is not permitted by management to continue the original audit engagement, the auditor is required to:

- Withdraw from the audit engagement where possible under applicable law or regulation; and
- Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners, or regulators.

4.5 Case Studies—Client Acceptance and Continuance

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

Note: In general, a more structured approach (such as checklists etc) has been used for documenting the audit evidence for Dephta Furniture and a less structured approach (use of memoranda etc) for Kumar. This is simply to illustrate alternative means of documentation. It would not preclude memoranda from being used in the audit of Dephta or checklists being used in the audit of Kumar. The choice of how to document compliance with the SLAuSs is a matter of professional judgment that should ideally be discussed during audit planning.

Assuming that this is an ongoing audit engagement, the partner or senior manager in the audit firm would make some inquiries to identify and assess any new or revised risk factors relevant to deciding to continue with the audit engagement. Include inquiries such as the following:

Case Study A—Dephta Furniture, Inc.

Client Acceptance and Continuance

A questionnaire such as the following could be used.

• Have the audit preconditions been met?	*Dephta's financial statements will be prepared by management using SLFRS.* *The engagement letter has been signed, and management have acknowledged their responsibility to:* • Make available all information as requested. • Provide unlimited access to personnel. • Design and implement 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.*
• Have the acceptance/continuance requirements in the firm's quality control manual been followed?	*Yes. Refer to policies XX and YY of our QC manual.*
• Any change in the terms of reference or requirements for the audit engagement?	*No.*
• Any independence issues or conflicts of interest? Consider: family/personal relationships with key client people, non-audit services such as accounting, financial interests, and other business relationships.	*Only matter noted was that one of our staff bought a lot of bedroom furniture from Dephta; he paid the catalog price. This incident is not considered a threat to our independence.*
• Any circumstances that would cast doubt on the integrity of the client's owners? Consider convictions, regulatory proceedings/sanctions, suspicion or confirmation of illegal acts or fraud, police investigations, and any negative publicity.	*No. However, Parvin (daughter of the client's business advisor) received some negative publicity in July. She was an advisor in a land deal where government officials were accused of receiving bribes from developers. This matter has also been noted on our listing of risk factors for the audit.*
• Are there areas where specialized knowledge is necessary?	*We will use David (who is knowledgeable in the IT area) to review controls over the Internet sales.*
• Does the firm have the capacity in time, competencies, and resources to complete the engagement in accordance with professional and firm standards?	*Yes. See the planned budget.*
• Are there any issues identified in previous audits and other engagements for this entity that need to be addressed?	*Need for a review of the general IT controls in light of the decision to accept sales over the Internet.*
• Are there any new circumstances that increase our engagement risk?	*No. Management has a good attitude toward internal control.*
• Can the client continue to pay our fees?	*Yes.*

Conclusion

Overall assessment of engagement risk = Low

We should continue with this client.

Sang Jun Lee

The terms of engagement would be included in a letter such as outlined below.

Jamel, Woodwind & Wing LLP
55 Kingston St., Cabetown, United Territories 123-53004

October 15, 20X2

Mr. Suraj Dephta, Managing Director
Dephta Furniture, Inc.
2255 West Street
North Cabetown
United Territories
123-50214

Dear Mr. Dephta:

You have requested that we audit the financial statements of Dephta Furniture, which comprise the balance sheet as at December 31, 20X2, and the income statement, statement of changes in equity and cash-flow statement for the year then ended, and 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. Our audit will be conducted with the objective of our expressing an opinion on the financial statements.

Our Responsibilities
We will conduct our audit in accordance with Sri Lanka Auditing Standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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 SLAuSs.

In making our risk assessments, we consider internal control relevant to the entity’s preparation of the financial statements 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 any significant deficiencies in internal control relevant to the audit of the financial statements that we have identified during the audit.

Unless unanticipated difficulties are encountered, our report will be substantially in the following form:

[Form and content of the auditor’s report not has not been reproduced.]

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

Management's Responsibility

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 Sri Lanka Accounting Standards;

(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 you are 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 you for the purpose of the audit; and
- (iii) Unrestricted access to persons within the company from whom we determine it necessary to obtain audit evidence.

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

We look forward to full cooperation from your staff during our audit.

Fees

Our fees, which will be billed as work progresses, are based on the time required by the individuals assigned to the engagement plus out-of-pocket expenses. Individual hourly rates vary according to the degree of responsibility involved and the experience and skill required.

This letter will be effective for future periods unless it is terminated, amended, or superseded.

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.

Yours truly,

____

Sang Jun Lee
Jamel, Woodwind & Wing, LLP

Acknowledged on behalf of Dephta Furniture, Inc. by

____

Suraj Dephta
Managing Director
November 1, 20X2

Case Study B—Kumar & Co.

Client Acceptance and Continuance

Assuming that this is an ongoing audit engagement, the inquiries to identify and assess any new or revised risk factors could be documented in a memo as follows.

Client Continuance Memo — Kumar & Co.

October 15, 20X2

We spoke to the client, Raj Kumar, on September 15, 20X2 to determine whether we should accept this engagement.

Matters arising:

- Raj requires an audit opinion on the financial statements of Kumar & Co. using SLFRSs.
- We considered all possible threats to our independence (as contained in section 290 of the CA Sri Lanka Code) and did not identify any.
- Nothing new happened that might raise concerns over the integrity of the owner.
- Operations are similar to the previous period, although Raj's absence from day-to-day operations does create more opportunity for fraud to be committed. We should consider expanding our substantive procedures this year to address the potential fraud risks.
- No additional specialists are necessary, and the same people as last period can perform the audit.

Two possible concerns this period:

- The company has experienced a drop in demand for products from its major customer, Dephta.
- Raj has diverted much of his focus to personal family matters. During our audit, we should ensure that books and records have been kept up to date and that no undetected errors occurred. This could also create a fraud risk.

Overall assessment of engagement risk = Moderate

We will accept this engagement for the current period.

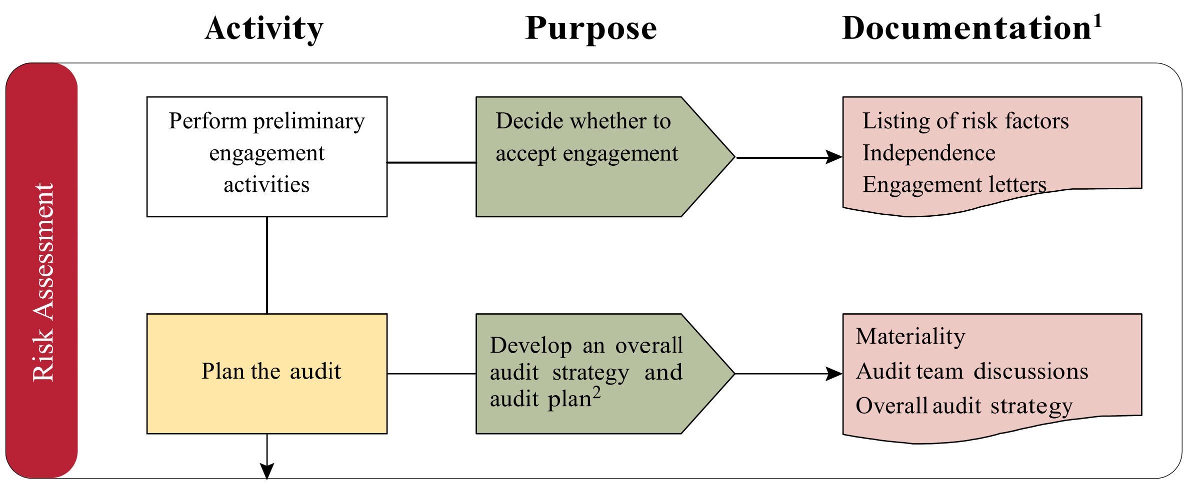
Sang Jun Lee

The terms of engagement would be included in a letter that would be very similar to the example previously provided in Case Study A: Dephta Furniture, Inc.

5. Overall Audit Strategy

Chapter Content	Relevant SLAuS
Outline of steps involved in developing an overall plan and strategy for the audit.	300

Exhibit 5.0-1



Notes:
1. Refer to SLAuS 230 for a more complete list of documentation required.
2. Planning (SLAuS 300) is a continual and iterative process throughout the audit.

Paragraph #	SLAuS Objective(s)
300.4	The objective of the auditor is to plan the audit so that it will be performed in an effective manner.

Paragraph #	Relevant Extracts from SLAuSs
200.15	The auditor shall plan and perform an audit with professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.
300.5	The engagement partner and other key members of the engagement team shall be involved in planning the audit, including planning and participating in the discussion among engagement team members. (Ref: Para. A4)
300.7	The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.
300.8	In establishing the overall audit strategy, the auditor shall: (a) Identify the characteristics of the engagement that define its scope; (b) Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required; (c) Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts; (d) Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and (e) Ascertain the nature, timing and extent of resources necessary to perform the engagement. (Ref: Para. A8-A11)
300.9	The auditor shall develop an audit plan that shall include a description of: (a) The nature, timing and extent of planned risk assessment procedures, as determined under SLAuS 315. (b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SLAuS 330. (c) Other planned audit procedures that are required to be carried out so that the engagement complies with SLAuS. (Ref: Para. A12)
300.10	The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. (Ref: Para. A13)
300.11	The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. (Ref: Para. A14-A15)

5.1 Overview

Planning is important to ensure that the engagement is performed in an efficient and effective manner and that audit risk has been reduced to an acceptably low level.

Audit planning is not a discrete phase of the audit. It is a continual and iterative process that starts shortly after completion of the previous audit, and continues until the completion of the current audit.

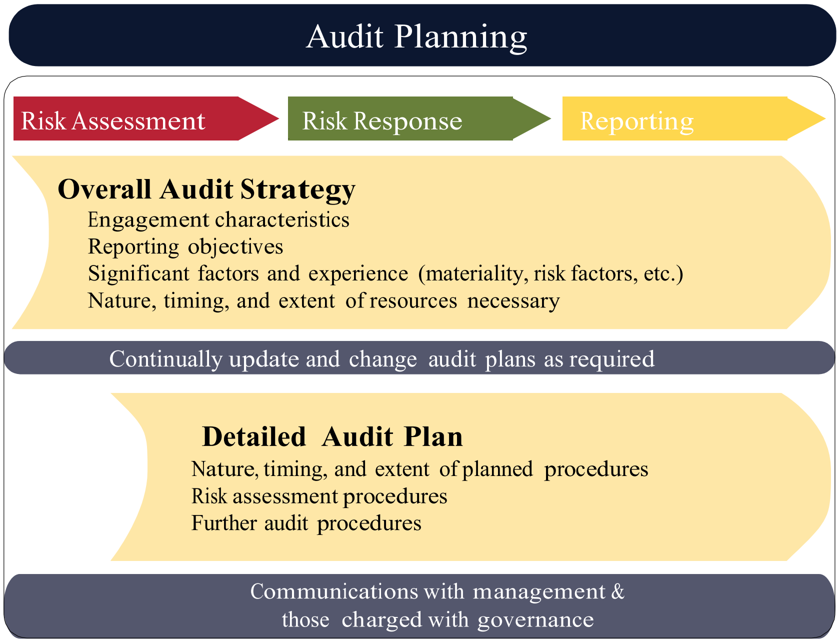
The benefits of audit planning are outlined in the exhibit below.

Exhibit 5.1-1

Benefits of Audit Planning	• Team members learn from the experience/insight of the partner and other key personnel.
	• The engagement is properly organized, staffed, and managed.
	• Experience gained from previous periods' engagements and other assignments is properly utilized.
	• Important areas of the audit receive the appropriate attention.
	• Potential problems are identified and resolved on a timely basis.
	• Audit file documentation is reviewed on a timely basis.
	• Work performed by others is coordinated (other auditors, experts, etc.).

There are two levels of planning for the audit as illustrated in the exhibit below.

Exhibit 5.1-2



CONSIDER POINT

It is often said that an hour spent planning can save five hours in execution. A well-planned audit ensures that the audit effort is directed to addressing the high-risk areas, that unnecessary audit procedures are scoped out, and that audit staff knows what is expected of them.

Development of the overall audit strategy begins at the commencement of the engagement, and is completed and then updated based on the information obtained from:

- Previous experience with the entity;
- Preliminary (client acceptance and continuation) activities;
- Discussions with the client on changes since last period and recent operating results;
- Other engagements performed for the client during the period;
- Audit team discussions and meetings;
- Other external sources such as newspaper and Internet articles; and
- New information obtained, failed audit procedures, or new circumstances encountered during the audit that will change previously planned strategies.

The detailed audit plan will begin a little later when the specific risk assessment procedures are planned and when there is sufficient information about assessed risks to develop an appropriate audit response. The requirements for developing the detailed audit plan are addressed in Volume 2, Chapter 16.

The time required to prepare an overall audit strategy will vary based on:

- The size and complexity of the entity;
- The composition and size of the audit team. Smaller audits will also have smaller teams, making planning, coordination, and communication easier;
- Previous experience with the entity; and
- Circumstances encountered in performing the audit.

CONSIDER POINT

Small entity audits are often conducted by very small audit teams. This makes coordination and communication among the team members easier, and development of the overall audit strategy can be straightforward. Documentation for small entities may be in the form of a brief memorandum that includes:

- Nature of engagement and timing;
- Issues identified in the audit just completed;
- What has changed in the current period;
- Any revisions required in the overall audit strategy or in the detailed audit plan; and
- Specific responsibilities of each member of the audit team.

Planning for the current period can start with a brief memo prepared at the end of the previous audit. However, the memo needs to be updated for the current period, based on discussions with the owner-manager and the results of audit team meetings.

5.2 Developing the Overall Audit Strategy

The overall audit strategy is a record of the key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team. The strategy will document the decisions arising from conducting the planning steps outlined in the exhibit below. Note that specific details of risk assessment and further audit procedures to be performed would be documented in the detailed audit plan.

Exhibit 5.2-1

Basic Steps	Description
Getting Started	• Perform preliminary activities (client acceptance/continuance and establish the terms of engagement). • Gather relevant information about the entity such as current operating results, results from previous engagements, and significant changes in the current period. • Assign staff to the engagement, including, where applicable, the engagement quality control reviewer and any experts required. • Schedule the audit team meeting (including the engagement partner) to discuss the susceptibility of material misstatements (including fraud) in the financial statements. • Determine the appropriate timeframes (dates) when each aspect of audit work will be undertaken (inventory counts, risk assessment procedures, external confirmations, the period-end visit, and meetings to discuss audit results).
Assessing Risks and Responses	• Determine materiality for the financial statements as a whole, and performance materiality. • Determine the nature and extent of the required risk assessment procedures and who will perform them. • When risk has been assessed at the financial statement level, develop an appropriate overall response (refer to Volume 1, Chapter 9). Also include the impact on the further audit procedures to be performed. • Communicate an overview of the planned scope and timing of the audit to those charged with governance. • Update and change the strategy and audit plan as necessary in light of new circumstances.

When the risks of material misstatement have been identified and assessed, the overall strategy (including timing, staffing, and supervision) can be finalized, and the detailed audit plan developed. The detailed plan will set out the further audit procedures required at the assertion level that respond to the identified and assessed risks.

As work commences, changes may be required to the overall strategy and detailed plans to respond to new circumstances, audit findings, and other information obtained. Any such changes are to be documented along with the reasons in the audit documentation, such as the overall audit strategy or audit plan.

The overall strategy documents relevant matters such as those listed below.

Exhibit 5.2-2

Document	Description
Engagement Characteristics	• The financial reporting framework to be used. • Additional reports required, such as stand-alone financial and industry-specific requirements (by regulators, etc.). • Any need for specialized knowledge or expertise to address complex, specific, and high-risk audit areas. • Evidence required from service organizations. • Use of evidence obtained in previous audits (such as risk assessment procedures and tests of controls). • Effect of information technology on audit procedures (availability of data and use of computer-assisted audit techniques). • Need to introduce some unpredictability in performing audit procedures. • Availability of entity personnel and data.
Reporting Objectives	• Entity’s timetable for reporting. • Timing of meetings with management and those charged with governance to discuss: − The nature, timing, and extent of the audit work. This could include dates for inventory counts, external confirmations, and interim and other required procedures, − Status of audit work throughout the engagement, and − The auditor’s report and other communications such as management letters. • Timing of meetings/communications among engagement team members to discuss: − Entity risk factors (business and fraud), − Nature, timing, and extent of work to be performed, − Review of work performed, and − Other communications with third parties.

Document	Description
Significant Factors	• Materiality (overall, individual financial statement areas, and performance materiality). • Preliminary assessment of risk at the overall financial statement level and the impact on the audit. • Preliminary identification of: − Significant and material classes of transactions, account balances, and disclosures; and − Areas where there may be a higher risk of material misstatement. • How engagement team members will be reminded to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence. • Relevant results of previous audits, including identified control deficiencies and action taken by management to address them. • Discussions with firm’s personnel who provided other services to the entity. • Evidence of management’s attitude toward internal control, and importance attached to internal control generally throughout the entity. • Volume of transactions, which may determine whether it is more efficient for the auditor to rely on internal control.
Significant Changes and Developments	• Significant business developments affecting the entity, including changes in information technology and business processes, changes in key management and acquisitions, mergers, and divestitures. • Significant industry developments, such as changes in industry regulations and new reporting requirements. • Significant changes in the financial reporting framework, such as changes in accounting standards. • Other significant relevant developments, such as changes in the legal environment affecting the entity.
Nature, Timing, and Extent of Resources Required	• The engagement team (including, where necessary, the engagement quality control reviewer). • Assignment of audit work to the team members, including the assignment of appropriately experienced team members to areas where there may be higher risks of material misstatement. • Engagement budgeting, including considering the appropriate amount of time to set aside for areas where there may be higher risks of material misstatement.

If the entity has components (such as subsidiaries or operating divisions), reference should be made to the additional planning considerations outlined in the Appendix to SLAuS 300 and to the requirements of SLAuS 600.

For smaller entities, a brief memorandum may serve as the documented overall strategy. For the audit plan, standard audit programs or checklists may be used, assuming there are few relevant control activities and provided the programs are tailored to the circumstances of the engagement, including the auditor’s risk assessments.

5.3 Communicating the Audit Plan With Management and Those Charged With Governance

Paragraph #	Relevant Extracts from SLAuSs
260.15	The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit. (Ref: Para. A11-A15)

An ongoing, two-way dialogue with management and those charged with governance can play an important role in the audit planning process. Good communication regarding the planned scope and timing of the audit may assist management and those charged with governance to:

- Understand the consequences of the auditor's work;
- Discuss issues of risk and the concept of materiality with the auditor; and
- Identify any areas in which they may request the auditor to undertake additional procedures. This dialogue may also assist the auditor in developing a better understanding of the entity and its environment.

Take care, though, not to compromise the effectiveness of the audit. For example, communicating the exact nature and timing of detailed audit procedures may reduce the effectiveness of those procedures by making them too predictable.

Matters that the auditor may consider for communication include:

- How the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error;
- The auditor's approach to internal control relevant to the audit; and
- The application of materiality in the context of an audit.

Other planning matters that may be appropriate to discuss include:

- The views of those charged with governance of:
  - The allocation of responsibilities between those charged with governance and management,
  - The entity's objectives and strategies, and the related business risks that may result in material misstatements,
  - Matters that those charged with governance consider warrant particular attention during the audit, and any areas where they request additional procedures to be undertaken,
  - Significant communications with regulators, and
  - Other matters that those charged with governance consider may influence the audit of the financial statements;
- The attitudes, awareness, and actions of those charged with governance concerning management's processes for identifying and responding to the risks of error and fraud in the entity and the internal control that management has established to mitigate such risks. This would also include how those charged with governance oversee the effectiveness of such internal control;
- The actions of those charged with governance in response to developments in accounting standards, corporate governance practices, and other related matters; and
- The responses of those charged with governance to previous communications with the auditor.

Note: This two-way communication does not change the auditor's sole responsibility to establish the overall audit strategy and the audit plan, including the nature, timing, and extent of procedures necessary to obtain sufficient appropriate audit evidence.

Further matters may be required to be communicated by law or regulation, by agreement with the entity, or by additional requirements applicable to the engagement. Also note that SLAuS 265 sets out the requirements to communicate significant deficiencies identified in internal control.

5.4 Documentation

Paragraph #	Relevant Extracts from SLAuSs
300.12	The auditor shall include in the audit documentation: (a) The overall audit strategy; (b) The audit plan; and (c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. (Ref: Para. A16-A19)

The overall audit strategy and detailed audit plan, including details of any significant changes made during the audit engagement, would be documented. The auditor may use a memorandum, standard audit programs, or audit planning and completion checklists, tailored as needed to reflect the particular engagement circumstances.

5.5 Case Studies—The Overall Audit Strategy

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

Once the decision has been made to continue with the audit, and materiality has been determined, the next step is to develop or update the overall audit strategy for conducting the engagement. This can be documented by some form of planning checklist or a brief but structured memorandum (see the consider point in 5.1 above) such as the examples that follow.

Case Study A—Dephta Furniture, Inc.

Dephta Furniture, Inc.

Overall strategy memo

Period end December 31, 20X2

Scope

The scope of the audit has not changed this period. Audit to comply with SLAuSs and the SLFRS accounting framework. There have been no changes in SLFRS that affect Dephta this year.

Entity Changes

Dephta is planning to make sales in foreign currencies.

Internet sales are also increasing and Dephta's IT capabilities will be stretched.

Dephta is now selling to Franjawa Merchandising. This company is renowned for squeezing profit margins of suppliers in exchange for giving large orders. It also requires suppliers to maintain additional inventories of some products for instant delivery as required.

Risk

Our assessment of risk at the financial statements level is **low** (refer to WP ref. #). Management is not particularly sophisticated but there is a strong commitment to competence; it has introduced a code of ethics and, in general, has a good attitude toward internal control.

Overall Strategy

- Materiality for the financial statements as a whole will be increased from Rs. 8,000 to Rs. 10,000 this period to reflect the growth in sales and profitability during the last period. Management bonuses of approximately Rs.70,000 were added back to income for calculating materiality for the financial statements as a whole [refer to working paper on determining materiality Volume 2, Chapter 6]. Performance materiality (based on our assessment of audit risk) has been set at Rs. 7,000, except for certain account balances as described on WP ref. #.
- Use the same senior staff as last period and perform the work at the same time.
- Perform our risk assessment procedures before the end of the year. There are no plans to change any major systems at present.
- At our team planning meeting to be held on November 15, we need to:
  - Consider the susceptibility of the financial statements to fraud,
  - Emphasize use of professional skepticism by our staff,
  - Identify fraud scenarios by employees and management, and
  - Focus on identification of related party transactions that have been growing and then expanding our testing.
- Attend the period-end inventory counts. There are still no ongoing inventory control procedures.
- Use David (who is knowledgeable about IT systems) to identify the risks of material misstatement relating to the Internet sales and whether any relevant internal controls exist to mitigate such risks. He will also assess the general IT controls, which were weak last year but are now understood to have been improved.

Audit partner (signed): Sang Jun Lee

Date: October 20, 20X2

Case Study B—Kumar & Co.

Kumar & Co.

Overall strategy memo

Period end December 31, 20X2

Scope

- Perform the statutory audit
- Management wants to use SLFRS for SMEs

Risk

- Risk at the financial statement level has been assessed as **moderate** (refer to WP ref. #).

Entity Changes

- Lower sales due to fewer orders from Dephta.
- Could lead to unsaleable finished-goods inventory and sales returns.
- Raj not as active in the business as in prior period, which could increase the risk of fraud.
- New financing, resulting in new bank covenants to maintain.

Overall Strategy

- Materiality for the financial statements as a whole will be decreased from Rs. 3,000 to Rs. 2,500 due to decline in sales and profitability. Performance materiality (based on our assessment of audit risk) has been set at Rs. 1,800, except for certain account balances as described on WP ref. #.
- Use the same staff as last period for continuity and audit efficiency.
- Perform risk assessment procedures at end of December.
- At our team planning meeting to be held on November 30, we need to:
  - Consider the susceptibility of the financial statements to fraud,
  - Discuss the potential for employee fraud and management override. The bookkeeper seems disgruntled and may have motivation and opportunity. Raj has not been as involved in reviewing the financial statements as he did in the past, and
  - Focus on the growing related party transactions to Dephta.
- Attend the period-end inventory count.
- Expand our testing with regard to related party transactions.

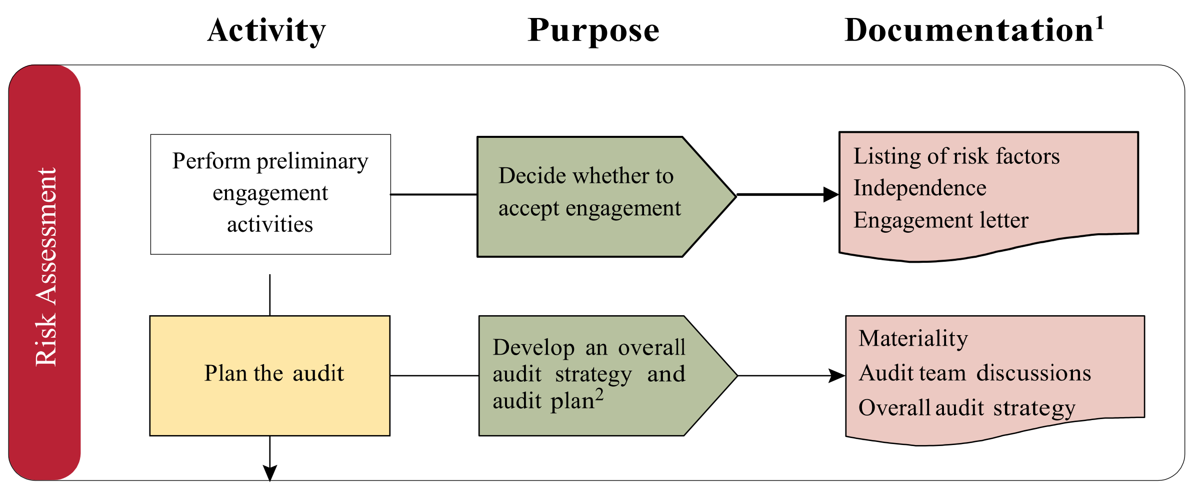
Audit partner (signed): Sang Jun Lee

Date: October 20, 20X2

6. Determining and Using Materiality

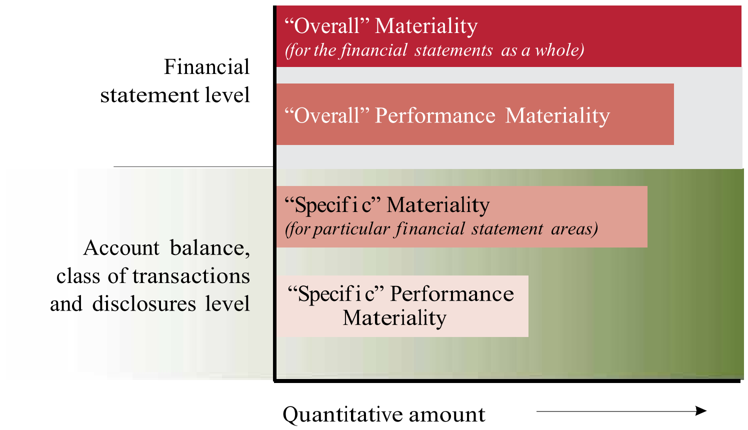
Chapter Content	Relevant SLAuSs
Determination and use of materiality in an audit engagement.	320, 450

Exhibit 6.0-1



Notes:
1. Refer to SLAuS 230 for a more complete list of documentation required.
2. Planning (SLAuS 300) is a continual and iterative process throughout the audit.

Exhibit 6.0-2



Note: The terms "overall" materiality and "specific" materiality used in the exhibit above and in the text below are used solely for the purposes of this Audit Manual and are terms that are not used in the SLAuSs. Overall materiality refers to the financial statements as a whole, and specific materiality relates to materiality of particular classes of transactions, account balances, or disclosures.

Paragraph #	SLAuS Objective(s)
320.8	The objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.
450.3	The objective of the auditor is to evaluate: (a) The effect of identified misstatements on the audit; and (b) The effect of uncorrected misstatements, if any, on the financial statements.

Paragraph #	Relevant Extracts from SLAuSs
320.9	For purposes of the SLAuSs, performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.
320.10	When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or levels to be applied to those particular classes of transactions, account balances or disclosures. (Ref: Para. A2-A11)
320.11	The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (Ref: Para. A12)
320.12	The auditor shall revise materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) in the event of becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially. (Ref: Para. A13)
320.13	If the auditor concludes that a lower materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures) than that initially determined is appropriate, the auditor shall determine whether it is necessary to revise performance materiality, and whether the nature, timing and extent of the further audit procedures remain appropriate.
320.14	The auditor shall include in the audit documentation the following amounts and the factors considered in their determination: (a) Materiality for the financial statements as a whole (see paragraph 10); (b) If applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures (see paragraph 10); (c) Performance materiality (see paragraph 11); and (d) Any revision of (a)-(c) as the audit progressed (see paragraphs 12-13).

Paragraph #	Relevant Extracts from SLAuSs
450.6	The auditor shall determine whether the overall audit strategy and audit plan need to be revised if: (a) The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material; or (Ref: Para. A4) (b) The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SLAuS 320. (Ref: Para. A5)

6.1 Overview

Decisions made by the auditor on materiality will form the basis for risk assessments and for determining the extent of auditing procedures required.

Determining materiality is a matter of professional judgment. It is based on the auditor's perception of the common financial information needs of users of the financial statements as a group. Overall materiality (which is a term used in this Audit Manual to summarize materiality for the financial statements as a whole) is the total amount of misstatements in a financial statement, including omissions, which, if exceeded, could reasonably be expected to influence the economic decisions of users. This differs from audit risk, which relates to an inappropriate audit opinion being issued on financial statements that are materially misstated.

This chapter addresses the determination of overall and specific materiality, and the auditor's use of performance materiality to obtain sufficient and appropriate audit evidence. Materiality is used throughout the audit for audit planning, risk assessment, risk response, and reporting. Additional information on materiality and audit risk is contained Volume 1, Chapter 7 of this Audit Manual.

There are two levels of materiality to consider—overall materiality, and specific materiality—as described below.

Exhibit 6.1-1

	Description
Overall Materiality *(For the Financial Statements as a Whole)*	Materiality for the financial statements as a whole (overall materiality) is based on the auditor's professional judgment as to the highest amount of misstatement(s) that could be included in the financial statements without affecting the economic decisions taken by a financial statement user. If the amount of uncorrected misstatements, either individually or in the aggregate, is higher than the overall materiality established for the engagement, it would mean that the financial statements are materially misstated. Overall materiality is based on the common financial information needs of the various users as a group. Consequently, the possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

	Description
Specific Materiality (*Materiality Level or Levels for Particular Classes of Transactions, Account Balances, or Disclosures)*	In some cases, there may be a need to identify misstatements of lesser amounts than overall materiality that would affect the economic decisions of financial statement users. This could relate to sensitive areas such as particular note disclosures (i.e., management remuneration or industry-specific data), compliance with legislation or certain terms in a contract, or transactions upon which bonuses are based. It could also relate to the nature of a potential misstatement.

Nature of Misstatements

In addition to the size of a misstatement, the auditor would consider the nature of potential misstatements and the particular circumstances of their occurrence when evaluating their effect on the financial statements. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below materiality. Examples could include illegal acts, non-compliance with loan covenants, and non-compliance with statutory/regulatory reporting requirements. However, it is not considered practicable to design audit procedures to detect misstatements that could be material solely because of their nature.

Performance Materiality

Performance materiality is used by the auditor to reduce the risk to an appropriately low level that the accumulation of uncorrected and unidentified misstatements exceeds materiality for the financial statements as a whole (overall materiality), or materiality levels established for particular classes of transactions, account balances, or disclosures (specific materiality).

Performance materiality is set at a lower amount (or amounts) than overall or specific materiality. The objective is to perform more audit work than would be required by the overall or a specific materiality to:

- Ensure that misstatements less than overall or specific materiality are detected, so as to appropriately reduce the probability that the aggregate of uncorrected errors and undetected misstatements exceeds materiality for the financial statements as a whole; and thus
- Provide a margin or buffer for possible undetected misstatements. This buffer is between detected but uncorrected misstatements in the aggregate and the overall or specific materiality.

This margin provides some assurance for the auditor that undetected misstatements, along with all uncorrected misstatements, will not likely accumulate to reach an amount that would cause the financial statements to be materially misstated.

The determination of performance materiality is not a simple mechanical calculation. It involves the exercise of professional judgment based on the specific risk factors identified, the auditor's understanding of the entity, and any matters the auditor has identified in previous audit engagements.

Performance materiality is set in relation to overall materiality or specific materiality. For example, a specific performance materiality can be set at a lower amount than overall performance materiality for testing repairs and maintenance expenses if there is a higher risk of assets not being capitalized. Specific performance materiality may also be used to perform additional work in areas that may be sensitive due to the nature of potential misstatements and their occurrence, rather than their monetary size.

6.2 How to Determine Materiality

The following paragraphs address the determination and use of overall and specific materiality.

Overall Materiality

Overall materiality is based on the auditor's perceptions of the needs of financial statement users. Auditors can assume the following about financial statement users.

Exhibit 6.2-1

	Assumptions
Financial Statement Users	• Have a reasonable knowledge of business and economic activities and accounting; • Have a willingness to study the information in the financial statements with reasonable diligence; • Understand that financial statements are prepared, presented, and audited to levels of materiality; • Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment, and the consideration of future events; and • Make reasonable economic decisions on the basis of the information in the financial statements.

A percentage numerical threshold (or benchmark) is often used as a starting point in the determination. The nature of the benchmark and the percentage to be applied are based on professional judgment. For example, in an owner-managed business where the owner takes much of the profit before tax in the form of remuneration, a benchmark such as profit before remuneration and tax may be more relevant.

CONSIDER POINT

To provide some consistency, accounting firms may want to establish some firm-wide guidelines on how materiality will be initially be determined, including the use of appropriate benchmarks. However, the actual benchmark to be used would be based on professional judgment in light of the particular circumstances of the entity. This also applies to the use of performance materiality, which is essentially a tool used by the auditor to address the risk of material misstatement by "catching" misstatements that fall below a certain threshold.

When identifying an appropriate benchmark to use, the auditor would consider the matters outlined in the exhibit below, and obtain an understanding of the views and expectations of management and those charged with governance.

Exhibit 6.2-2

	Consider
Choosing the Right Benchmark to Use	**Users** Determine who are the likely users of the financial statements. This would include the entity's owners (and other shareholders) and those charged with governance, financial institutions, franchisors, major funders, employees, customers, creditors, and government agencies and departments.

<table>
<tr><th></th><th>Consider</th></tr>
<tr><td rowspan="8">Choosing the Right Benchmark to Use
(continued)</td><td>Specific user expectations
Identify any specific user expectations such as the following:
• Measurement or disclosure of items such as related party transactions, management remuneration, and compliance with sensitive laws and regulations;
• Industry-specific disclosures such as exploration costs in a mining company and research costs in a high technology or pharmaceutical company;
• Major events or contingencies. This could include disclosure of events such as an acquisition, divestiture, restructuring, or significant legal proceedings against the entity; and
• Existence of covenants in loan agreements, particularly those where the entity is close to breaching a covenant. If a small uncorrected error would mean that a covenant had been violated, this could have a significant effect on the financial statements and could, at worst, affect the appropriateness of using the going concern assumption in preparing the financial statements.</td></tr>
<tr><td>Relevant financial statement elements
What are the major elements of the financial statements that will be of interest to users (e.g., assets, liabilities, equity, income, and expenses)?</td></tr>
<tr><td>Nature of the entity
Consider the nature of the entity, where the entity fits in the life cycle (growing, mature, declining, etc.), and the industry and economic environment in which the entity operates.</td></tr>
<tr><td>Adjustments required
Are adjustments required to “normalize” the benchmark base? For example, income from continuing operations could be adjusted for:
• Unusual or non-recurring revenue/expense items; and
• Items such as a management bonus, which may be based on profits before the bonus or simply paid out to reduce income left in the company.</td></tr>
<tr><td>The primary focus of users
What information in financial statement items will attract the most attention by users? For example, users interested in:
• Evaluating financial performance will focus on profits, revenues, or net assets; and
• The resources utilized to achieve certain goals or ends will focus on the nature and extent of revenues and expenditures.</td></tr>
<tr><td>Financing
How is the entity financed? If financed solely by debt (rather than equity capital), users may put more emphasis on the pledged assets and any claims than on the entity’s earnings.</td></tr>
<tr><td>Volatility
How volatile is the proposed benchmark? For example, a benchmark based on earnings might normally be appropriate, but if the entity is operating close to break-even each period (such as small profits or losses) or their results fluctuate widely, it may not be the appropriate base for determining materiality.</td></tr>
<tr><td>Alternatives
Is an alternative benchmark necessary to address special circumstances? Alternative benchmarks could include current assets, net working capital, total assets, total revenues, gross profit, total equity, and cash flow from operations.</td></tr>
</table>

Performance Materiality

Whereas overall and specific materiality is set in relation to the needs of financial statement users, performance materiality is set at a lower amount. This will result in more audit work being performed (smaller misstatements may be identified) and audit risk being reduced to an appropriately low level.

If the audit was planned solely to detect individually material misstatements, there would be no margin of error to identify and account for immaterial misstatements that might exist. As a result, it could be possible for the aggregate of individually immaterial misstatements to cause the financial statements to be materially misstated.

Performance materiality is designed to:

- Ensure that immaterial misstatements less than overall or specific materiality are detected, and
- Provide a margin or buffer for possible undetected misstatements. This buffer is between detected but uncorrected misstatements in the aggregate and the overall or specific materiality.

The determination of performance materiality would not be a simple mechanical calculation such as 80% of overall materiality. This simplification would ignore specific risk factors that may be relevant to the entity. For example, if there was a high risk of errors in inventory pricing, performance materiality could be lowered so that additional work is performed to identify the extent of misstatements. Conversely, if the risk of misstatement in the receivables balance is assessed as low, the performance materiality could be raised, resulting in less substantive audit work on the balance.

Performance materiality requires the auditor to exercise professional judgment and is affected by:

- The auditor's understanding of the entity, which is updated during the execution of the risk assessment procedures; and
- The nature and extent of misstatements identified in previous audits.

CONSIDER POINT

Do not reduce the overall materiality level based on high audit risks

Avoid the mistake of reducing the overall (financial statement) materiality level because of an audit risk assessed as high. Overall materiality is based on users' information needs, not on how risky a particular balance might be to audit. Lowering the overall materiality threshold implies that:

- The decision of a financial statement user is affected by audit risk rather than the information contained in the financial statements; and
- Additional work will be performed by the auditor to ensure that no misstatements exist in the financial statements that, individually or accumulated together, exceed the overall materiality threshold.

A better approach is to address audit risk by setting the performance materiality at the class of transaction or account balance level at a lower level. This will ensure that sufficient work is performed to detect any misstatements, without having to reduce the overall materiality level. It also creates a safety buffer to cover unidentified misstatements in the work performed.

Establish the overall materiality level by reference to financial statement users, and then establish performance materiality for the purpose of designing further audit procedures.

Sensitive financial statement disclosures, balances, and issues

Use a specific performance materiality for designing further audit procedures that address specific risks and balances in sensitive audit areas.

Summary

The materiality levels and use of performance materiality are summarized in the exhibit below.

Exhibit 6.2-3

	Overall	Specific	Performance
Purpose	To establish the threshold for determining whether the financial statements are free from material misstatement, whether due to error or fraud.	To establish a threshold(s) (lower than overall materiality) to be applied to particular classes of transactions, account balances, or disclosures where misstatements of lesser amounts than overall materiality for the financial statements could reasonably be expected to influence the economic decisions of users.	To establish the threshold(s) (lower than overall or specific materiality) that ensures immaterial misstatements (less than overall or specific materiality) are identified, and provide the auditor with a safety margin.
Basis of Calculation	What level of misstatement in the financial statements would be tolerable to users (i.e., would not affect the economic decisions made by a financial statement user)?	What level of misstatement relating to special circumstances in a particular class of transactions, account balances, or disclosures could reasonably be expected to influence the economic decisions of users?	What amount of audit work will be required to: • Identify misstatements below overall or specific materiality; and • Leave a sufficient buffer for undetected misstatements?
Rules of Thumb (For Use as a Starting Point)	Materiality is a matter of professional judgment rather than a mechanical exercise. As a result, no specific guidance is provided in the SLAuS. However, profit from continuing operations (3 to 7%) is often used in practice as having the greatest significance to financial statement users. If this is not a useful measure (such as for a not-for-profit entity or where profit is not a stable base), then consider other bases such as: • Revenues or expenditures 1 to 3%; • Assets 1 to 3%; or • Equity 3 to 5%.	Establish a lower, specific materiality amount (based on professional judgment) for the audit of specific or sensitive financial statement areas.	No specific guidance is provided in the SLAuSs. Percentages range from 60% (of overall or specific materiality), where there is a higher risk of material misstatement, up to 85%, where the assessed risk of material misstatement is less.

	Overall	Specific	Performance
Use in the Audit	Determining whether uncorrected misstatements, individually or in aggregate, exceed overall materiality.	Determining whether uncorrected misstatements, individually or in aggregate, exceed the specific materiality.	• Assessing the risks of material misstatement; and • Designing further audit procedures to respond to assessed risks.
Revision as Audit Progresses	• A change in circumstances that occurred during the audit such as the sale of part of the business; • New information; or • A change in the auditor's understanding of the entity and its operations, as a result of performing further audit procedures (e.g., actual operating results being very different from expected).	A change in the special circumstances.	• Changes in assessed risks; • Nature and extent of misstatements found when performing further audit procedures; or • Change in understanding of the entity.

6.3 Materiality in Planning and Risk Assessment

Determining the various materiality levels is a key component of the planning process. This is not a discrete phase of an audit, but rather a continual and iterative process. The following exhibit summarizes the use of materiality in planning and risk assessment.

Exhibit 6.3-1

	Materiality
Planning *(Overall Strategy and Audit Plans)*	Use materiality to: • Determine what financial statement areas require auditing. • Set the context for the overall audit strategy. • Plan the nature, timing, and extent of specific audit procedures. • Determine specific materiality for particular classes of transactions, account balances, or disclosures where misstatements at lesser amounts than overall or performance materiality could reasonably be expected to influence the economic decisions of users. • Determine performance materiality for each specific materiality level, as it may be necessary for the auditor to work using a performance materiality level for a particular class of transactions, account balance, or disclosure, depending on the level of risk associated with that item. • Evaluate later evidence to determine the need for any adjustment to any of the materiality levels. If so, the auditor would revise the nature, timing, and extent of procedures accordingly.

	Materiality
Risk Assessment Procedures	• Identify what risk assessment procedures are necessary. • Provide a context when evaluating the information obtained. • Assess the magnitude (impact) of the risks identified. • Assess results of risk assessment procedures.
Team Meetings	• Ensure that team members understand the identified users and what could reasonably be expected to change their economic decisions. This may help in the event that a team member becomes aware of information during the audit that would have caused a different amount of materiality to be determined initially. Examples of such matters include: – A decision to dispose of a major part of the entity's business, – New information or risk factors that would have affected the initial determination of materiality, and – A change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures, such as when actual financial results are substantially different from anticipated results. • Establish overall audit strategy. • Determine the extent of testing in relation to: − Performance materiality, and − Specific performance materiality. • Identify critical audit issues and areas for significant audit focus.

CONSIDER POINT

The determination of overall performance and specific performance materiality levels requires the use of professional judgment. It is suggested (but not required) that teams discuss the judgments applied in determining materiality levels with the engagement partner and obtain his/her approval. Finally, record the judgments used in determining materiality in sufficient detail in the audit working papers.

6.4 Materiality in Performing Audit Procedures

Auditors should consider materiality when determining the nature, timing, and extent of audit procedures, as illustrated in the following exhibit.

Exhibit 6.4-1

	Materiality
Performing Audit Procedures	**Use materiality to:** • Identify what further audit procedures are necessary. • Determine which items to select for testing and whether to use sampling techniques. • Assist with determining sample sizes (e.g., sampling interval = precision (materiality) ÷ confidence factor). • Evaluate representative sampling errors by extrapolating across population for "likely" misstatements. • Evaluate the aggregate of total errors at the account level up to the financial statement level. • Evaluate the aggregate of total errors, including the net effect of uncorrected misstatements in opening retained earnings. • Assess results of procedures.

Note: The overall audit strategy and audit plan will need to be revised where:

- The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material; or
- The aggregate of misstatements accumulated during the audit approaches materiality.

CONSIDER POINT

Overall materiality is unlikely to change very often. However, it may need to be revised as the auditor becomes aware of new information or if there is a change in the auditor's understanding of the entity and its operations. If a change is required, ensure that the audit team is informed and assesses the impact on the audit plan.

Performance materiality may change based on new risk factors or new audit findings that may not impact overall materiality. Changes in performance materiality will result in the modification of the nature, timing, and extent of audit procedures. Of course, if overall materiality changes, a corresponding change will likely be required in performance materiality.

6.5 Materiality in Reporting

Paragraph #	Relevant Extracts from SLAuSs
450.11	The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider: (a) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and (Ref: Para. A13-A17, A19-A20) (b) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. (Ref: Para. A18)
450.12	The auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected. (Ref: Para. A21-A23)

Refer to Volume 2, Chapter 21 for more information on evaluating misstatements.

Prior to issuing an opinion, the auditor would:

- Confirm the materiality established for the financial statements as a whole;
- Evaluate the nature and the aggregate of uncorrected misstatements that are identified; and
- Make an overall assessment as to whether the financial statements are materially misstated.

Exhibit 6.5-1

	Materiality
Reporting	The auditor would use materiality to: • Evaluate the aggregate of total errors at the account level up to the financial statement level. • Evaluate the aggregate of total errors, including the net effect of uncorrected misstatements in opening retained earnings. • Determine whether additional audit procedures should be performed when the aggregate misstatements are approaching overall or specific materiality. • Request that management correct all identified misstatements. • Consider rechecking areas of highest misstatement. • Make judgments about the nature and sensitivity of the misstatements identified, as well as their size. • Determine whether the auditor’s report needs to be modified due to uncorrected material misstatements.

The aggregate of misstatements is made up of:

- Specific misstatements identified by the auditor as a result of their audit testing; and
- An estimate of other misstatements identified that cannot otherwise be specifically quantified.

The auditor would then request management to record all the identified misstatements. Refer to Volume 2, Chapter 21 for additional information on evaluating audit evidence obtained.

6.6 Other Considerations

Other considerations include:

- Communicating to management and those charged with governance;
- Updating materiality; and
- Reducing materiality level from previous period.

Communicating with Management and Those Charged With Governance

Management and those charged with governance need to understand the limitations concerning the degree of precision that can be expected from an audit. They also need to be aware that it is not economically feasible to design audit procedures that will provide absolute assurance that the financial statements are not materially misstated. An audit can provide only reasonable assurance in this regard.

When misstatements are identified by the auditor during the course of the audit, the first step is to request from management that all the uncorrected misstatements be corrected. If management decides not to correct certain misstatements, the auditor is then required to communicate with those charged with governance the following:

- Details of uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report (unless prohibited by law or regulation);
- Material uncorrected misstatements individually; and
- The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances, or disclosures, and the financial statements as a whole.

Updating Materiality

The preliminary assessment of overall and performance materiality may change from the initial audit planning to the time of evaluating the results of the audit procedures. This could result from a change in circumstances or from a change in the auditor's knowledge as a result of performing audit procedures. For example, if audit procedures are performed prior to the period end, the auditor will anticipate the results of operations and the financial position. If the actual results of operations and financial position are substantially different, the assessments of materiality and audit risk may also change.

Reducing Materiality Level from Previous Period

When circumstances change from one period to the next, the auditor should consider the effect of any misstatement on the opening equity. For example, where sales and income are substantially less than the previous period's, a lower materiality is required. Errors could exist in opening figures, as the audit was previously conducted using a higher materiality level. To reduce the risk of a material error occurring in the opening equity, the auditor may perform further audit procedures on the opening asset and liability balances.

CONSIDER POINT

New engagements
When accepting a new audit engagement, inquire about the overall materiality used by the previous auditor. If available, this would help in determining whether further audit procedures may be required on the opening asset and liability balances.

Use of management experts
Ensure that any experts employed by the entity (to assist the entity in preparing the financial statements) or used by the audit team are instructed to use an appropriate materiality level in relation to the work they perform.

6.7 Documentation

Document the determination of the following and the factors considered in their determination:

- Overall materiality;
- Where applicable, the specific materiality level(s) for particular classes of transactions, account balances, or disclosures;
- Performance materiality; and
- Any revision of the above factors as the audit progresses.

6.8 Case Studies—Determining and Using Materiality

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

Materiality is often documented on a worksheet that includes a summary of operating results and provides space for other materiality considerations such as qualitative factors.

Case Study A — Dephta Furniture, Inc.

Dephta Furniture, Inc.

(Excerpt)

Materiality assessment

The main users of the financial statements are the bank and the shareholders. The materiality number used in last period was Rs.8,000.

See WP ref. # for possible materiality amounts based on income from continuing operations, as well as revenue. Using our professional judgment, we decided to base our materiality on 5% of the profit before tax after adding back the management bonus of Rs.70,000. Other bases for materiality, such as revenues, were also considered but it was felt that profit before tax was the most meaningful amount in relation to the identified financial statement users.

For this period, the plan is to use Rs.10,000 as the overall materiality. The concept of materiality and its use in the audit has been discussed in general terms with the client.

Using professional judgment, and the types of misstatements identified in previous audits, overall performance materiality has been set at Rs.7,500.

A specific materiality for the local sales taxes paid has been set at Rs.1,000 as we are required to audit and report on this amount to the local government.

Also see WP 615 on quantitative analysis……..

Prepared by: JF **Date:** December 8, 20X2

Reviewed by: LF **Date:** January 5, 20X3

Case Study B—Kumar & Co.

Kumar & Co.

(Excerpt)

Materiality assessment
The main users of the financial statements are the bank and the owners.

The materiality number used in the last period was Rs.3,000.

Based on consideration of user needs, we decided to base materiality at approximately 1% of sales.
In our judgment, revenues provide a more stable base for materiality than profits before tax. For this period, we plan to use Rs.2,500 as the overall materiality. The concept of materiality and its use in the audit has been discussed in general terms with the client.

Using professional judgment, which is largely based on the history of errors in previous periods, overall performance materiality has been set at Rs.1,800.

Other matters
See WP 615 for…..

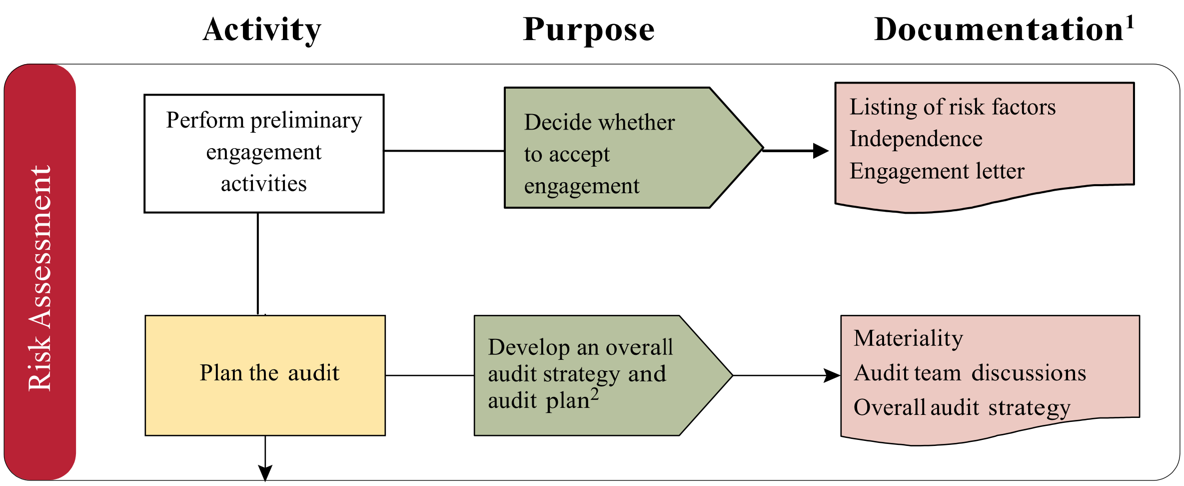
Prepared by: JF **Date:** December 8, 20X2

Reviewed by: LF **Date:** January 5, 20X3

7. Audit Team Discussions

Chapter Content	Relevant SLAuSs
Purpose and nature of required discussions among the audit team about the susceptibility of the entity's financial statements to material misstatements.	240, 300, 315

Exhibit 7.0-1



Notes:
1. Refer to SLAuS 230 for a more complete list of documentation required.
2. Planning (SLAuS 300) is a continual and iterative process throughout the audit.

Paragraph #	Relevant Extracts from SLAuSs
240.15	SLAuS 315 requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion. This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. (Ref: Para. A10-A11)

Paragraph #	Relevant Extracts from SLAuSs
240.44	The auditor shall include the following in the audit documentation of the auditor's understanding of the entity and its environment and the assessment of the risks of material misstatement required by SLAuS 315: (a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and (b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.
315.10	The engagement partner and other key engagement team members shall discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion. (Ref: Para. A14-16)

7.1 Overview

A critical element in the success of any audit engagement is good communication among the audit team members. Communication starts with the assignment of team members, arranging the team meeting to plan the engagement, and then continues throughout the engagement. The benefits of good communication include those set out in the following exhibit.

Exhibit 7.1-1

	Benefits
Need for Ongoing Communication Among the Audit Team Members	**Audit productivity** • Each person on the team will understand the entity being audited, the financial reporting framework to be used, what his/her specific role will be in the audit, and the expectations about how and when work will be performed. • Potential for over- and under-auditing will be significantly reduced.
	Audit effectiveness • Staff is provided insights into the client and audit expectations directly from senior personnel such as the engagement partner. • Team discussions on the susceptibility of the financial statements to material misstatements will help determine the business and fraud risks that need to be addressed. • Better decisions will be made about the nature, timing, and extent of risk assessment and further audit procedures. • Open lines of communication enable quick reactions to new information in areas such as unusual transactions/events, related parties, and reporting issues.
	Staff development • Best practices in auditing will be transferred from partners to staff. • Staff will be encouraged to ask questions and reconsider the effectiveness of the previous period's responses to assessed risks.

Effective ongoing communication requires:

- Involvement by (and undivided attention of) the engagement partner and senior personnel; and
- Willingness of senior personnel to listen to junior staff. This includes understanding the engagement from the perspective of junior staff, encouraging their questions and suggestions, and then providing feedback.

The following exhibit summarizes what to consider and discuss in audit team communications.

Exhibit 7.1-2

Audit Team Communications

Assigning team members and roles

Consider:
- Skills and experience
- Need for experts
- Need for engagement quality control reviewer

Team Planning meeting

Discuss:
- Materiality
- Insights based on knowledge of entity
- Potential business and fraud risks
- How/where financial statements might be susceptible to material misstatement
- Audit plan including who, what, where & when
- Supervision and review

During and after the audit

Discuss:
- Audit results, progress, and issues identified
- Changes in audit plan
- New information
- Unusual events/ transactions
- Suggestions for next period's audit

CONSIDER POINT

Audit team discussions are critical to an effective audit. Avoid the temptation to rush through the agenda due to other time pressures. These discussions enable audit risks to be discussed, fraud scenarios to be developed, and possible responses drafted. It also provides an opportunity for staff to learn about the entity's business and what is expected from them on the audit. Staff can also be encouraged to put forward their ideas on how the audit could be improved.

7.2 Audit Team Planning Meeting

On larger engagements, a planning meeting should be scheduled well in advance of the commencement of fieldwork. This will provide the time necessary to prepare or make changes in the detailed audit plan. On very small engagements, planning may best be achieved through brief discussions at the start of the engagement and as the audit progresses.

Team members should be encouraged to come to the meeting with a questioning mind, and be prepared to participate and share information with an attitude of professional skepticism. They should set aside any beliefs that management and those charged with governance are honest and have integrity. The extent of the discussion should be influenced by the roles, experience, and the information needs of the audit engagement team members.

The three key areas to address are outlined in the exhibit below.

Exhibit 7.2-1

Key Areas to Address	Purpose: To have an open discussion
Share Insights on the Entity, Such As the People, Operations, and Objectives	**The entity** • History and business objectives. • The corporate culture. • Changes in operations, personnel, or systems. • Application of the applicable financial reporting framework to the entity's facts and circumstances. **Management** • The nature/structure of the entity and management. • The attitude toward internal control. • Incentives to commit fraud. • Unexplained changes in the behavior or lifestyle of key employees. • Any indications of management bias. **Known risk factors** • Experience from previous audit engagements. • Significant business risk factors. • Opportunity for fraud to be perpetrated.

Key Areas to Address	Purpose: To brainstorm ideas and possible audit approaches
Brainstorm	**Potential for errors and fraud** • Which financial statement areas may be susceptible to material misstatement (fraud and error)? This step is a requirement on all audits. • How could management perpetrate and conceal fraudulent financial reporting? It may be helpful to develop various fraud scenarios or, where possible, use the services of a forensic accountant. Consider journal entries, management bias in estimates/provisions, changes in accounting policies, etc. • How could assets be misappropriated or misused for personal purposes? • Are there non-selfish incentives (such as to maintain a funding source for a not-for-profit entity) to manipulate the financial statements? **Response to risks** • What possible audit procedures/approaches might be considered to respond to the risks identified above? • Consider whether an element of unpredictability will be incorporated into the nature, timing, and extent of the audit procedures to be performed.

Key Areas to Address	Purpose: To provide direction
Audit Planning	**Specific areas to address:** Ensure that the specific requirements of all SLAuSs relevant to the audit are appropriately addressed in the audit plan. SLAuSs that include specific procedures to be performed include: SLAuS 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* SLAuS 402 *Audit Considerations Relating to an Entity Using a Service Organization* SLAuS 540 *Auditing Accounting Estimates, Including Fair value Accounting Estimates, and Related Disclosures* SLAuS 550 *Related Parties* SLAuS 600 *Audits of Group Financial Statements (Including the Work of Component Auditors)* Provide direction to the audit team: • Determine materiality levels. • Assign roles and responsibilities. • Provide staff with an overview of the audit sections they are responsible for completing. Address the approach required, special considerations, timing, documentation required, the extent of supervision provided, file review, and any other expectations. • Stress the importance of maintaining professional skepticism throughout the audit.

Note: If non-key members of the audit team are not able (or are not invited) to attend the meeting, the engagement partner would determine which matters arising are to be communicated to them.

CONSIDER POINT

Emphasize the importance for staff to be alert for indications of dishonesty, but also to be careful not to jump to any conclusions, particularly when discussing findings with the entity's management or staff. Indicate possible circumstances (red flags) that, if encountered, might indicate the possibility of fraud.

Fraud is generally discovered by identifying patterns, exceptions, and oddities in transactions and events. For example, a false claim in an expense account would be immaterial to the financial statements by itself, but could be indicative of a much larger issue such as lack of management integrity.

7.3 Communication During and At Completion of the Audit

Each member of the audit team will have a slightly different perspective on the entity. Some of the information gathered by a particular team member may not even make sense unless it is combined with information obtained by other team members. This is particularly true in relation to fraud, where it is the identification of small patterns, oddities, and exceptions that may lead to its ultimate detection.

A simple analogy is the jigsaw puzzle. Each part by itself does not enable a person to see the entire picture; it is only when all the pieces are put together that the big picture can be seen. The same is true in auditing. It is only when the individual knowledge/findings of each auditor are shared with the team that the bigger picture emerges. This is illustrated in the following exhibit.

Exhibit 7.3-1
Sharing Findings

Team discussions need not be confined to just the planning meeting. Audit team members should be encouraged to communicate and share the information that they obtain throughout the audit on any matters of relevance, particularly when it affects the assessment of risk and planned audit procedures.

CONSIDER POINT

Hold short debriefing meetings at strategic times during the audit
In addition to the audit planning discussions at the start of the engagement, it may be beneficial (but not required) for the audit team, however small, to meet (or arrange a conference call) and discuss audit findings after the following audit phases.

Performing risk assessment procedures and further audit procedures
These debriefing sessions do not need to be formal or long, but they enable audit team members to report verbally on their findings, exceptions found, and concerns noted. They can also report on any matters (however small) that seemed odd or did not make sense. It is often the small matters that, when combined with information obtained by other team members, point to a possible risk factor (such as fraud) that may require further work to be performed. Even when the audit team comprises only two people, these meetings can yield significant results.

CONSIDER POINT (*continued*)

Completing the audit

Once the previous audit is complete, the temptation is always to move on and start the next engagement. As a result, a lot of knowledge that could be helpful for performing the next period's audit can get lost. A short meeting or conference call after each audit could be used to obtain feedback from the audit team and determine what can be improved. This would include identifying:

- Audit areas that might require additional, or less, attention in the future;
- Any other unexpected findings, unusual transactions, or financial pressures on personnel that may be an indicator of fraud or an incentive to commit fraud;
- Any planned changes that will affect future engagements such as key personnel changes, new financing, an acquisition, new products or services, the installation of a new accounting system, or other internal control changes;
- Areas where additional assistance could be provided by the entity such as an analysis of certain financial statement areas; and
- Where significant risk factors exist, the debriefing meeting could also address whether the firm wishes to continue with the client the following period. If the firm resigns right after the audit finishes, the reasons will be fresh in everyone's mind, and it would provide the entity with more time to find another auditor.

At the initial planning meeting, a time and date for these debriefing sessions can be scheduled.

7.4 Case Studies—Audit Team Discussions

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

The most recent financial statements, the listing of assessed risks from previous periods (or this period, if updated), and the audit response could usefully be circulated to engagement team members before the meeting. At the meeting, emphasize the need for professional skepticism, and the need to immediately report any suspicious situations or possible warning signals of fraud.

Documentation may be in the form of a standard agenda or a memo to file.

Case Study A — Dephta Furniture, Inc.

Date of meeting: December 8, 20X2

Agenda item	Minutes of meeting
1. Materiality and significant account balances.	*Increase overall materiality to Rs.10,000 based on growth in profitability and sales, and performance materiality to Rs. 7,500.*
2. Timing, key dates, and availability of client personnel.	*Confirmed that last period's timing is appropriate* and our requests for management help in preparing *certain schedules are reasonable.*
3. What can we learn from past experience such as issues/events that caused delays and areas of over-/under-auditing?	*Inventory internal control was poor last year and resulted in additional work. Client has indicated that this will be addressed before this period end.*
4. Any new concerns about management integrity, going concern, litigation, etc.?	*See newspaper clipping re: Parvin. This may be isolated but we need to be cautious.*
5. Changes this period in business operations and/or financial condition, industry regulations, accounting policies used, and people.	*Internet sales now account for 12% of sales. There are also plans for significant growth. This will put a strain on cash resources, internal control, and the operating systems. The current economic downturn puts additional pressure on the organization to maintain sales levels despite the drop in demand and sales prices.*
6. Susceptibility of the financial statements to fraud. In what possible ways could the entity be defrauded? Develop some possible scenarios, and then plan procedures that would confirm or dispel any suspicions.	*Management bias and override to avoid tax liability are possible. Management's estimates, journal entries, and related party transactions are susceptible to manipulation. Also, Arjan (the senior salesperson) lives an expensive lifestyle. We should also look at the bonus calculations and the sales revenue.*
7. Significant risks that require special attention.	*Defaulting on bank covenants. Suraj says he is going to renegotiate the bank terms this period to provide some flexibility.*
8. Appropriate audit responses to the risks identified.	*The detailed audit plan was reviewed in some detail with the staff member responsible and a number of efficiencies were identified.*
9. Consider the need for specialized skills or consultants, testing internal controls vs. substantive procedures, the need to introduce unpredictability in some audit tests, and work that could be completed by the client.	*IT specialist to look at Internet sales and IT controls in general. Scheduled visit for December this period.*
10. Audit team roles, scheduling, and file reviews	*Overall and detailed audit plans have been updated.*
Prepared by: FJ **Date:** December 8, 20X2 **Reviewed by:** LF **Date:** January 5, 20X3	

Case Study B — Kumar & Co.

Memo to file: Kumar & Co.

On December 8, 20X2, the audit team (partner and senior) met to plan the Kumar & Co. audit engagement.

We discussed the following:

- Overall materiality has been decreased to Rs.2,500 based on decline in profitability and sales. Performance materiality has been set at Rs.1,800.
- Raj's focus has been diverted recently to personal family matters. The bookkeeper's work may not be adequately reviewed. That leaves Ruby with a lot of control over the reported numbers. Any unintentional or intentional errors of Ruby's could go undetected. This should be treated as a significant fraud risk in the audit.
- Management bias and override could occur to avoid tax liability or bank covenant violations. Management's estimates have traditionally been conservative. The audit team was reminded to be alert for anything that appears unusual.
- We will pay careful attention to transactions and pricing of products with the related party, Dephta.

Audit Plan:

- Confirmed that last period's timing is appropriate and we will again request management's help in preparing certain schedules. However, since Kumar & Co. had a difficult time getting the requested schedules for us on time last period, we will spend time this period with Ruby in advance, and provide her with example schedules to ensure that she understands what is needed and the required due dates.
- The detailed audit plan was reviewed in some detail. Procedures in some areas were expanded based on the assessed risk, and a number of other procedures were eliminated where the assessed risk was low.
- We decided that it will be more efficient to perform substantive procedures than to perform tests of controls, as there are no assertions where substantive procedures alone would not provide sufficient appropriate audit evidence.

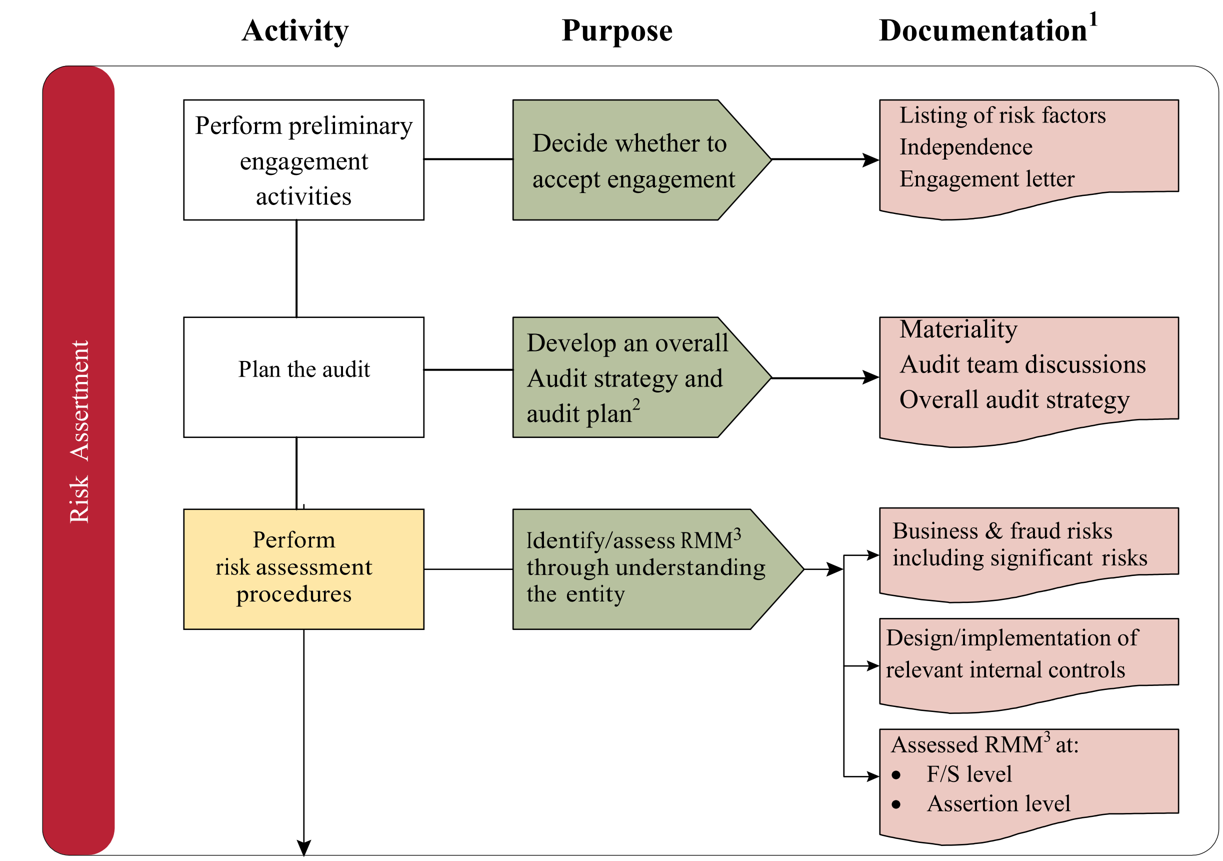
Prepared by: FJ **Date:** December 8, 20X2

Reviewed by: LF **Date**: January 5, 20X3

8. Inherent Risks — Identification

Chapter Content	Relevant SLAuSs
How to identify risks of material misstatement in the financial statements.	240, 315

Exhibit 8.0-1



Notes:

1. Refer to SLAuS 230 for a more complete list of documentation required.
2. Planning (SLAuS 300) is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Paragraph #	SLAuS Objective(s)
240.10	The objectives of the auditor are: (a) To identify and assess the risks of material misstatement of the financial statements due to fraud; (b) To obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and (c) To respond appropriately to fraud or suspected fraud identified during the audit.
315.3	The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

Paragraph #	Relevant Extracts from SLAuSs
200.13	For purposes of the SLAuSs, the following terms have the meanings attributed below: (n) Risk of material misstatement—The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level: (i) Inherent risk—The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls. (ii) Control risk—The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.
240.11	For purposes of the SLAuSs, the following terms have the meanings attributed below: (a) Fraud—An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. (b) Fraud risk factors—Events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.
240.12	In accordance with SLAuS 200, the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. (Ref: Para. A7- A8)
240.13	Unless the auditor has reason to believe the contrary, the auditor may accept records and documents as genuine. If conditions identified during the audit cause the auditor to believe that a document may not be authentic or that terms in a document have been modified but not disclosed to the auditor, the auditor shall investigate further. (Ref: Para. A9)
240.15	SLAuS 315 requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion. This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity. (Ref: Para. A10-A11)

Paragraph #	Relevant Extracts from SLAuSs
240.17	The auditor shall make inquiries of management regarding: (a) Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments; (Ref: Para. A12-A13) (b) Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention, or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist; (Ref: Para. A14) (c) Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and (d) Management's communication, if any, to employees regarding its views on business practices and ethical behavior.
240.18	The auditor shall make inquiries of management, and others within the entity as appropriate, to determine whether they have knowledge of any actual, suspected or alleged fraud affecting the entity. (Ref: Para. A15-A17)
240.22	The auditor shall evaluate whether unusual or unexpected relationships that have been identified in performing analytical procedures, including those related to revenue accounts, may indicate risks of material misstatement due to fraud.
240.23	The auditor shall consider whether other information obtained by the auditor indicates risks of material misstatement due to fraud. (Ref: Para. A22)
240.24	The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present. While fraud risk factors may not necessarily indicate the existence of fraud, they have often been present in circumstances where frauds have occurred and therefore may indicate risks of material misstatement due to fraud. (Ref: Para. A23-A27)
240.44	The auditor shall include the following in the audit documentation of the auditor's understanding of the entity and its environment and the assessment of the risks of material misstatement required by SLAuS 315: (a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and (b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.
315.11	The auditor shall obtain an understanding of the following: (a) Relevant industry, regulatory, and other external factors including the applicable financial reporting framework. (Ref: Para. A17-A22) (b) The nature of the entity, including: (i) its operations; (ii) its ownership and governance structures; (iii) the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and (iv) the way that the entity is structured and how it is financed to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial statements. (Ref: Para. A23-A27) (c) The entity's selection and application of accounting policies, including the reasons for changes thereto. The auditor shall evaluate whether the entity's accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry. (Ref: Para. A28) (d) The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement. (Ref: Para. A29-A35) (e) The measurement and review of the entity's financial performance. (Ref: Para. A36-A41)

8.1 Overview

Identification of risk is the foundation of the audit. It is based upon, and forms an integral part of, the auditor's procedures to understand the entity and its environment. Without a solid understanding of the entity, the auditor may miss certain risk factors. For example, if a client's sales were increasing, it would be important for the auditor to know that the industry sales as a whole were actually in sharp decline.

The objective of the risk assessment phase of the audit is to identify sources of risk, and then to assess whether they could possibly result in a material misstatement in the financial statements. This provides the auditor with the information needed to direct audit effort to areas where the risk of material misstatement is the highest, and away from less risky areas.

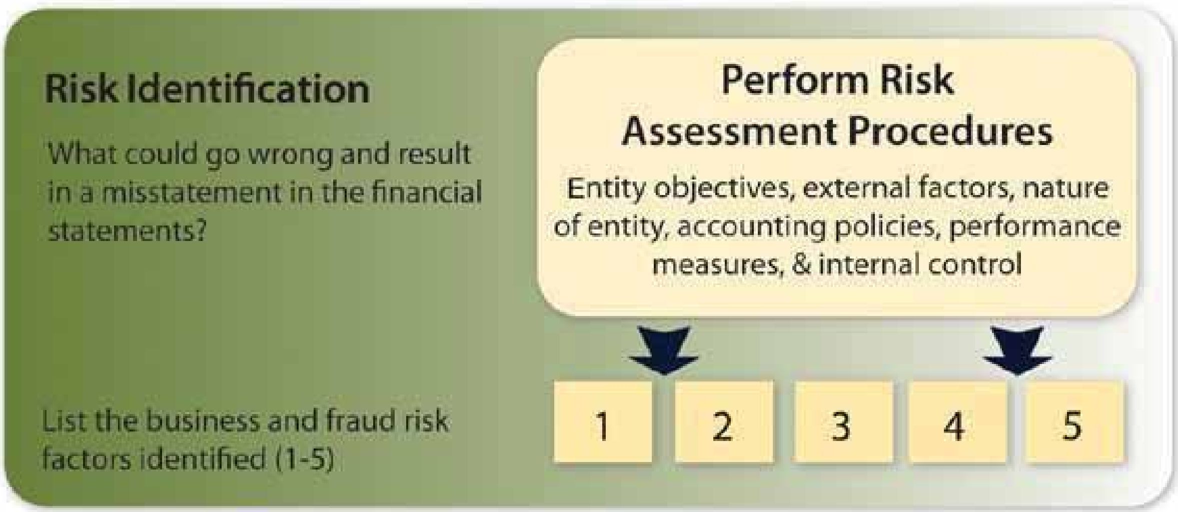
Risk assessment has two distinct parts:

- Risk identification (asking "what can go wrong"); and
- Risk assessment (determining the significance of each risk).

Risk assessment is addressed in Volume 2, Chapter 9.

Risk identification is illustrated below.

Exhibit 8.1-1



CONSIDER POINT

First, identify the risks
You cannot assess a risk that has not first been identified. Avoid the temptation to assume that because the entity is small, there are no relevant risks or that the risks of material misstatement will be the same as the previous period. New risks may now exist, and the nature/significance of some previously identified risks may have changed.

After the first engagement, focus on what has changed from previous period
After the first engagement, focus on what has changed within each of the six risk sources (see Exhibit 8.4-1) as opposed to starting all over again. This will save time, and focuses attention on the nature and effect of new risks that may now exist and revisions to risks previously identified.

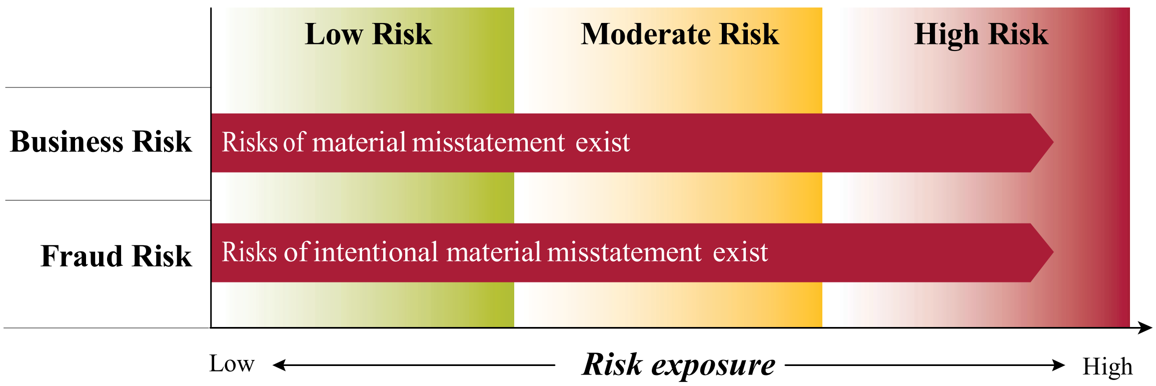
8.2 Types of Risk

There are two major classifications of risk:

- Business risk; and
- Fraud risk.

The difference between business risk and fraud risk is that fraud risk results from a person's deliberate actions. This is illustrated in the following exhibit.

Exhibit 8.2-1



Note: In many instances, a risk can be both a business and a fraud risk. For example, the introduction of a new accounting system creates uncertainty (errors could be made as personnel learn the new system) and would be classified as a business risk. However, it could also be classified as a fraud risk, because someone could take advantage of the uncertainty to misappropriate assets or manipulate the financial statements.

Business Risk

The term "business risk" encompasses more than just the risks of material misstatement in the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies. This could also include the setting of inappropriate objectives and strategies.

Business risk also includes events that arise from change, complexity, or the failure to recognize the need for change. Change may arise, for example, from:

- The development of new products that may fail;
- An inadequate market, even if new products are successfully developed; or
- Flaws in the products that may result in liabilities and damage to the entity's reputation.

Fraud Risk

Fraud risk relates to events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud.

The auditor's understanding of business and fraud risk factors increases the likelihood of identifying the risks of material misstatement. However, there is no responsibility for the auditor to identify or assess all of the possible business risks.

8.3 *Sources of Information about the Entity*

The first step in the risk assessment process is to gather (or update) as much relevant information about the entity as possible. This information provides an important frame of reference for identifying and assessing possible risk factors.

Information about the entity and its environment can be obtained from both internal and external sources. In many cases, the auditor will start with internal sources of information. This information can then be checked for consistency with information obtained from external sources such as trade association data and data about general economic conditions, which can often be obtained from the Internet. The following exhibit shows some of the potential sources of information available.

Exhibit 8.3-1

	Internal Sources	**External Sources**
Financial Information	Financial statements Budgets Reports Performance measures Tax returns Accounting policies in use Judgments and estimates	Information on the Internet Industry information Competitive intelligence Credit rating agencies Creditors Government agencies Media and other external parties
Non- financial Information	Vision, values, objectives, and strategies Organization structure Job descriptions Human Resources les Performance indicators Policy & procedure manuals	Information on the Internet Trade association data Industry forecasts Government agencies Media articles

CONSIDER POINT

A major source of information that is often overlooked is the auditor's working paper files from previous periods' engagements. They often contain valuable information on matters such as:

- Considerations or issues to address in planning this period's audit;
- Evaluation and source of possible adjustments and uncorrected errors;
- Areas where there are recurring disagreements, such as the assumptions used for accounting estimates;
- Areas which appear to be susceptible to error; and
- Matters raised in the auditor's communication with management and those charged with governance.

The information gained from risk assessment procedures conducted before engagement acceptance or continuance can be used as part of the audit team's understanding of the entity.

8.4 Risk Assessment Procedures

Based on the information obtained about the entity, the auditor is now in a position to design the risk assessment procedures discussed in Volume 1, Chapter 8. These risk assessment procedures will be designed to obtain and document an understanding of the entity and its environment, including internal control.

The scope of the understanding required by the auditor for identifying risks is contained in six key areas, as follows.

Exhibit 8.4-1

A. External Factors	Nature of industry Regulatory environment Financial reporting framework
B. Nature of Entity	Operations and key personnel Ownership and governance Investment, structure and financing
C. Accounting Policies	Selection and application Reasons for changes Appropriateness to entity
D. Entity Objectives & Strategies	Business plans and strategies Financial implications and risks undertaken
E. Measurement/ Review of Financial Performance	What is measured Who reviews financial results
F. Internal Control Relevant to the Audit	Processes and relevant controls to mitigate risks at the entity level and at the transactional level

The sufficiency of information (depth of understanding) required by the auditor is a matter of professional judgment. It is less than that possessed by management in managing the entity. The last section ("F" in the exhibit above), which relates to internal controls relevant to the audit, is discussed in Volume 1, Chapter 5, and Volume 2, Chapters 4, 11, and 12.

Obtaining an understanding of the nature of the entity and its environment, including internal control, has a number of benefits, as outlined below.

Exhibit 8.4-2

	Provides a Frame of Reference
Benefits Obtained from Understanding the Entity	**Identifying risks and developing responses** • Making judgments about the risk assessments. • Developing appropriate responses to identified risks of material misstatement in the financial statements. • Establishing materiality (refer to Volume 2, Chapter 6). • Developing expectations needed for performing analytical procedures. • Designing/performing further audit procedures to reduce audit risk to an acceptably low level. • Evaluating sufficiency/appropriateness of audit evidence obtained (e.g., appropriateness of assumptions used and management's oral and written representations). **Financial statement review** • Assessing management's selection and application of accounting policies. • Considering the adequacy of financial statement disclosures. • Identifying audit areas for special consideration (e.g., related party transactions, unusual or complex contractual arrangements, going concern or unusual transactions).

CONSIDER POINT

Obtaining an understanding of the entity is not a discrete task that can be completed early in the audit and then put to one side. It is important to keep learning about the entity throughout the audit, and to remain alert to risk factors not previously identified or where the original assessment of risk needs updating.

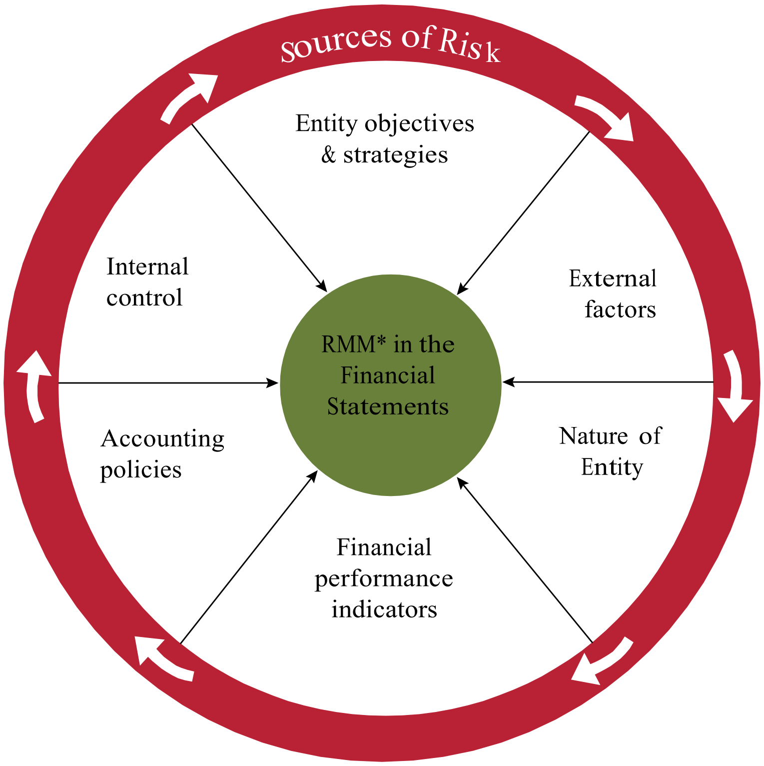
8.5 Sources of Risk

Errors and fraud in financial statements arise from risk factors that have their origin in one or more of the six required areas of understanding the entity (see Exhibit 8.4-1).

An example would be a new and complex tax being imposed on the entity. This would be an external risk factor. A risk of misstatement in the financial statements could be a misinterpretation of the new law, resulting in an incorrect calculation of tax payable and the amount owed. Note that the source (or cause) of the risk is the new tax that affects the entity, and not the error in calculation, which is the effect of the risk factor. As a consequence of the new tax, the risk of a calculation error increases.

The following exhibit shows the six required areas of understanding as being potential sources of risk. Note that the that sources of risk do not usually relate to a specific financial statement area. For example, a downturn in the economy could result in misstatements in many financial statement areas such as inventory, receivables, sales etc. So first identify the source of the risk and then identify where the misstatements could consequently occur in the financial statements.

Exhibit 8.5-1



* RMM = Risks of material misstatements

Examples of sources of risk (but not the effect on specific financial statement areas) are outlined below.

Exhibit 8.5-2

Sources of Business and Fraud Risk	
Entity Objectives and Strategies	• Inappropriate, unrealistic, or overly aggressive objectives and strategies. • New products or services, or moving into new lines of business. • Entering into business areas/transactions with which the entity has little experience. • Inconsistencies between IT and business strategies. • Response to rapid growth or decline in sales that can strain internal control systems and people's skills. • Use of complex financing arrangements. • Corporate restructurings. • Significant transactions with related parties.

Sources of Business and Fraud Risk	
External Factors	• State of the economy and changes in government regulation. • Declining demand for the entity's products or services. • High degree of complex regulation. • Changes in the industry. • Inability to obtain required resources (materials or skilled personnel). • Deliberate sabotage of an entity's products or services. • Constraints on the availability of capital and credit.
Nature of Entity	• Poor corporate culture and governance. • Incompetent personnel in key positions. • Changes in key personnel, including departure of key executives. • Complexity in operations, organizational structure, or products. • Product or service flaws that may result in liabilities and reputation risk. • Failure to recognize the need for change (skills required or technology). • Weaknesses in internal control, especially those not addressed by management. • Poor relationships with external funders, such as banks. • Going concern and liquidity issues, including loss of significant customers. • Installation of new systems related to financial reporting.
Performance Indicators	• Performance measures not used by management to assess the entity's performance and achievement of objectives. • Measures not used to improve operations or take corrective actions.
Accounting Policies	• Inconsistent application of accounting policies. • Inappropriate use of accounting policies.
Internal Control	• Inadequate management oversight of day-to-day operations. • Poor or nonexistent controls over entity-level activities such as human resources, fraud, and preparation of accounting information such as estimates and financial reports. • Poor or nonexistent controls over transactions such as revenues, purchases, expenses, and payroll. • Poor safeguarding of assets.

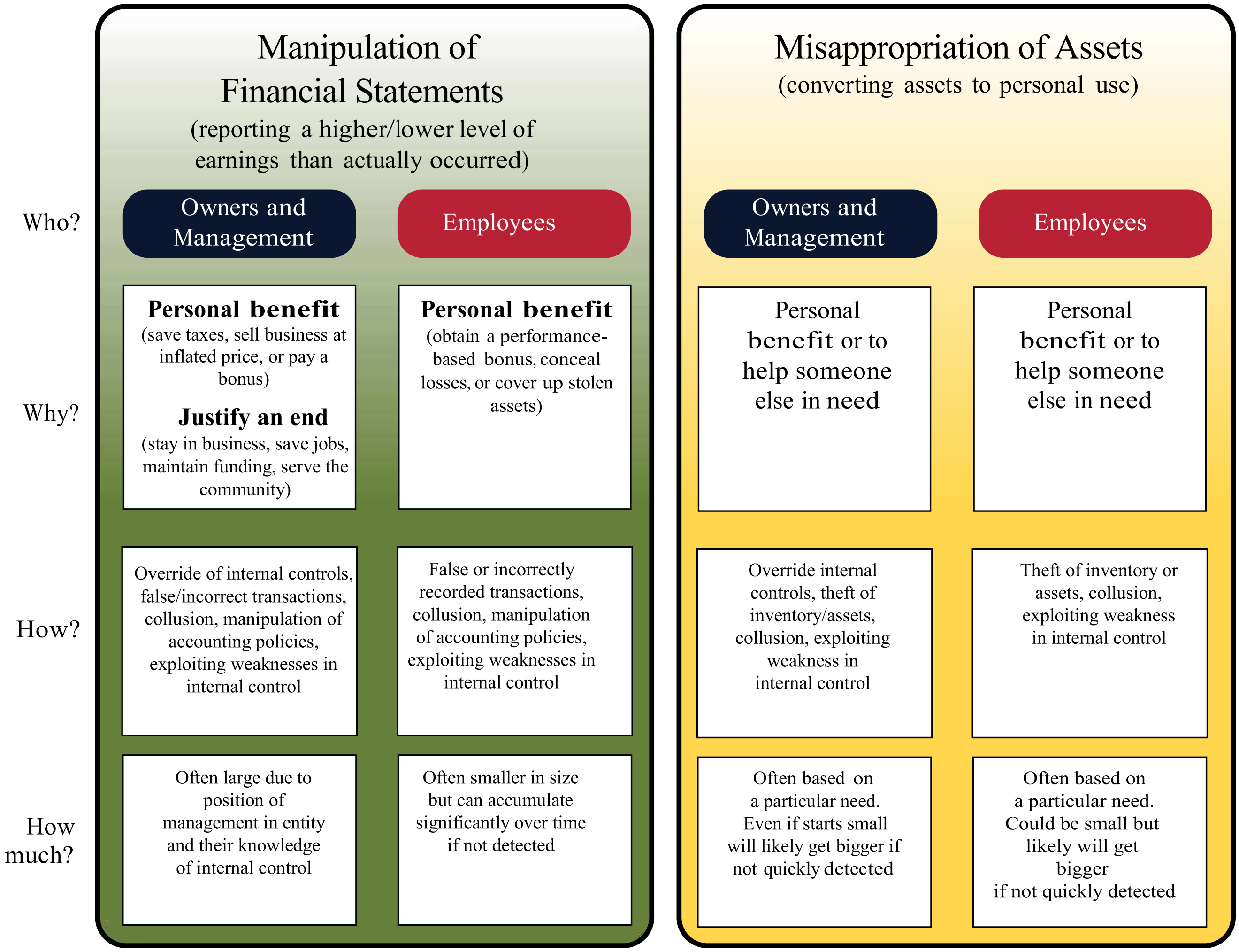
8.6 Fraud Risk

The term "fraud" refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties involving the use of deception to obtain an unjust or illegal advantage.

Fraud involving one or more members of management or those charged with governance is referred to as "management fraud." Fraud involving only employees of the entity is referred to as "employee fraud." In either case, there may be collusion within the entity or with third parties outside of the entity.

The following exhibit outlines the types and characteristics of fraud.

Exhibit 8.6-1



CONSIDER POINT

For each risk factor identified, consider whether it is a business risk, a fraud risk, or both. Many sources of risk can result in both business and fraud risks. For example, a change in accounting personnel can result in errors being made (business risk), but may also provide an opportunity for someone to commit a fraud.

8.7 Types and Characteristics of Fraud

Although fraud can occur at any level in the organization, it tends to be more serious (and involve higher monetary amounts) when senior management is involved.

Some of the major conditions that create an environment for fraud include:

- Ineffective corporate governance;
- Lack of leadership by management and poor “tone at the top”;
- High incentives provided for financial performance;

- Taxes or other expenses that are considered very high or onerous;
- Complexity in the entity's rules, regulations, and policies;
- Unrealistic expectations from bankers, investors, or other stakeholders;
- Downward and unexpected shifts in profitability;
- Unrealistic budget targets for staff to attain; and
- Inadequate internal control, especially in the presence of organizational change.

As can be determined from the above, the most effective anti-fraud internal control would be a strong commitment by those in governance and senior management positions to doing the right thing. This is evidenced through articulated entity values and a commitment to ethics that are modeled on a day-to-day basis. This is true for any size of organization.

8.8 The Fraud Triangle

In conducting risk assessment procedures, audit team members need to consider the existence of the three conditions that often provide clues to the existence of fraud. Forensic accountants often refer to this as the "fraud triangle" (see exhibit below) because when all three conditions are present, it is highly likely that fraud may be occurring.

The conditions are:

- **Pressure**

This is often generated by immediate needs (such as having significant personal debts or meeting an analyst's or bank's expectations for profit) that are difficult to share with others.

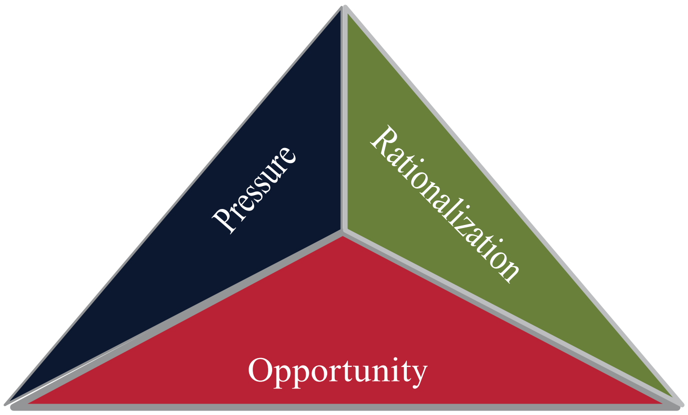
- **Opportunity**

A poor corporate culture and a lack of adequate internal control procedures can often create confidence that a fraud could go undetected.

- **Rationalization**

Rationalization is the belief that a fraud has not really been committed. For example, the perpetrator rationalizes that "this is not a big deal" or "I am only taking what I deserve."

Exhibit 8.8-1



For example, an owner-manager in the construction business might be offered a job to build a significant addition to a friend's house, as long as it is a cash-only transaction with no paperwork involved. Consider the three conditions.

- The **“pressure”** on the owner-manager might be to reduce taxes that would otherwise be payable.
- The **“opportunity”** is for the owner-manager to override the internal controls over revenue recognition and not record the revenue from the sale.
- The **“rationalization”** could be that the owner-manager is already paying far too much in taxes.

Note: If any one of the three conditions is not present, the cash sale is unlikely to take place.

Consider the three sources of fraud risk set out below.

Exhibit 8.8-2

<table>
<tr><th colspan="2">Sources of Fraud Risk</th></tr>
<tr><td>Incentives and Pressures</td><td>• Financial stability or profitability is threatened by economic, industry, or the entity’s operating conditions.
• Excessive pressure exists for management to meet the requirements or expectations of third parties or those charged with governance (such as earnings targets or compliance with onerous environmental regulations, etc.).
• Personal financial obligations may create pressure on management or employees with access to cash or other assets susceptible to theft to misappropriate those assets.
• Adverse relationships between the entity and employees with access to cash or other assets. For example:
– Known or anticipated future employee layoffs,
– Recent or anticipated changes to employee compensation or benefit plans, and
– Promotions, compensation, or other rewards inconsistent with expectations.
• The personal financial situation of management or those charged with governance may be threatened by the entity’s financial performance (such as financial interests, compensation, guarantees, etc.).</td></tr>
<tr><td>Attitudes and Rationalizations</td><td>Rationalizations
• Management is interested in employing inappropriate means to:
– Minimize reported earnings for tax-motivated reasons, and
– Increase reported earnings to avoid violating bank covenants, increase the sale price of the entity, or meet targets set by a third party.
• Employee behavior indicates displeasure or dissatisfaction with the entity.
• Low morale exists among senior management.
• Management is tolerant of some employee thefts. For example, no disciplinary action is taken when an employee is caught stealing.
• Management does not enforce the entity’s values or ethical standards.
• Management disregards the need for monitoring or reducing risks related to the misappropriations of assets.</td></tr>
</table>

Sources of Fraud Risk	
Attitudes and Rationalizations (*continued*)	**Attitudes** • Management has a known history of violations of laws and regulations, or allegations of fraud. • Management exhibits changes in behavior or lifestyle that may indicate assets have been misappropriated. • Senior managers demonstrate a poor ethical example (such as inflating expense accounts and committing petty thefts, etc.). • Management has overridden existing controls. • Management has failed to take appropriate remedial action on known deficiencies in internal control. • The owner-manager makes no distinction between personal and business transactions. • Disputes exist between shareholders in a closely-held entity. • Management makes recurring attempts to justify marginal or inappropriate accounting on the basis of materiality. • The relationship between management and the current or predecessor auditor is strained.
Opportunities	**Assets susceptible to misappropriation** • Large amounts of cash on hand or processed. • Inventory items that are small in size, of high value, or in high demand. • Easily convertible assets, such as bearer bonds, diamonds, or computer chips. • Property, plant, and equipment are small in size, marketable, or lack observable identification of ownership.
	Inadequate internal controls • Inadequate oversight by those charged with governance of management's processes for identifying and responding to the risks of fraud. • Inadequate segregation of duties or checks. • Inadequate oversight of senior management expenditures. • Inadequate management oversight of employees responsible for assets. • Inadequate job-applicant screening for employees with access to assets. • Inadequate record keeping with respect to assets. • Inadequate authorization and approval of transactions. • Inadequate physical safeguards over cash, investments, inventory, or property, plant, and equipment. • Lack of complete and timely reconciliations of assets. • Lack of timely and appropriate documentation of transactions (e.g., credits for merchandise returns). • Lack of mandatory vacations for employees performing key control functions. • Inadequate management understanding of information technology, which enables information-technology employees to perpetrate a misappropriation. • Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Sources of Fraud Risk	
Opportunities *(continued)*	**Specific areas of vulnerability** • Management estimates, revenue recognition, use of journal entries, transactions with related parties, etc.

CONSIDER POINT

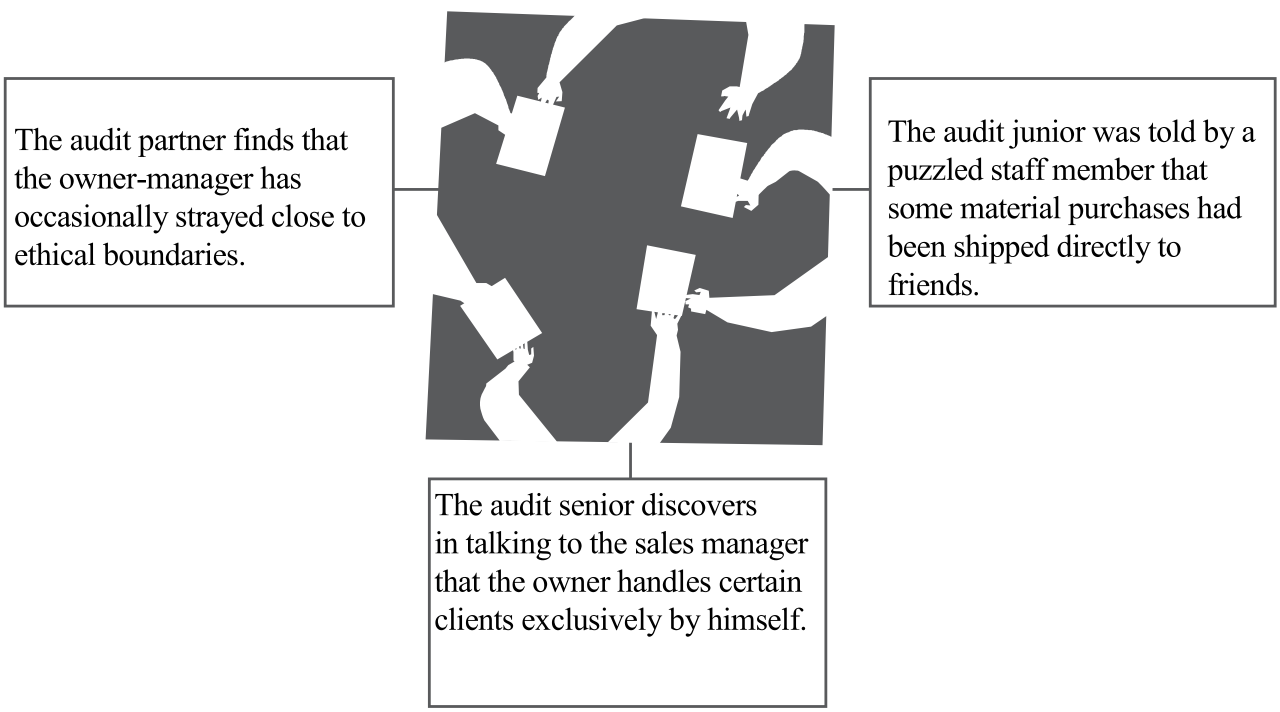
Fraud is always intentional. It involves concealment of information from the auditor and deliberate misrepresentations. Consequently, fraud is discovered by looking for patterns, oddities, and exceptions, often in what might be considered very small monetary amounts.

Fraud is unlikely to be detected through substantive procedures alone. For example, an auditor is unlikely to identify a missing transaction or determine that a transaction is invalid unless there is some additional "understanding of the entity" that can be used as a frame of reference.

Auditors, depending on their role and position on the audit team, may identify a fraud risk factor that relates to one or more of the triangle elements. However, it is less likely that any one auditor will identify all three conditions (opportunity, pressure, and rationalization) together. For this reason, it is important for the audit team to continually discuss their findings throughout the engagement.

The benefits of audit team discussions are outlined in the exhibit below.

Exhibit 8.8-3



In the absence of communication, it would be difficult for any single member of the above audit team to see the big picture. Ongoing audit team discussion enables the team to pull together small pieces of information so that the bigger picture can be seen.

8.9 Professional Skepticism

It is the responsibility of the auditor to maintain an attitude of professional skepticism at all times during the engagement. An attitude of professional skepticism involves matters outlined in the following exhibit.

Exhibit 8.9-1

Skepticism Involves:	
Recognizing That Management Can Always Commit Fraud	Management is always in a position to override otherwise good internal control. Engagement team members are to set aside any beliefs that management and those charged with governance are honest and have integrity, notwithstanding the auditor's past experience of their honesty and integrity.
A Questioning Mind	Make critical assessments about the validity of audit evidence obtained.
Being Alert	Does audit evidence contradict or bring into question the reliability of: • Documents and responses to inquiries? • Other information obtained from management and those charged with governance?
Being Careful	Avoid: • Overlooking unusual circumstances. • Over-generalizing when drawing conclusions from audit observations. • Using faulty assumptions in determining the nature, timing, and extent of the audit procedures and evaluating the results thereof. • Accepting less than persuasive audit evidence in a belief that management and those charged with governance are honest and have integrity. • Accepting representations from management as a substitute for obtaining sufficient appropriate audit evidence.

CONSIDER POINT

Applying professional skepticism to an audit of a client you know and trust can be difficult. There is a natural human tendency to place trust in people, assuming there is no information to the contrary. Consequently, partners and staff need to be reminded on a regular basis to apply professional skepticism. Some practical suggestions for applying this concept include:

- Create a fictional character (and name) of someone who has a bad attitude toward control and poor ethics. When the discussion around possible fraud scenarios and financial statement susceptibilities takes place, imagine this person (not your client) as being the client or the senior manager in charge.
- Inviting someone (ideally with some forensic experience) who does not know the entity to participate in the planning discussions about fraud.

8.10 How to Identify Inherent Risk Factors

The most effective way to avoid missing a relevant risk factor is to make risk identification an integral part of understanding the entity. The more that the auditor knows about the six areas of understanding, the more likely the auditor will be able to identify risk factors. Understanding the entity is also helpful when identifying and later responding to possible fraud scenarios. Remember that management override is always a possibility and fraud is thereby concealed (especially from the auditor).

As information is gathered (or updated) about each of the required areas of understanding the entity, the existence of relevant business and fraud risk factors will be considered. For many of the business risks identified, there may also be a fraud risk to consider. For this reason, it is suggested that, where possible, fraud risks be listed separately from business risks and assessed separately. For example, if the sales outlook for an entity's products was poor (an external source of risk), consider what could go wrong (implications for) in the financial statements. Poor sales could result in excess inventory that may need to be written down, but it could also trigger a fraud risk if it provided an incentive for a salesperson to inflate his/her sales to meet a bonus threshold.

CONSIDER POINT

The business and fraud risks (inherent risks) are identified before any consideration of any internal controls that might mitigate such risks. Internal control to mitigate risks is addressed in Volume 2, Chapters 11 and 12. This is also important for identifying any significant risks that might exist (refer to Volume 2, Chapter 10).

The effect of some of the risk factors identified will relate to a specific financial statement area, but other risk factors will be pervasive and relate to many financial statement areas. For example, if the senior accountant is incompetent, errors will not likely be limited to one financial statement area. In addition, if someone took advantage of the situation to commit fraud, misstatements could occur in any number of asset or liability balances, and could be covered up with additional misstatements in revenue and expense transactions.

Pervasive risks often derive from a weak control environment and potentially affect many financial statement areas, disclosures, and assertions. Pervasive risks will likely affect the assessment of risk at the financial statement level. Risks at the financial statement level will be addressed through an overall response by the auditor (such as more audit work performed, assigning more experienced staff members, etc.).

As the audit progresses, additional risk factors may be identified. These should be added to the list of identified risks and appropriately assessed before making any decisions as to the impact on audit strategy and the audit plan, such as the nature and extent of further audit procedures required. This will ensure that, when planning takes place for the next period, the risk identification and assessment will be complete.

A suggested three-step risk identification process is outlined below.

Exhibit 8.10-1

Risk Identification	
Step 1 Gather Basic Information about the Entity	The starting point is to obtain a basic understanding or frame of reference for designing the risk assessment procedures to be performed. Without this understanding, it would be difficult, if not impossible, to identify what errors and fraud could occur in the financial statements. • Obtain (or update) relevant basic information about the entity, its objectives, culture, operations, key personnel, and the internal organization and control.
Step 2 Design, Perform and Document Risk Assessment Procedures	• Risk assessment procedures/activities (see Volume 1, Chapter 8) are required to be performed so that: – The sources of risks of material misstatement are identified, – An appropriate understanding of the entity is obtained, and – The necessary supporting audit evidence is obtained. • Using the basic understanding of the entity obtained in step 1 above, design and perform risk assessment procedures and related activities. • Hold discussions among the audit team regarding the susceptibility of the entity's financial statements to material misstatement, caused by error or fraud (see Volume 2, Chapter 7). • Make inquiries of management as to how they identify and manage risk factors (particularly fraud), and what risk factors have in fact been identified and managed. Also ask management if errors or fraud have actually occurred. • Document all risk factors identified.

Risk Identification	
Step 3 Relate or Map the Risks Identified to Material Financial Statement Areas	For each risk factor (risk cause) identified, identify the effect (specific misstatements such as fraud and error) that could occur in the financial statements as a result. Note that a single risk factor can result in a number of differing types of misstatements that may affect more than just one financial statement area. (See the Consider Point below for some examples.) • Identify the material account balances, class of transactions, and disclosures in the financial statements. • Relate or map the risks identified to the specific financial statement areas, disclosures, and assertions affected. If the risk identified is pervasive, then relate it to the financial statements as a whole. Identifying the effect of risks by financial statement area helps in assessing risks at the assertion level. Identifying the effect of pervasive risks helps in assessing risks at the financial statement level.

CONSIDER POINT

A natural tendency for auditors is to use the financial statements as the starting point for identifying risks. For example, inventory may be considered high risk because of the errors found in previous periods. However, this is equivalent to identifying the effect of a risk but not the underlying cause. Knowing inventory is high risk is important; however, it is even better to know the cause of the risk. If the cause of a risk is not identified, it is possible that some risk factors will be missed altogether. Consider the following:

Missing balances or transactions
Financial statements only summarize the results of business decisions and transactions that have been recorded. If transactions have not been recorded, or if assets have been misappropriated or contingencies are not disclosed, it is quite possible that the risk factors associated with such missing amounts or disclosures will not be identified or assessed.

Fact gathering versus risk identification
The process of understanding the entity can easily become focused on collecting facts about the entity rather than identifying sources of risk. When this occurs, new risk factors, events, transactions, and fraud risks may be missed altogether.

Cause and effect of misstatements
The significance of certain risk sources may be missed if attention is paid primarily to the effect or consequence of the risk factor (such as focusing on the errors in the inventory balance, rather than the reasons for their occurrence in the first place). The source of the risk is the event(s) that would cause errors to occur in the first place. The source of errors in the inventory balance could be inadequate or poorly trained staff, an outdated system of internal control, misapplication of accounting policies such as revenue recognition, lack of security over inventory or outright fraud by employees, etc.

CONSIDER POINT *(continued)*

A cause with multiple misstatement effects
An individual risk source may often affect many financial statement balances. For example, a downturn in the economy may affect the valuation of inventory, the collectability of receivables, compliance with banking agreements, manipulation of sales transactions to achieve bonus thresholds, and possibly even going concern issues.

Pervasive risks
By focusing on one financial statement area at a time, certain pervasive risks and fraud risks may not be identified. For example, the introduction of a new accounting system could result in errors being made in many financial statement balances. In addition, someone could take advantage of the uncertainty created by the new system to commit a fraud.

8.11 Documenting the Risk Identification Process

The auditor should use professional judgment regarding the manner in which these matters are documented. For example, the documentation of the risk identification process following the three steps outlined above would consist of:

- Information about the entity;
- Risk assessment procedures; and
- Relating identified risks to possible errors and fraud in the financial statements.

Exhibit 8.11-1

Document	Description
Information about the Entity	Document information obtained under the appropriate area of understanding, such as the entity's objectives, external factors, nature of the entity, etc. Documentation may vary from very simple to complex, depending on the size of the entity, and could include: • Client-prepared information (such as business plans and analysis); • External data (industry reports, internal staff communications, documented policies and procedures); • Relevant correspondence (legal, government agencies, etc.), emails, consultants' reports, memoranda; and • Firm's checklists.

Document	Description
Risk Assessment Procedures	Document details of the risk assessment procedures performed. This would include: • Discussions among the audit team regarding the susceptibility of the entity's financial statements to material misstatement caused by error or fraud, and the results; • Key elements of the understanding of the entity obtained, including: – Each of the aspects of the entity and its environment outlined above, – Each of the five internal control components, as outlined in Volume 1, Chapter 5, and – Sources of information from which the understanding was obtained; and • The identified and assessed risks of material misstatement at the financial statement level and assertion level.
Relate Identified Risks to Possible Errors and Fraud in the Financial Statements	Document the material account balances, class of transactions, and disclosures in the financial statements; and then, for each source of risk identified, indicate whether it is: • Pervasive to the financial statements as a whole; or • Confined to specific financial statement areas, disclosures, and assertions.

There are a number of ways that identified risks can be documented. One way of documenting the risks identified is outlined in the following exhibit. The exhibit shows the risk source by area of understanding (external factors, nature of entity, etc.), the impact or possible consequence of the risk, and the financial statement areas affected.

Exhibit 8.11-2

Risk Source	Impact of Risk on Financial Statements (Errors or Fraud)	Financial Statement Area Affected or Pervasive Risk
Entity's Objectives		
Introduction of a new product during the year	Errors in cost allocation and inventory valuation.	Inventory valuation
	New product costing and pricing methodologies/systems could create opportunities for fraud to occur.	Inventory accuracy
	The new financing required will make it difficult to comply with existing bank covenants. If the entity is in breach of covenants, the loan may actually be payable on demand.	Note disclosures on financing, debt covenants, and loan classification
	Management may be tempted to manipulate financial statements to ensure compliance with the bank covenants.	Pervasive risk

Risk Source	Impact of Risk on Financial Statements (Errors or Fraud)	Financial Statement Area Affected or Pervasive Risk
Nature of the Entity		
Senior accountant not trained properly	Errors in the financial statements.	Pervasive risk
	Opportunity for fraud.	Pervasive risk

CONSIDER POINT

One location for risks

Consider recording all the risk factors identified in a single document, single place, or with a common file reference number in the working paper file. This has a number of advantages:

- Ease of file review. All risk factors identified can be found in one place.
- Consistent assessment. When risks are reviewed together, a particular risk that has been assessed differently from others will be more evident.
- Risks can be sorted (using an electronic spreadsheet) enabling the most significant risks to appear at the top of the page. In this way, a file reviewer can check to ensure that all the major risks identified have been addressed with an appropriate audit response.

Separate lists of fraud and business risk factors

List and assess fraud risks separately from business risk factors. Many business risks also create an opportunity or incentive for fraud to occur. If fraud is not separately considered, some fraud risk factors may be missed. For example, a new accounting system may create potential for errors (business risk), but may also provide an opportunity for someone to manipulate the financial results or misappropriate assets (fraud risk). Another reason for keeping them separate is that the audit response to a fraud risk (identification of any patterns, exceptions, or oddities that might exist) might be quite different from the response to a related business risk.

Leave the assessment of risk until later

Avoid the temptation to only list risk factors that are likely to be significant or important. A key part of risk or event identification is to develop as complete a listing of risk factors as possible. Inconsequential risk factors can always be removed later after each risk is appropriately assessed. This will help to ensure that all material risks are indeed identified.

Re-use documentation to extent possible

Avoid having to re-document the risk factors identified and the understanding of the entity obtained each period. If information about risk assessment procedures performed and the risks identified is captured in a structured way (see “one location for risks above”), it can simply be updated each period. This may require more time initially (in the first period) to prepare, but will save time in subsequent periods. However, be sure that appropriate risk assessment procedures are carried out and documented each period, and that any changes made can be identified. Also ensure that each document records the fact that the information was updated.

CONSIDER POINT *(Continued)*

Impact of risks
The most important, but also the most difficult, column to complete is "impact of risk on financial statements" (see above exhibit). It is in this column that the auditor sets out the implication of the identified risk. Declining sales is a risk factor but, if recorded accurately by the entity, this would not result in risks of material misstatement. However, declining sales could result in inventories being obsolete or overvalued, and receivables may become difficult to collect. It is the implication of each risk factor that the auditor needs to identify so that an appropriate audit response can be developed.

Note: The risk sources identified in this example have multiple impacts, each of which has been considered separately. If the various impacts of risk sources are not broken out into discrete components, not only will the risk assessment process be more difficult, but the auditor could easily miss some risk implications (such as fraud) altogether.

8.12 Case Studies — Inherent Risks — Identification

For details of the case studies, refer to Volume 2, Chapter 2 — Introduction to the Case Studies.

Risk identification involves:

- Performing risk assessment procedures to understand the entity and identify possible sources (causes) of business risk and fraud risk. This includes performing the specific risk assessment procedures outlined in SLAuSs such as SLAuS 240 on fraud, SLAuS 540 on estimates, SLAuS 550 on related parties, and SLAuS 570 on going concern;
- Documenting the risks identified. A common form of documentation to use is a "Risk Register" where all risks are listed and assessed in one place; and
- For each risk source that is identified, consider what sort of misstatements (error and fraud) could occur (the 'effect' of each risk) in the financial statements as a result.

Documentation required:

- **Understanding of the entity**
  This can be documented in a memo that is similar to the one in Volume 2, Chapter 2 that outlines the details of these two case studies.
- **The risk factors involved**
  One way of documenting the cause and effect of identified risks (both business and fraud) is to list them in a structured format such as the risk register outlined below. This will ensure that all risks are recorded in one place and that the assessment of risks will be consistent. The alternative approach is to list the risks identified in a memo format. Avoid the temptation to combine business and fraud risk on one form. The assessment of and response to a business risk versus a fraud risk may be quite different.

Case Study A — Dephta Furniture, Inc.

Planned Risk Assessment Procedures:

1. Document potential risk factors identified from:
    a) Client acceptance/continuance procedures;
    b) Other types of engagements performed for the entity; and
    c) Previous audit engagements.
2. Review the most recent trial balance for:
    a) Revenue and expense trends; and
    b) Changes in assets and liabilities.

Inquire about the reasons for significant changes or trends identified.

3. Identify potential risk factors from reading key entity documents such as business plans, budgets, minutes, and most recent financial results.
4. Make inquiries of management and key financial personnel about:
    a) Business objectives, industry trends, management's assessment of current and potential risk factors and their planned responses.
    b) Major events or changes that took place during the period.
    c) Any instances of alleged, suspected or actual

       fraud.
    d) Any performance bonuses or incentive plans.
    e) The identity of and nature/amount of related party transactions during the period.
    f) Any going concern events or conditions.
    g) Transactions, events and conditions that give rise to accounting estimates.
    h) Nature, extent and status of litigation/claims against the entity or key personnel.
5. Make inquiries of members of the governance board about:
    a) The composition, mandate and meetings of the governance board.
    b) Any knowledge of management override, fraud or suspected fraud.
    c) Their opinion on:
        – The effectiveness of management oversight; and
        – The control environment (culture, competence, attitudes, etc.).
    d) What financial statement areas are susceptible to fraud.

6. Identify others (if any) in the entity who could provide information about potential risk factors and changes occurring since the previous period.

Outlined below is a structured format for documenting the results of performing risk assessment procedures for Dephta Furniture, Inc.

Business Risks		
Risk Event/Source	**Implication of Risk Factor**	**Assertions**
	What financial statement areas could be misstated and in what way?	P CAEV
Downturn in economy	*Receivables may be difficult to collect*	v
Downturn in economy	Inventory write-downs may be required	v
Inventory clerk known to make errors	*Inventory balances may be overstated/understated and possibly impact valuation*	*CAEv*
Continued growth (despite downturn) and poor inventory control	*Breach of debt covenants*	*P*
General IT controls are weak in a number of areas	*Data integrity may be compromised or data may even be lost*	*P*
New sales being sought in other countries	*Foreign exchange risks in receivables*	*A*

Key:

P = Pervasive (all assertions)

C = Completeness

A = Accuracy

E = Existence

V = Valuation

Fraud Risks		
Risk Event/Source	**Implication of Risk Factor**	**Assertions**
	What financial statement areas could be misstated and in what way?	P CAEV
Pressures		
Minimize tax burden	*Management bias in estimates (such as valuation of inventory) to reduce income.*	*CAv*
Minimize tax burden	*Unauthorized journal entries or manipulation of financial statements.*	*P*
Rapid growth putting pressure on financing	*Financial statement manipulation to avoid bank covenant being violated.*	*P*
Salesman's bonus based on sales above certain thresholds	*Inflated sales to meet thresholds.*	*E*
Paying bribes to obtain contracts	*Damage to reputation, overstatement of expenses, unaccrued fines.*	*CAE*
Opportunities		
High value, easily transportable items of inventory	*Goods stolen from inventory.*	*E*
High incidence of cash sales	*Goods stolen/cash stolen.*	*E*
Transactions with related parties	*Sales/purchases may not be complete, properly valued or disclosed in the financial statements.*	*P*
Significant expansion in the use of related party transactions	*Sales/purchases could be undervalued/overvalued. Balances with related parties may not be collectable. Manipulation of financial statements could be achieved by transferring "risky" balances to a related party. This would replace a risky balance with a related party balance*	*v*
Rationalization		
Low morale among temporary workers	*Goods or cash stolen*	*E*

Key:
P = Pervasive (all assertions)

C = Completeness

A = Accuracy

E = Existence

V = Valuation

Case Study B — Kumar & Co.

Planned Risk Assessment Procedures:

1. Inquire about the state of the industry and update our understanding of the entity W/P x.x and the risk assessment memos). This will involve:
   a) Discussions with Raj and Ruby (the bookkeeper) about what has changed this year. Specifically address any personnel or organizational changes, related-party transactions, management estimates, going concern uncertainties and management's compliance with relevant laws and regulations;
   b) Inquiries of any changes in operations during the year, new laws and regulations and any changes being planned for the future;
   c) Inquiries about the impact and risks involved with Raj not spending as much time on the business. Ask whether Raj will be resuming his regular duties next year or if the family situation will continue to consume his time;
   d) Outcome of last year's management estimates;
   e) Knowledge of any fraud that has occurred during the year and any areas susceptible to fraud;
   f) Any change in the type and nature of transactions with Dephta; and
   g) Documenting the source and effects of any new risks identified and indicating whether they have been mitigated through any new internal controls.
2. Review the most recent trial balance for:
   a) Revenue and expense trends; and
   b) Changes in assets and liabilities.

Inquire about the reasons for significant changes or trends identified.

Memo to File—Kumar & Co.

Inherent Risk Identification

As a result of performing the risk assessment procedures outlined on working paper X.X, which included potential sources of risk arising from the six areas of required understanding, we have identified the following risk factors:

Business Risks

Raj's absence from operations—a pervasive risk

- The quality and accuracy of the accounting records could be compromised due to Raj's focus on personal family matters. The financial statements could be materially misstated.

  Risk Assessment: *(to be addressed in volume 2, Chapter 9)*

  Risk Response: *(to be addressed in volume 2, Chapter 16)*

- Raj used to inspect goods for quality before shipment. The quality of products sold could be compromised, leading to greater returns and/or unsaleable inventory. (Valuation)

  Risk Assessment: *(to be addressed in volume 2, Chapter 9)*

  Risk Response: *(to be addressed in volume 2, Chapter 16)*

Downturn in economy and economic dependence

- Kumar & Co. is dependent on its primary customer, Dephta Furniture, Inc., which represents over 90% of its sales. In this economic downturn, Dephta could cancel orders. The impact could be bank covenant violations and overvalued assets.
- A decline in sales and liquidity pressures may lead to financial statement manipulation to avoid bank covenant violations.
- If the bank called their loan, the company may not be able to continue as a going concern. This could result in a material uncertainty that should be disclosed in the financial statements, and an evaluation of the basis (i.e., the going concern assumption) on which the financial statements are prepared. This would affect all assertions.

Risk Assessment: (to be addressed in volume 2, Chapter 9)

Risk Response: *(to be addressed in volume 2, Chapter 16)*

Fraud Risks

Tax minimization

- There has been a management desire to minimize the tax burden. There may be a bias in management's estimates, or unauthorized journal entries could be used. (Completeness, Accuracy)

Risk Assessment: *(to be addressed in volume 2, Chapter 9)*

Risk Response: *(to be addressed in volume 2, Chapter 16)*

Raj's absence from operations—a pervasive risk

- Raj's absence results in minimal oversight of Ruby's work. In addition, Ruby appears to have low morale (potential rationalization) and personal financial pressures (possible incentive). As a result, Ruby (who operates with minimal supervision) has the incentive, opportunity, and rationalization for misappropriating cash/goods. This should be treated as a fraud risk.

Risk Assessment: *(to be addressed in volume 2, Chapter 9)*

Risk Response: *(to be addressed in volume 2, Chapter 16)*

Related Parties

- Transactions with related parties could be manipulated, leading to sales being overvalued. (Valuation) Attention should also be paid to the possible existence of other related parties and the valuation/accuracy of balances with related parties at period end.

Risk Assessment: *(to be addressed in volume 2, Chapter 9)*

Risk Response: *(to be addressed in volume 2, Chapter 16)*

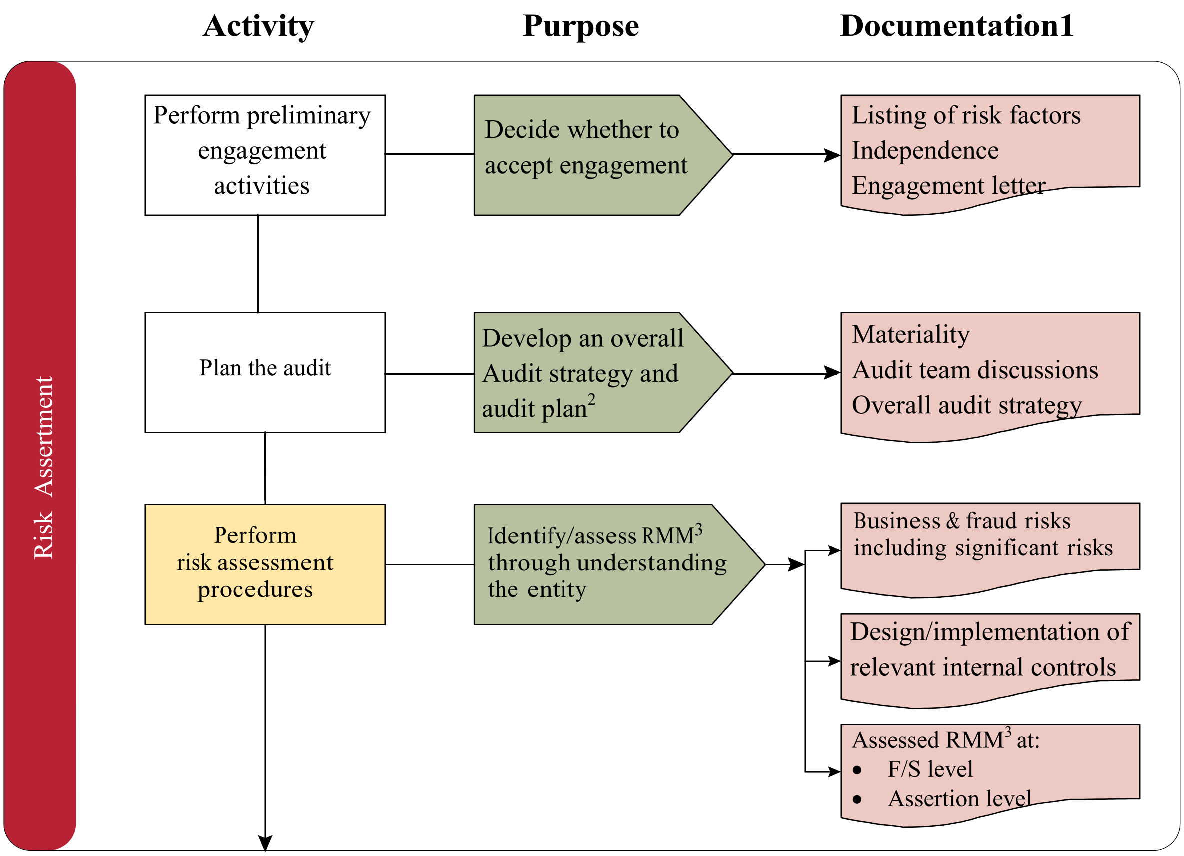
Prepared by: FJ **Date:** December 8, 20X2

Reviewed by: LF **Date:** January 5, 20X3

9. Inherent Risks — Assessment

Chapter Content	Relevant SLAuSs
How to assess the identified risks of material misstatement in the financial statements.	240, 315

Exhibit 9.0-1



Notes:
1. Refer to SLAuS 230 for a more complete list of documentation required.
2. Planning (SLAuS 300) is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Paragraph #	Relevant Extracts from SLAuSs
240.25	In accordance with SLAuS 315, the auditor shall identify and assess the risks of material misstatement due to fraud at the financial statement level, and at the assertion level for classes of transactions, account balances and disclosures.
240.26	When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph 47 specifies the documentation required where the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud. (Ref: Para. A28-A30)
240.27	The auditor shall treat those assessed risks of material misstatement due to fraud as significant risks and accordingly, to the extent not already done so, the auditor shall obtain an understanding of the entity's related controls, including control activities, relevant to such risks. (Ref: Para. A31-A32)
315.25	The auditor shall identify and assess the risks of material misstatement at: (a) the financial statement level; and (Ref: Para. A105-A108) (b) the assertion level for classes of transactions, account balances, and disclosures (Ref: Para. A109-A113) to provide a basis for designing and performing further audit procedures.
315.26	For this purpose, the auditor shall: (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements; (Ref: Para. A114-A115) (b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions; (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and (Ref: Para. A116-A118) (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

9.1 Overview

Risk identification, which was addressed in the previous chapter, involves:

- Performing risk assessment procedures to identify sources (causes) of risk through understanding the entity;
- Determining the possible effects of the risk sources identified (potential misstatements in the financial statements), including the possibility of fraud; and
- Relating the effects of risks to the financial statement area and assertions affected, or determining that the risks are pervasive to the financial statements as a whole and potentially affect many assertions.

The next step is to assess the identified risks and determine their significance for the audit of the financial statements. Again, it is preferable to assess the inherent risks before considering any internal control that might mitigate such risks.

Risk assessment involves consideration of two attributes about the risk:

- What is the likelihood of a misstatement occurring as a result of the risk?
- What would be the magnitude (monetary impact) if the risk did occur?

Likelihood of a Misstatement Occurring

What is the probability that the risk will occur? The auditor could evaluate this probability simply as high, medium, or low, or could assign a numerical score, such as 1 to 5. A numerical score provides a slightly more precise assessment. The higher the score, the more likely the risk would occur.

Magnitude (Monetary Impact) if the Risk Did Occur

If the risk occurred, what would be the monetary impact? This judgment needs to be assessed against a specified monetary amount, such as performance materiality. If not, different people (with different materiality amounts in mind) could come to entirely different conclusions. For audit purposes, the specified amount would relate to what constitutes a material misstatement for the financial statements as a whole. This assessment can also be evaluated simply as high, medium, or low, or by assigning a numerical score, such as 1 to 5. The higher the score is, the higher the magnitude of the risk.

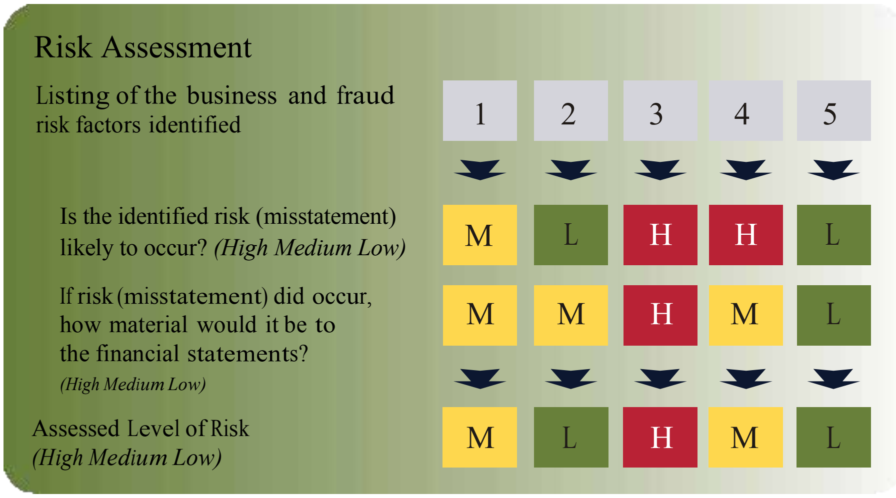
CONSIDER POINT

If numeric scores are used to assess likelihood and magnitude, the numbers can be multiplied to provide a combined or overall risk assessment score. This calculation can be useful in considering whether significant risks exist. In addition, if an electronic worksheet is used, the listing of risks may be ranked and sorted so that the most significant identified risks are always at the top of the list. This can be useful information when reviewing the file and ensuring that an appropriate response has been developed for the assessed risks.

In smaller entities where the number of risk factors is small and the audit response has already been established, the two assessments (likelihood and magnitude) can still be considered separately but documented as one combined assessment.

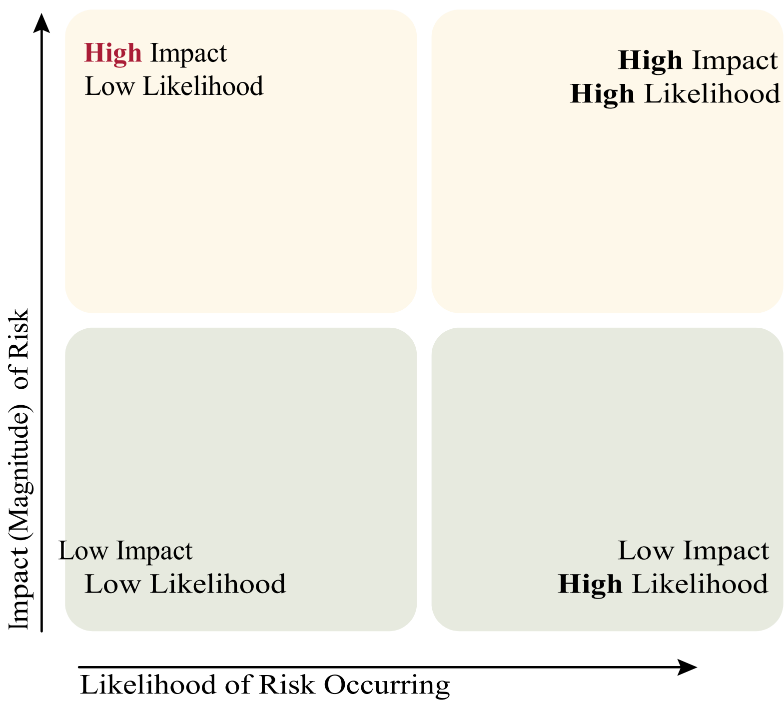
The steps involved in risk assessment (using assessment criteria of high, medium, or low) are illustrated below.

Exhibit 9.1-1



The results of the risk assessment process can also be set out in a chart, as illustrated below. Some commercial software packages provide charting capabilities.

Exhibit 9.1-2



Risks falling in the "high impact (magnitude), high likelihood" area of the chart clearly require management action to mitigate. In addition, these risks will likely be determined as being significant, which will require special audit consideration (refer to Volume 2, Chapter 10).

CONSIDER POINT

Discussions with management

When risk factors are documented and assessed by the auditor, it is important that the results be discussed with the entity's management. This discussion will help to ensure that a risk factor has not been overlooked and that the auditor's assessment of risks (likelihood and impact) is reasonable. However, it is always important to use professional skepticism when evaluating management's input and responses.

9.2 Risk Assessments Performed by the Entity

Risk assessment is one of the five components of internal control (see Volume 1, Chapter 5) that should be addressed by the entity's management.

In smaller entities, the risk assessment process is likely to be informal and unstructured. Risk in smaller entities is often recognized implicitly rather than explicitly. Management may be aware of risks related to financial reporting through direct personal involvement with employees and outside parties. As a result, the auditor would make inquiries of management as to how it identifies and manages risk, and then as to what risks have actually been identified and managed. The auditor would document the results.

As management understands the benefits of a more formalized risk assessment process, it may decide to develop, implement, and document its own processes. When this occurs, the auditor would evaluate:

- Controls in place over management's processes;
- The completeness of the business and fraud risks identified. This is often recorded on what is commonly referred to as a "risk register";
- Management's assessment of the magnitude of the risks and the likelihood of their occurrence; and
- Management's responses to address the assessed risks.

If management has failed to identify key risks, consideration should be given as to whether there is a significant deficiency in the entity's risk assessment process.

9.3 Documenting Assessed Risks

Professional judgment should be used regarding the manner in which risk factors are assessed.

The assessment of the risks of material misstatement is made at the:

- Financial statement level; and
- Assertion level for classes of transactions, account balances, and disclosures.

Documentation may be in the form of memoranda or a risk listing (for fraud) such as that outlined in Exhibit 9.3-1. Note the following:

- The first two columns in the table below would be completed as part of risk identification as discussed in Volume 2, Chapter 8.
- The assertion column is an assessment of:

- The specific assertions that relate to the financial statement area or disclosure impacted by the risk. This will help in the assessment of risks at the assertion level, and
- Pervasive risks that affect many assertions, and would impact the assessment of risk at the financial statement level.

- The risks being assessed are inherent risks. Control risk is addressed in Volume 2, Chapters 11 and 12.
- The assessments of likelihood and magnitude (impact) used the numeric scale of 1 = low likelihood/ magnitude and 5 = high likelihood/magnitude. These scores may be multiplied to provide a combined overall score. However, these risks could just as easily have been assessed as high, medium or low.

Exhibit 9.3-1

Period ended: December 31, 20X2 Materiality Rs.50,000					
			Inherent Risk Assessment		
Risk Event/Source	**Implication of Risk Factor**	**Assertions** PCAEV	Likeli-hood to Occur	*Rs* Impact	Com-bined Score
Salespersons' compensation based on sales commissions	*Sales could be fictitious, recorded in the wrong period, overstated, or at terms different from the standard terms and conditions in order to achieve bonus targets*	EA	4	4	16
Failure to comply with debt covenants is covered up to avoid bank inquiries	*Unauthorized journal entries to defer expense, bias in management estimates, etc.*	P	2	5	10
Fictitious suppliers inserted by employees	*Acme pays for expenses at inflated prices or for which no services/goods were rendered*	EA	2	4	8
Related party transactions not identified. Shareholders not involved in business could be disadvantaged	*Revenue and expenses not recorded at FMv (Fair Market value)*	P	3	5	15
Cash sales for parts and service may go unrecorded and undeposited	*Revenue and assets are understated*	CAE	4	1	4

CONSIDER POINT

When documenting risk factors, consider how they will be updated and used in subsequent periods. Recording information in one place and in a structured format (such as above) may take a little longer to prepare initially, but will be much easier to update in the future. A structured format also helps to ensure:

- That risks are not addressed more than once (which can occur if spread throughout the audit file);
- A consistent assessment of each risk;
- That significant risks are identified;
- Ease of review. An electronic worksheet enables risks (scored numerically) to be sorted on their combined score, or by likelihood or impact; and
- The risk listing can be shared with the client (to obtain their input) or to request that the client prepare the listing of risk factors for the auditor's review.

9.4 Case Studies — Inherent Risks — Assessment

For details of the case studies, refer to Volume 2, Chapter 2 — Introduction to the Case Studies.

Where a structured format is used to document the assessment, it can be completed using the same form as the one started in Volume 2, Chapter 8. The audit response column can be used to cross-reference the risk factors to the specific audit procedures or audit programs that address the identified risks.

If a memo is to be used, the risk assessment and risk response could be added to the memo started in Volume 2, Chapter 8.

Case Study A—Dephta Furniture, Inc.

Business Risks						
Risk Event/Source	Implication of Risk Factor	Assertions	Inherent Risk Assessment			Signi-ficant Risk? Y/N
	What financial statement areas could be misstated and in what way	PCAEV	Likelihoo d to	Rs. Impact	Com-bined Score	
Continued growth (despite downturn) and poor inventory control	*Breach of debt covenants*	*P*	*4*	*5*	*20*	*Y*
Inventory clerk known to make errors	*Inventory balances may be overstated/understated and possibly impact valuation*	*CAE*v	*5*	*3*	*15*	*N*
General IT controls are weak in a number of areas	*Data integrity may be compromised or data may even be lost*	*P*	*3*	*5*	*15*	*N*
Downturn in economy	*Inventory write-downs may* be required	v	*3*	*3*	*9*	*N*
New sales being sought in other countries	*Foreign exchange risks in receivables*	*A*	*2*	*2*	*4*	*N*
Downturn in economy.	*Receivables may be difficult to collect (i.e., overstated)*	v	*1*	*3*	*3*	*N*

Key:	Assess likelihood (probability) to occur on a scale of 1-5	Assess the magnitude (monetary impact) in relation to materiality on a scale of 1–5
P = Pervasive (all assertions)	1 = Remote	1 = Immaterial
C = Completeness	2 = Unlikely	2 = Minor
A = Accuracy	3 = Likely	3 = Moderate
E = Existence	4 = Most likely	4 = Major
V = Valuation	5 = Almost certain	5 = Material

(As a guide, risk factors with a combined risk assessment (Likelihood x Impact) score of 20 or more should be considered as "significant" fraud risks.)

Note: The possible violation of the bank covenants has a combined risk score of 20, and is therefore considered to be a significant risk. Significant risks require special audit consideration by the auditor, including obtaining an understanding of the entity's related controls relevant to such risks.

Fraud Risks							
Risk Event/Source	**Implication of Risk Factor**	**Assertions**	**Inherent Risk Assessment**			Signi-ficant Risk? Y/N
	What financial statement areas could be misstated and in what way?	PCAEV	Likeli hood	Rs. Impact	Com-bined Score	
Pressures						
Minimize tax burden	*Unauthorized journal entries/ financial statement manipulation*	*P*	*4*	*5*	*20*	*Y*
Rapid growth putting pressure on financing	*Financial statement manipulation to avoid bank covenant being violated*	*P*	*4*	*5*	*20*	*Y*
Minimize tax burden	*Management bias in estimates to reduce income*	*CAv*	*4*	*4*	*16*	*Y*
Salesman's bonus based on sales above certain thresholds	*Inflated sales to meet thresholds. However, the bonus amounts are small.*	*E*	*3*	*2*	*6*	*N*
Paying bribes to obtain contracts	*Damage to reputation, overstatement of expenses, unaccrued fines.*	*CAE*	*2*	*2*	*4*	*N*
Opportunities						
Revenue recognition	*Inconsistent application of accounting policies*	*CAE*	*3*	*4*	*12*	*Y*
Significant expansion in the use of related party transactions	*Sales/purchases could be undervalued/overvalued*	v	*4*	*5*	*20*	*Y*
High value, easily transportable items of inventory	*Goods stolen from inventory*	*E*	*4*	*3*	*12*	*N*
High incidence of cash sales	*Goods stolen/cash stolen.*	*E*	*4*	*3*	*12*	*N*
Transactions with related parties	*Sales/purchases may not be complete, properly valued, or disclosed in the financial statements*	*P*	*3*	*4*	*12*	*N*
Rationalization						
Low morale among temporary workers	*Goods or cash stolen*	*E*	*3*	*2*	*6*	*N*

Key:	Assess likelihood (probability) to occur on a scale of 1-5	Assess the magnitude (monetary impact) in relation to materiality on a scale of 1–5
P = Pervasive (all assertions)	1 = Remote	1 = Immaterial
C = Completeness	2 = Unlikely	2 = Minor
A = Accuracy	3 = Likely	3 = Moderate
E = Existence	4 = Most likely	4 = Major
V = Valuation	5 = Almost certain	5 = Material

(As a guide, risk factors with a combined risk assessment (Likelihood x Impact) score of 20 or more should be considered as "significant" fraud risks.)

Note: The possible management bias in estimates, unauthorized journal entries, the pressures to finance the rapid growth, and related party transactions have been assessed as significant risks (where the combined score exceeded 20). Significant risks require special audit consideration by the auditor, including obtaining an understanding of the entity's related controls relevant to such risks. If no controls exist, it is likely that a significant deficiency exists. Note that revenue recognition has a combined score of less than 16 but is presumed to be a significant risk. (Refer to SLAuS 240.26.)

Case Study B—Kumar & Co.

Memo to File—Kumar & Co.

Inherent Risk Identification

Materiality = Rs.3,000

As a result of performing the risk assessment procedures outlined on working paper X.X, which included potential sources of risk arising from the six areas of required understanding, we have identified the following risk factors:

Business Risks

Raj's absence from operations—a pervasive risk

- The quality and accuracy of the accounting records could be compromised due to Raj's focus on personal family matters. The financial statements could be materially misstated.

  Risk Assessment: High likelihood of occurrence/High magnitude (in relation to materiality) = High Risk, and also a significant risk. See WP # X.X.

  Risk Response: *(to be addressed in volume 2, Chapter 16)*

- Raj used to inspect goods for quality before shipment. The quality of products sold could be compromised, leading to greater returns and/or unsaleable inventory. (Valuation)

  Risk Assessment: Low Likelihood/Low Magnitude = Low Risk

  Risk Response: *(to be addressed in volume 2, Chapter 16)*

Downturn in economy and economic dependence - a pervasive risk

- Kumar & Co. is dependent on its primary customer, Dephta Furniture, Inc., which represents over 90% of its sales. In this economic downturn, Dephta could cancel orders. The impact could be bank covenant violations and overvalued assets. If the bank called its loan, the company would be unable to continue. (Valuation)

  Risk Assessment: Moderate Likelihood/Moderate Magnitude = Moderate Risk

  Risk Response: *(to be addressed in volume 2, Chapter 16)*

Fraud Risks

Revenue Recognition

- Possibility of inconsistent application of accounting policies.

  Risk Assessment: Moderate Likelihood/Moderate Magnitude = Moderate Risk, but this is presumed by SLAuS 240.26 to be a significant risk, and will be treated as such.

  Risk Response: *(to be addressed in volume 2, Chapter 16)*

Tax minimization - a pervasive risk

- There may be a management bias to minimize the tax burden. There may be a bias in management's estimates, or unauthorized journal entries could be used. (Completeness, Accuracy)

  Risk Assessment: High Likelihood/Moderate Magnitude = Moderate to High Risk, and should be considered a significant risk.

  Risk Response: *(to be addressed in volume 2, Chapter 16)*

Downturn in economy and economic dependence - a pervasive risk

- A decline in sales and liquidity pressures may lead to financial statement manipulation to avoid bank covenant violations. (All assertions)

  Risk Assessment: Moderate Likelihood/High Magnitude = Moderate to High Risk, and should be considered a significant risk.

  Risk Response: *(to be addressed in volume 2, Chapter 16)*

Raj's absence from operations—a pervasive risk

- Raj's absence results in minimal oversight of Ruby's work. In addition, Ruby appears to have low morale and personal financial pressures. This creates incentive, opportunity, and rationalization for cash/goods being stolen (Existence) and/or financial statement manipulation.

  Risk Assessment: Moderate Likelihood/Moderate Magnitude = Moderate Risk

  Risk Response: *(to be addressed in volume 2, Chapter 16)*

Related Parties

- Transactions with related parties could be manipulated leading to sales being overvalued. (Valuation)

  Risk Assessment: Moderate Likelihood/Moderate Magnitude = Moderate Risk and should be considered a significant risk

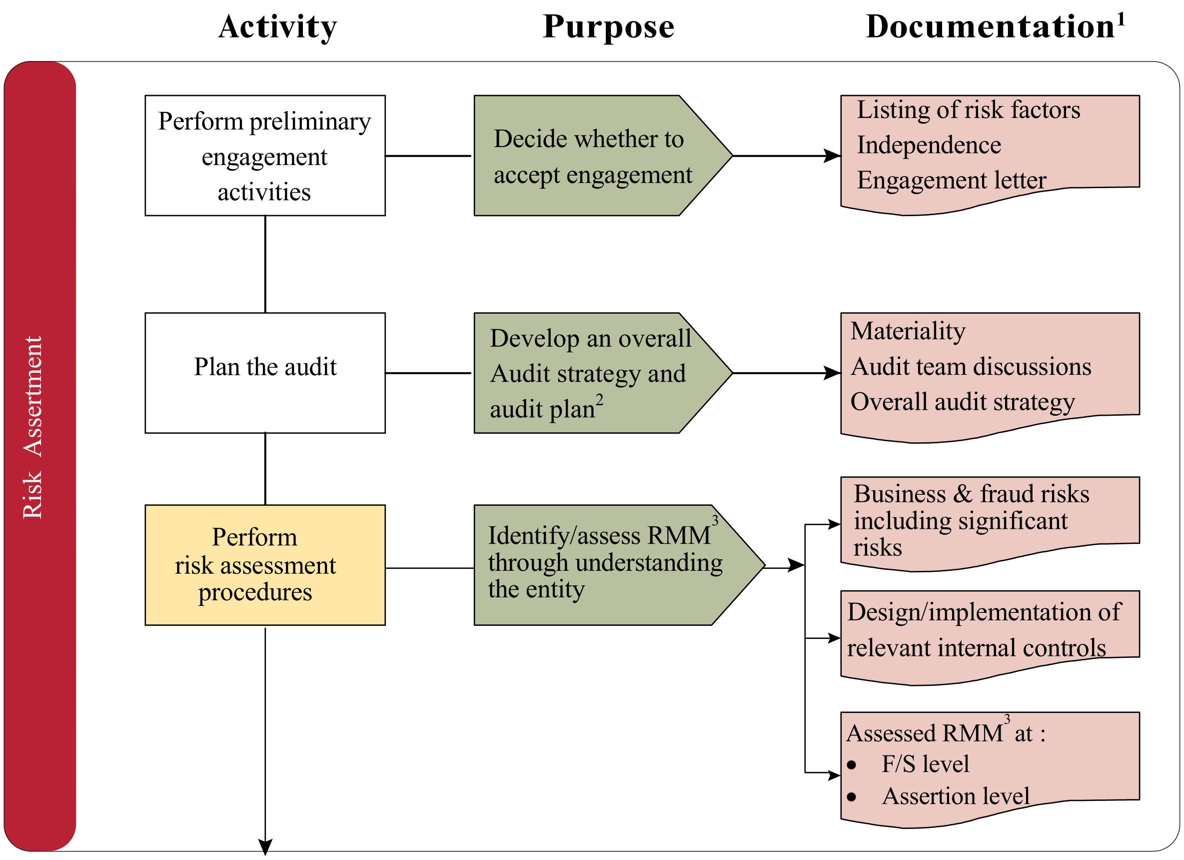
  Risk Response: *(to be addressed in volume 2, Chapter 16)*

Note: Significant risks require special audit consideration by the auditor, including obtaining an understanding of the entity's related controls relevant to such risks. If no controls exist, it is likely that a significant deficiency exists.

10. Significant Risks

Chapter Content	Relevant SLAuSs
Guidance on the nature and determination of significant risks, and the consequences for the audit.	240, 315, 330

Exhibit 10.0-1



Notes:

1. Refer to SLAuS 230 for a more complete list of documentation required.
2. Planning (SLAuS 300) is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Paragraph #	Relevant Extracts from SLAuSs
240.26	When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks. Paragraph47 specifies the documentation required where the auditor concludes that the presumption is not applicable in the circumstances of the engagement and, accordingly, has not identified revenue recognition as a risk of material misstatement due to fraud. (Ref: Para. A28-A30)
315.4	For purposes of the SLAuSs, the following terms have the meanings attributed below: (e) Significant risk—An identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.
315.25	The auditor shall identify and assess the risks of material misstatement at: (a) the financial statement level; and (Ref: Para. A105-A108) (b) the assertion level for classes of transactions, account balances, and disclosures (Ref: Para. A109-A113) to provide a basis for designing and performing further audit procedures.
315.27	As part of the risk assessment as described in paragraph 25, the auditor shall determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor shall exclude the effects of identified controls related to the risk.
315.28	In exercising judgment as to which risks are significant risks, the auditor shall consider at least the following: (a) Whether the risk is a risk of fraud; (b) Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention; (c) The complexity of transactions; (d) Whether the risk involves significant transactions with related parties; (e) The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty; and (f) Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual. (Ref: Para. A119-A123)
315.29	If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk. (Ref: Para. A124-A126)
330.21	If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details. (Ref: Para. A53)
550.18	In meeting the SLAuS 315 requirement to identify and assess the risks of material misstatement, the auditor shall identify and assess the risks of material misstatement associated with related party relationships and transactions and determine whether any of those risks are significant risks. In making this determination, the auditor shall treat identified significant related party transactions outside the entity's normal course of business as giving rise to significant risks.
550.19	If the auditor identifies fraud risk factors (including circumstances relating to the existence of a related party with dominant influence) when performing the risk assessment procedures and related activities in connection with related parties, the auditor shall consider such information when identifying and assessing the risks of material misstatement due to fraud in accordance with SLAuS 240. (Ref: Para. A6, A29-A30)

10.1 Overview

After the business and fraud risks have been identified and assessed, consideration can be given to the existence of significant risks. A significant risk is where the assessed risk of material misstatement is so high that, in the auditor's judgment, it will require special audit consideration.

Significant risks are assessed before consideration of any mitigating controls. Significant risk is based on the inherent risk (before considering the related internal control) and not the combined risk (considering both inherent and internal control risks). For example, a company with a large inventory of diamonds would have a high inherent risk of theft. Management's response is to maintain secure facilities. The combined risks of material misstatement are therefore minimal. However, because the risk of loss (before considering internal control) is highly likely and its size would have a material impact on the financial statements, the risk would be determined as "significant."

CONSIDER POINT

When considering the existence of significant risks, it can be difficult to ignore the mitigating effect of relevant internal control. This is particularly true when the people implementing the control are well known to the auditor and most likely are highly competent in what they do.

What is required is to separate the inherent risk from the controls in place. For example, an adult about to cross a busy street would not likely consider the activity to be very risky. This is because it is anticipated that adults use their eyes, ears, and previous experience (in crossing streets) to cross safely. But such a risk assessment combines the inherent risk involved in crossing the street with a number of control activities (the use of the eyes, ears, and previous experience). To assess whether crossing the street is a significant risk (i.e., before any controls), the person would have to be blindfolded, given earplugs, and then asked to walk across the street.

10.2 Examples

Examples of significant risks are set out in the exhibit below.

Exhibit 10.2-1

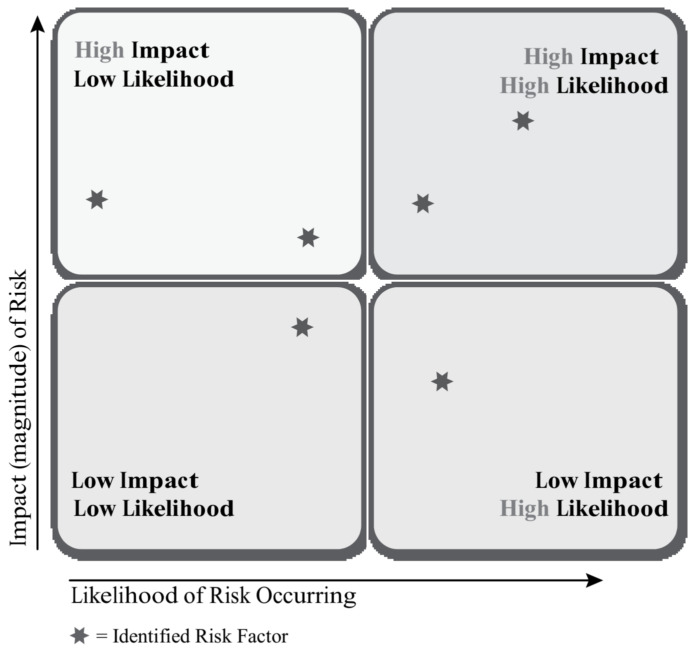
Sources	Examples
High-Risk Activities	Includes operations or events where a material misstatement could easily occur. For example, an inventory of high-value diamonds or gold bars held by a jeweller, or a new/complex accounting system being introduced.

Sources	Examples
Large Non-Routine Transactions (Size or Nature)	Identified significant related party transactions outside the entity's normal course of business are to be treated as giving rise to significant risks. Includes infrequent and large transactions. For example: • Unusual volume of routine transactions with a related party; • A major sales or supply contract; • The purchase or sale of major business assets or business segments; and • Sale of the business to a third party. Routine non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks.
Matters Requiring Judgment or Management Intervention	Examples would include: • The assumptions and calculations used by management in developing major estimates; • Complex calculations or accounting principles; • Revenue recognition (presumed to be a significant risk) that is subject to differing interpretation; • Extensive manual data collection and processing; and • Where management intervention is required to specify the accounting treatment to be used.
Potential for Fraud	The risk of not detecting a material misstatement resulting from fraud (which is intentional and deliberately concealed) is higher than the risk of not detecting one resulting from error. In evaluating whether significant risks could result from the identified fraud risk factors and the possible scenarios and schemes identified in team discussions (see Volume 2, Chapter 7), consider the following: • Skillfulness of the potential perpetrator; • Relative size of individual amounts manipulated; • Level of authority of management or employee to: − Directly or indirectly manipulate accounting records, and − Override control procedures; • Frequency and extent of manipulation involved; • Possible degree of collusion; • Intentional misrepresentations being made to the auditor; and • Previous audit experience or concerns expressed by other persons. Significant fraud risks may be identified at any stage in the audit as a result of new information being obtained.

10.3 Identifying Significant Risks

If the risks of material misstatement have already been identified and assessed, all that is required is to review the findings and then select (based on the use of professional judgment) those risks that are indeed significant. For example, if the assessment of risks was charted as illustrated below (the stars represent assessed risks), it would be the two risks falling within the shaded area (risks with high magnitude and high likelihood) that would first be considered as significant risks.

Exhibit 10.3-1



When considering whether significant risks exist, the auditor would consider the matters set out below.

	Considerations
Factors That May Indicate Possible "Significant Risks"	Risk of fraud.
	Risks related to recent significant economic, accounting, or other developments, and therefore require specific attention.
	Complexity of transactions.
	Significant transactions with related parties.
	The degree of subjectivity in the measurement of financial information related to the risk, especially those involving a wide range of measurement uncertainty.
	Significant transactions that are outside the normal course of business for the entity or that otherwise appear to be unusual.

In smaller entities, significant risks can often relate to the matters outlined in the exhibit below.

Exhibit 10.3-2

Subject Matter/ Information	Characteristics
Significant Non-Routine Transactions	• High inherent risk (likelihood and impact). • Transactions that occur infrequently and are not subject to systematic processing. • Unusual due to their size or nature (such as the acquisition of another entity). • Require management intervention: − To specify accounting treatment, and − For data collection and processing. • Involve complex calculations or accounting principles. • Nature of transactions makes it difficult for entity to implement effective internal control over the risks.
Significant Judgmental Matters	• High inherent risk. • Involve significant measurement uncertainty (such as the development of accounting estimates). • Accounting principles involved may be subject to differing interpretation (such as preparation of accounting estimates or application of revenue recognition). • The required judgment by management may be subjective, complex, or require assumptions about the effects of future events (such as judgments about fair value, valuation of inventory subject to rapid obsolescence, etc.).
Significant Transaction al Risks	• There may be a small number of transactional risks relating to the major business processes (such as goods being shipped but not invoiced in a sales process) that would result in a material misstatement in the financial statements if not mitigated. Where these risks require special audit consideration, they would be regarded as significant risks. If there were no internal controls in place to mitigate such risks, they would also be reported to management as being a significant deficiency.
Fraud	• Revenue recognition. This is a presumed significant risk. • Management override or bias in estimates, etc. • Major related party transactions used to increase sales or purchases. • Collusion with suppliers or customers such as price or bid rigging. • Unrecorded or fictitious transactions.

10.4 Responding to Significant Risks

When a risk is classified as being "significant," the auditor should respond as outlined below.

Audit Steps	Description
Evaluate Internal Control Design & Implementation Over Each Significant Risk	Has management designed and implemented internal control that mitigates the significant risks? Consider the existence of direct controls such as control activities and indirect (pervasive) controls which may be included in the control environment, risk assessment, information systems, and monitoring elements. This information will be helpful in developing an effective audit response to the identified risks. Where significant non-routine or judgmental matters are not subject to routine internal control (such as a one-off or an annual event), the auditor would evaluate management's awareness of the risks and the appropriateness of its response. For example, if the entity purchased the assets of another business, the entity's response might include: • Hiring an independent valuator for the acquired assets; • Applying appropriate accounting principles; and • Proper disclosure of the transaction in the financial statements. Where the auditor determines that management has not appropriately responded (by implementing internal control over significant risks), a significant deficiency would exist in the entity's internal control, which would be communicated (as soon as possible) to those charged with governance.
Design an Audit Response to the Identified Significant Risks	Do the planned further audit procedures specifically address the significant risk? These procedures would be designed to obtain audit evidence with high reliability, and could include tests of controls and substantive procedures. In many cases, the audit procedures may simply be an extension of procedures that would be performed in any event. For example, if the significant risk related to potential management bias, such as in the preparation of an estimate, the extended substantive procedures would include: • Assessing the validity of the assumptions used; • Identifying the sources and reliability of the information used (both external and internal); • Considering the existence of any bias in the prior period's estimates as compared to actual facts; and • Reviewing the methods used (including formulas in electronic spreadsheets) in the estimate calculation.
No Reliance Can Be Placed on Evidence Obtained in Previous Periods	Where a test of operating effectiveness is planned for a control that mitigates a significant risk, the auditor may not rely on audit evidence about the operating effectiveness of internal control obtained in prior audits.

Audit Steps	Description
Substantive Analytical Procedures Alone are not Sufficient	The use of substantive analytical procedures by themselves is not considered an appropriate response to address a significant risk. When the approach to significant risks consists only of substantive procedures, the audit procedures shall consist of either: • Tests of details alone; or • A combination of tests of details and substantive analytical procedures.

10.5 Documenting Significant Risks

The identification of significant risks and the proposed audit response would be documented. If all risks are documented in a single location, the documentation of significant risks may simply be an extension of the information already documented.

Note: If the auditor concludes that revenue recognition is not a significant risk of material misstatement due to fraud, the reasons for that conclusion are to be included in the audit documentation.

10.6 Case Studies—Significant Risks

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

Significant risks can be identified from the listing of risk factors and their assessment. See the forms contained in the case studies discussion in Volume 2, Chapters 8 and 9. Such a form can also be used to cross-reference each significant risk to the related detailed audit plan.

For each significant risk identified, management's response should be documented and appropriate audit procedures developed that respond to the specific risk.

Case Study A — Dephta Furniture, Inc.

(Excerpt)

Significant Risk	Management's Response	Audit Response	WP Reference
Possible violation of terms of their bank's financing?	*Preparation and monitoring of cash-flow forecasts.* *Renegotiate amount and terms of financing.*	*Look at the company's growth plans and whether the forecasted cash flows are realistic.* *Review and compare actual results and cash flows.* *Ensure that the valuations of receivables and inventory (the security for the loans) are reasonable.* *Review the company's refinancing submission to the bank.*	*(Not included)*
Financial statement manipulation could occur to avoid the bank covenants being violated.	*None. Management does not see this as a risk at all.*	*Carefully review the assumptions used in the cash-flow forecasts and the basis on which actual cash-flow reports are prepared.* *Ensure that the basis for the valuations of receivables and inventory is valid and correct. Carefully test the existence and accuracy of sales, as there is pressure to maintain and grow sales levels despite the challenging economic environment.*	
Inconsistent revenue recognition (a presumed fraud risk).	*Sales contracts over Rs.500 are reviewed by the sales manager.*	*Review of major contracts (and a sample of smaller contracts) and discussion with sales manager to ensure that revenue was appropriately recognized in the period.*	
Unauthorized journal entries.	*Management has agreed to put policy in place requiring approval of all journal entries, but it has not yet been implemented.*	*Identify and review all journal entries over Rs.1,500 and all entries in the month before and after the period end.*	
Significant expansion in the use of related party transactions.	*Policy is that all related party transactions are identified as such and conducted at the normal terms of sale. This includes any corporate assets or services provided for personal use by management or employees.*	*Review employees' understanding of the* policy through inquiry and inspection. *Seek to ensure that all related party transactions have been identified and that the transactions, terms of sale, nature of transaction, and the dates are indeed appropriate.*	

Prepared by: FJ Date: December 9, 20X2

Reviewed by: LF Date: January 5, 20X3

Case Study B—Kumar & Co.

Memo to File: Kumar & Co.

Identification of Significant Risks

The following significant risk areas, including management's response and the audit response, are identified below.

Downturn in economy
The company has not suffered too badly in the downturn. However, Raj should periodically review bank covenant calculations, but he has not been attentive to this in the current period under audit. We will recalculate all ratios to see status against covenants. We will also perform more audit procedures for audit areas that are input into the calculation. The risk is heightened the closer the company is to violation, due to possibility of financial statement manipulation.

Tax minimization
There are no management controls that specifically address this issue. The response to this risk will be to carefully review management's estimates and journal entries (see below).

Unauthorized Journal Entries
Raj should authorize all journal entries, but this has not been happening consistently. We will identify and review all journal entries over Rs.500 and all entries in the month before and after period end.

Related Party Transactions
Company policy is that all related party transactions are identified as such and conducted at the normal terms of sale. We will review Raj's and Ruby's understanding of the policy through inquiry and inspection. We will ensure that for all related party transactions, the terms of sale, nature of transactions, and the dates are indeed appropriate. We will also remain alert throughout the audit for transactions outside the normal course of business, and that all related party transactions have in fact been identified.

Revenue recognition
Revenue recognition policies on sales are fairly straightforward and the majority of sales made by Kumar are to Dephta Furniture, Inc. The audit work performed on cutoff and related party transactions addressed any potential for fraud through inappropriate revenue recognition.

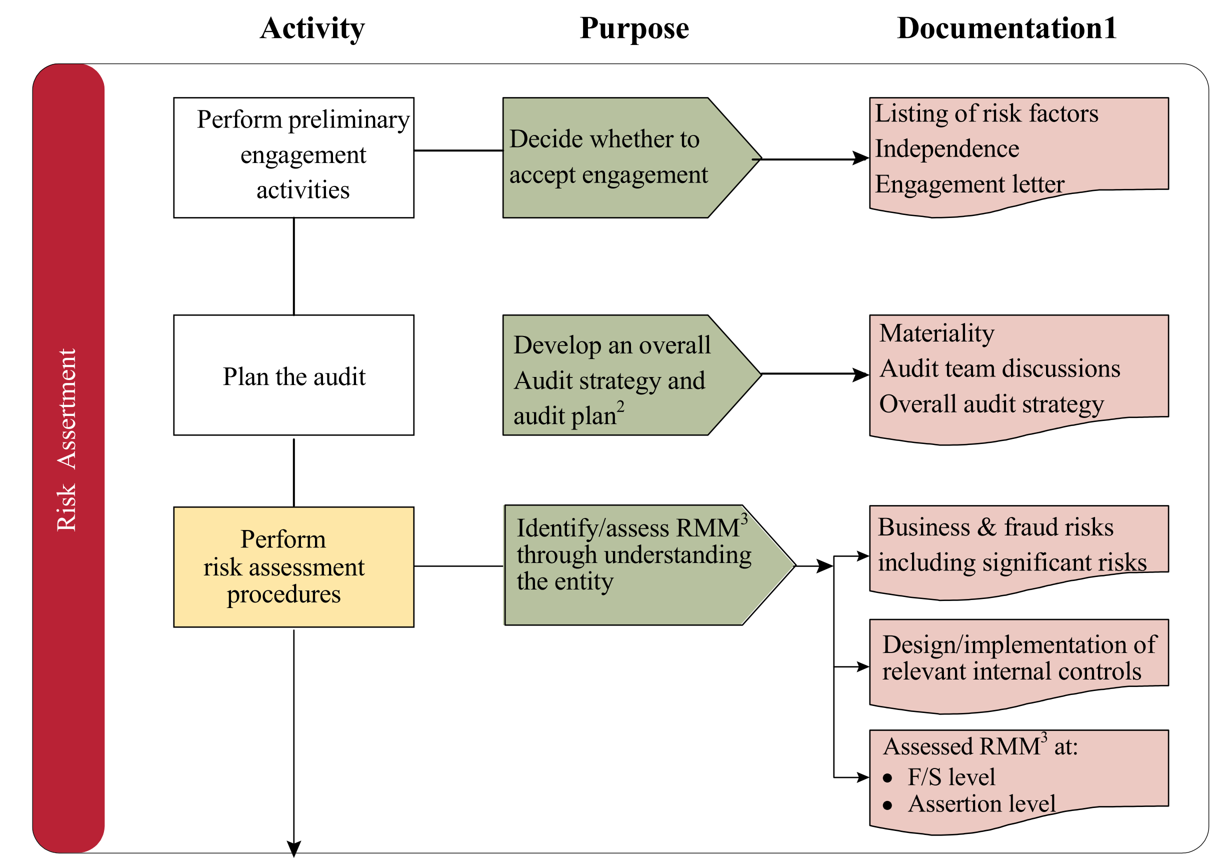
Prepared by: FJ **Date:** December 9, 20X2

Reviewed by: LF **Date:** January 5, 20X3

11. Understanding Internal Control

Chapter Content	Relevant SLAuSs
Guidance on the steps involved in understanding internal control relevant to the audit: • Evaluating control design and implementation; and • Documentation using two possible approaches.	315

Exhibit 11.0-1



Notes:
1. Refer to SLAuS 230 for a more complete list of documentation required.
2. Planning (SLAuS 300) is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Paragraph #	Relevant Extracts from SLAuSs
315.4	For purposes of the SLAuSs, the following terms have the meanings attributed below: (a) Assertions—Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur. (b) Business risk—A risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies. (c) Internal control—The process designed, implemented and maintained by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations, and compliance with applicable laws and regulations. The term "controls" refers to any aspects of one or more of the components of internal control.
315.12	The auditor shall obtain an understanding of internal control relevant to the audit. Although most controls relevant to the audit are likely to relate to financial reporting, not all controls that relate to financial reporting are relevant to the audit. It is a matter of the auditor's professional judgment whether a control, individually or in combination with others, is relevant to the audit. (Ref: Para. A42-A65)
315.14	The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether: (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. (Ref: Para. A69-A78)
315.15	The auditor shall obtain an understanding of whether the entity has a process for: (a) Identifying business risks relevant to financial reporting objectives; (b) Estimating the significance of the risks; (c) Assessing the likelihood of their occurrence; and (d) Deciding about actions to address those risks. (Ref: Para. A79)
315.18	The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas: (a) The classes of transactions in the entity's operations that are significant to the financial statements; (b) The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements; (c) The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form; (d) How the information system captures events and conditions, other than transactions, that are significant to the financial statements; (e) The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures; and (f) Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments. (Ref: Para. A81-A85)

Paragraph #	Relevant Extracts from SLAuSs
315.19	The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting, including: (Ref: Para. A86-A87) (a) Communications between management and those charged with governance; and (b) External communications, such as those with regulatory authorities.
315.20	The auditor shall obtain an understanding of control activities relevant to the audit, being those the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. (Ref: Para. A88-A94)
315.21	In understanding the entity's control activities, the auditor shall obtain an understanding of how the entity has responded to risks arising from IT. (Ref: Para. A95-A97)
315.22	The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls. (Ref: Para. A98-A100)

11.1 Overview

This chapter addresses the scope of work required to understand internal control relevant to the audit. Volume 1, Chapter 5 addresses the nature of internal control and provides a detailed description of the five components of internal control. Volume 2, Chapter 12 outlines a four-step approach to internal control evaluation.

Internal control refers to the processes, policies, and procedures designed by management to ensure reliable financial reporting and the preparation of financial statements in accordance with the applicable accounting framework. Internal control addresses such matters as management's attitude toward control, competence of key people, risk assessment, accounting, and other financial information systems in use, as well as the traditional control activities.

The auditor is required to obtain an understanding of internal control on all audit engagements. This applies to any size of entity, even where the auditor has already decided that an entirely substantive approach would be the appropriate response to the risks of material misstatement.

Obtaining a sufficient understanding of internal control (relevant to the audit) involves the performance of risk assessment procedures to identify the controls that will directly or indirectly mitigate material misstatements. The information obtained will assist the auditor in:

- Assessing the residual risk (inherent and control risk) of material misstatement at the financial statement and assertion levels; and
- Designing further audit procedures that are responsive to the assessed risks.

However, not all control activities are relevant to the audit and therefore do not require understanding.
The auditor is only concerned with evaluating those controls that mitigate a risk of a material misstatement (caused by fraud or error) in the financial statements. Control activities that are not relevant can be scoped out of the audit altogether.

11.2 Risk and Control

The relationship between risk and control can be illustrated as follows.

Exhibit 11.2-1

The inherent risk bar represents the business and fraud risk factors that could result in the financial statements being materially misstated (before any consideration of internal control). The control risk bar reflects the control procedures put into effect by management to mitigate the inherent risks. The extent to which the control risk bar does not completely mitigate the inherent risks is often called management's residual risk.

Inherent business and fraud risks are identified during the risk identification and risk assessment phase. Management mitigates such risks by designing and implementing internal controls and procedures that will reduce such risks to an acceptably low level. The amount of risk left over, after internal controls have been designed and implemented, is the risk of material misstatement (sometimes referred to as residual risk).

Ideally, management would design sufficient controls to ensure that the residual risk is reduced to an acceptably low level for both internal management purposes and for the external audit. In practice, some managers will tend to have a high tolerance for risk (i.e., less controls are in place, resulting in a higher residual risk), and some managers (often in the public sector) will tend to be conservative and design controls to reduce risk to almost nothing.

CONSIDER POINT

The sole purpose of a control is to mitigate risk. A control without a risk to mitigate is obviously redundant. So, a risk has to exist before it can be mitigated by a management control. However, some auditors ignore this fact. They start their evaluation of internal control by documenting the system and controls that exist before taking the time to identify what risks actually require mitigation. This approach can result in a lot of unnecessary work in documenting processes and controls, which may later prove to be totally irrelevant to the audit objectives.

11.3 Pervasive and Specific Internal Controls

Internal controls can be broadly categorized as pervasive (or entity-level) controls that address pervasive risks, and specific (transactional) controls that address specific risks. The differences between these controls are illustrated below.

Exhibit 11.3-1

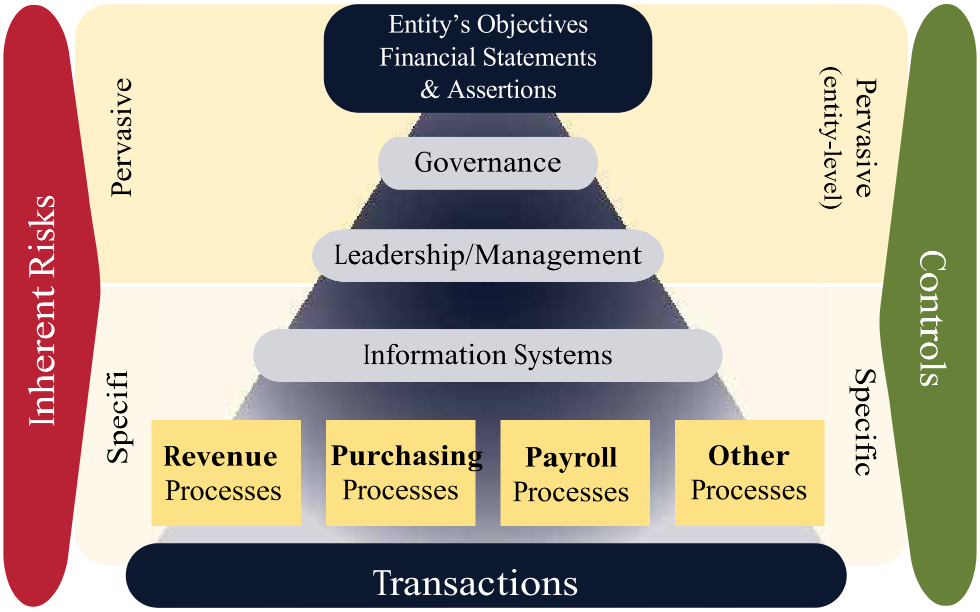


Exhibit 11.3-2

	Description
Pervasive (Entity-Level) Controls	Pervasive (entity-level) controls address governance and general management, and serve to establish the overall control environment or “tone at the top.” Typical control processes include human resources, fraud, risk assessment (management override), general IT management, preparation of financial information (including financial statements and underlying estimates, etc.), and the ongoing monitoring of operations. In small entities, these controls will refer primarily to management’s attitudes toward integrity and control. A solid understanding of the pervasive elements of internal control provides an important foundation for assessing relevant controls over financial reporting at the transactional (business process) level. For example, if there are poor controls over data integrity at the entity level, this will impact the reliability of all information produced by systems such as sales, purchases, and payroll.

	Description
Specific (Transactional) Controls	Transactional (business process) controls are specific processes/controls that are designed to ensure that: • Transactions are appropriately recorded for the preparation of financial statements; • Accounting records are maintained in reasonable detail to accurately and fairly reflect all the transactions and dispositions of assets; • Receipts and expenditures are made only in accordance with the authorizations of management; and • Unauthorized acquisition, use, or disposition of assets would be prevented or detected on a timely basis. Transactional control processes include routine transactions (such as revenues, purchases, and payroll) and non-routine transactions (such as purchasing equipment or the costs involved in starting a new line of business).

11.4 The Five Internal Control Components

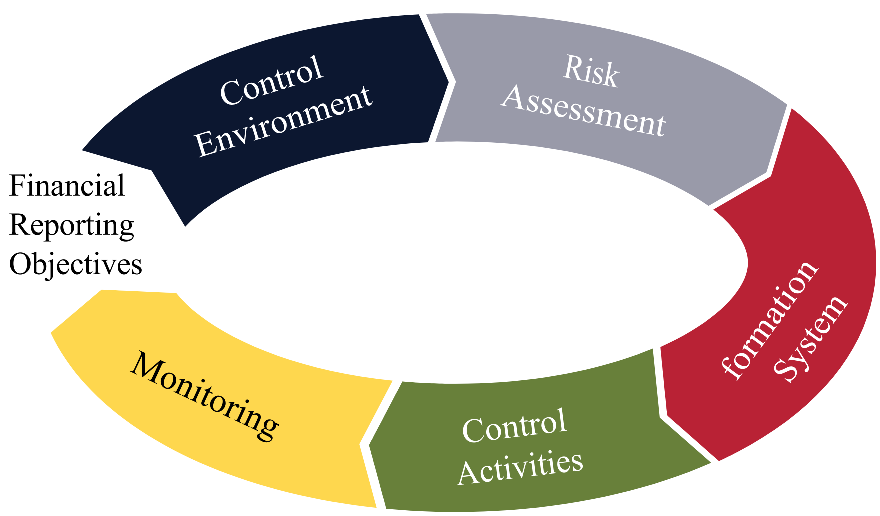
The various types of internal control that exist within an entity have been divided into five key components, as illustrated below.

Each of these components is to be addressed by the auditor as:

- Part of the understanding of the internal control (over financial reporting); and
- Information for considering how the different aspects of internal control may affect the audit.

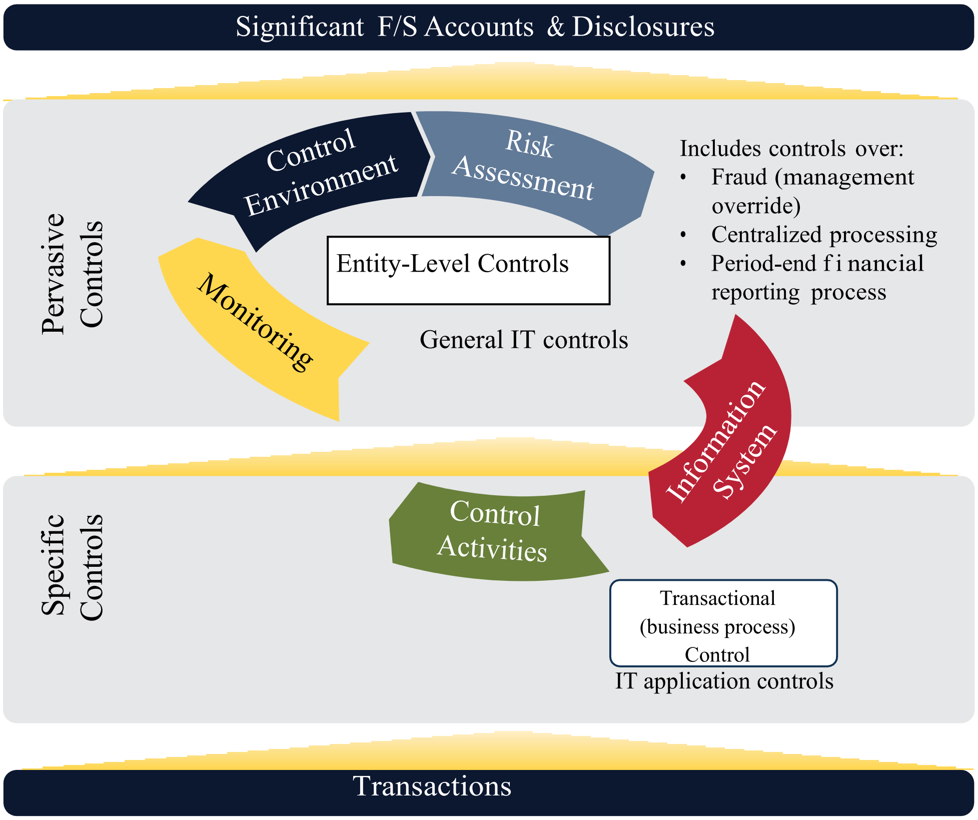
Exhibit 11.4-1 below outlines the five components of internal control that can be used by management to reduce the risks of material misstatement in the financial statements. The circle indicates the ongoing nature of the various components in achieving the entity's financial reporting objectives.

Exhibit 11.4-1



The interrelationships of the five components between the pervasive (entity-level) controls and the specific transactional (business process) controls are illustrated below.

Exhibit 11.4-2



Pervasive entity-level controls collectively provide the appropriate foundation for all the other components of internal control, because poor entity-level controls can render even the best business process controls ineffective. For example, an entity may have an effective purchasing system, but if the bookkeeper/accountant is incompetent (i.e., it is a poor control environment), a wide variety of errors could occur and possibly result in a material misstatement in the financial statements. Management override and poor "tone at the top" (that primarily occur at the entity level) are common themes in bad corporate behavior.

CONSIDER POINT

How an entity actually designs and implements its internal control will vary with an entity's size and complexity. In smaller entities, the owner-manager may perform functions that address several of the components of internal control.

11.5 Internal Control in Smaller Entities

In smaller entities, there are often few employees, which may limit the extent to which:

- Segregation of duties is practicable; and
- An appropriate paper trail of documentation is available.

Internal control in such entities often derives from the control environment (management's commitment to ethical values, competence, attitude toward control, and its day-to-day actions) as opposed to specific controls over transactions. Evaluating the control environment is quite different from traditional control activities, as it involves an assessment of the behavior, attitudes, competence, and actions of management. Such assessments are often documented in a memo or with a questionnaire.

The presence of a highly involved owner-manager is often an internal control strength and a control weakness. The control strength is that the person (assuming his/her competence) will be knowledgeable about all aspects of operations, and it is highly unlikely that material misstatements will be missed. The control weakness is the opportunity provided for that person to override the internal control for his/her own benefit.

CONSIDER POINT

Identify the pervasive (entity-level) controls
In the audit of small entities, there is a temptation to assume that internal control is nonexistent, and therefore, not worth understanding. However, any entity that wants to continue operating will have some form of internal control. For example, what business manager does not care whether the cash receipts are deposited in the bank, or that goods shipped are invoiced?

Consider how the pervasive (entity-level) controls could be evidenced
In cases where the owner-manager or equivalent approves transactions and carefully reviews financial results, the control can have the effect of preventing or detecting misstatements occurring at the assertion level. If reliance on such a control would reduce the need for other substantive procedures, consider whether such controls could be evidenced, such as by a signature on a report or a reconciliation to indicate review or approval. Such evidence could then be used to test the operating effectiveness of the control.

11.6 Absence of Internal Control

In virtually all entities, there is some form of internal control, such as the competence of the owner-manager (control environment). It may be informal and unsophisticated, but it is still internal control. An entity that does not mitigate any of the major risks it faces (through control components such as the control environment, risk assessment, information systems, control activities, or monitoring) is unlikely to stay in business for long.

Where there are not many control activities that can be identified, the auditor would consider whether:

- It is possible to address the relevant assertions by performing further audit procedures that are primarily substantive procedures; or
- The absence of control activities or of other components of control (in rare cases) makes it impossible to obtain sufficient appropriate audit evidence.

Other matters that would raise questions as to whether the audit should be conducted would include:

- Concerns about management's integrity, non-ethical behavior, or a poor attitude toward internal control. Deficiencies in the control environment tend to undermine controls that exist in other control components. It also raises the risk of management misrepresentation and fraud; and
- Concerns about the condition and reliability of an entity's records that make it unlikely that sufficient appropriate audit evidence will be available to support an unqualified opinion.

If these or similar concerns are present, the auditor should consider the need to modify the auditor's report or withdraw from the engagement altogether.

If withdrawal is chosen, the auditor would consider his/her professional and legal responsibilities, including any requirement to report to the persons who made the audit appointment and to regulatory authorities. The auditor would also discuss the withdrawal and the reasons with the appropriate level of management and those charged with governance.

11.7 Controls to Prevent Fraud (Anti-Fraud Controls)

Management override can often be mitigated or slowed down in small entities by establishing and then documenting key policies and procedures. For example, a written policy that says all non-routine journal entries require approval would empower the bookkeeper to ask the manager to approve proposed journal entries. It would not prevent management override from occurring, but would act as a deterrent. If anti-fraud policies and procedures are not in operation, the risk of management override will need to be addressed by the auditor through performing other audit procedures.

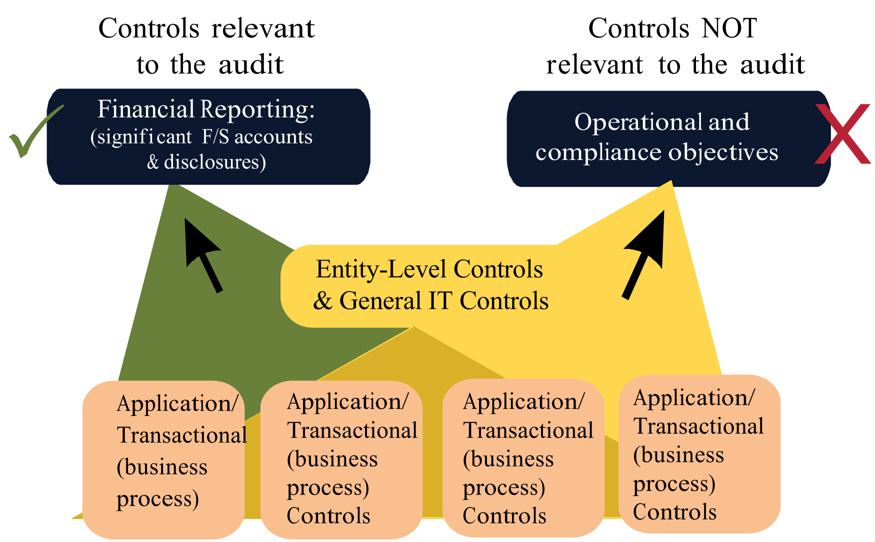
Note: Controls that address compliance with regulations that are not relevant to the audit (where non-compliance would not result in a material misstatement in the financial statements) do not need to be addressed in the audit.

11.8 Internal Controls Relevant to the Audit (the scope of understanding)

Not all controls are relevant to the audit. The auditor is only concerned with understanding and evaluating those controls that would mitigate a risk of a material misstatement (due to fraud or error) in the financial statements. This means that certain types of controls can be scoped out of the audit altogether, as illustrated in the following exhibit. These are controls that:

- Do not drive financial reporting (such as operational controls and controls that address compliance with regulations); and
- Even if non-existent, a material misstatement in the financial statements would be unlikely.

Exhibit 11.8-1



In some cases, there may be some overlap between financial controls and controls relating to operations and compliance objectives. Examples include controls that pertain to data the auditor evaluates or uses in applying other audit procedures such as:

- Data required for analytical procedures (e.g., production statistics);
- Controls that detect non-compliance with laws and regulations;
- Safeguarding of asset controls that pertain to financial reporting; and
- Controls over the completeness and accuracy of information produced that may form the basis for calculating key performance measures.

Controls that would always be relevant to the audit include those that mitigate the following risks.

Exhibit 11.8-2

	Description
Significant Risks	Significant risks are identified and assessed risks of material misstatement that, in the auditor's judgment, require special audit consideration.
Risks That Cannot Easily Be Addressed by Substantive Procedures	These are identified and assessed risks of material misstatement for which substantive procedures alone would not provide sufficient appropriate audit evidence.
Other Risks of Material Misstatement	These are identified and assessed risks of material misstatement that, in the judgment of the auditor, could potentially result in material misstatements occurring.

The auditor's judgment about whether a particular control is relevant to the audit is influenced by:

- Knowledge about the presence/absence of controls identified in other components of internal control. If a particular risk has already been addressed (such as by the control environment, information system, etc.), there is no need to identify any additional controls that may exist;
- The existence of multiple control activities that achieve the same objective. It is unnecessary to obtain an understanding of each of the control activities related to such objective;
- The need to test the operating effectiveness of certain key controls. For example, if there is not a practical way to test sales completeness (i.e., by performing substantive procedures), a test of the operating effectiveness of controls would be required; and
- The impact that testing the operating effectiveness of controls would have on the extent (i.e., the reduction) of substantive testing required.

Professional judgment is required to determine whether an internal control, individually or in combination with others, is in fact relevant.

CONSIDER POINT

Top-down and risk-based

The auditor's approach to understanding internal control should be from the top down. The first step is to identify the relevant entity-level and transactional risks, and then determine whether management's response is appropriate.

A solid understanding of entity-level controls provides an important basis for assessing relevant controls over financial reporting at the transactional (business process) level. For example, if there are poor controls over data integrity at the entity level, this will impact the reliability of all information produced by systems such as sales, purchases, and payroll.

Example

The top-down and risk-based approach to understanding internal control involves:

- Identifying the business processes involved (including accounting) for each significant account balance;
- Determining for each process identified whether a material misstatement in the financial statements could possibly occur, or whether other factors exist that would make it relevant; and
- Scoping out of the audit those processes and controls that are not relevant.

For example, a biscuit production company may have the following processes that drive the sales revenue figure:

- The main sales order system captures details and the progress of each order received by telephone. This accounts for 70% of sales.
- "Window sales" occur when customers buy broken biscuits from a small shop at the back of the production facility. These account for 2% of sales.
- Internet sales—orders are placed online and paid by credit card; these account for 28% of sales.
- The accounting system captures details of all types of sales.

In this situation, the window sales are unlikely to result in a material misstatement in the financial statements and may therefore be scoped out of the audit. However, before this decision is made, it would still be prudent to either:

- Inquire about the existence of controls over the window sales to ensure that all such sales are recorded, and that there is no deliberate breaking of biscuits for sale at reduced prices to related parties; or
- Perform an analytical review of the breakdown of sales to ensure that window sales have not deviated from the expected 2% of sales.

11.9 Case Studies—Identifying Relevant Controls

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

Note that the following step is often carried out as part of the planning process.

Since not all business processes and controls are relevant to the audit, it is important to understand which financial statement areas and controls could have a material impact on the financial statements.

Determining which financial statement areas and related business processes are in scope involves using overall materiality as a guide to identify:

- What financial statement areas are, or could be, material; and
- What entity-level controls and business processes are relevant.

Immaterial balances, transactions, business processes, and controls where no material misstatements are likely to result can be scoped out of any further consideration in the audit. However, before scoping an area out, consider:

- The possible accumulation of immaterial misstatements that could, in the aggregate, add up to a material misstatement; and
- Whether the financial statement area is understated due to fraud or error.

Case Study A—Dephta Furniture, Inc.

	Identify any Processes That Mitigate the Risks
Pervasive risks	Annual business planning cycle, management/owner monthly meetings, that include reviews of financial information, the code of conduct for staff, IT budgets, day-to-day involvement of management in operations, human resource policies and general IT controls
Cash and cash equivalent	Receivables, receipts process, investment of short-term (30 to 60-day) deposits at bank, bank reconciliations, and cash management
Trade and other receivables	Revenue, receivables, receipts process, valuation of overdue accounts, asset sales
Inventories	Purchases, payables, payments process, inventory management, stock taking, valuation of obsolete inventory
Property, plant, and equipment	Purchases, payables, payments process, calculation of amortization, capitalization of assets, asset sales
Bank indebtedness	Receivables, receipts process, bank reconciliation, and cash management
Trade and other payables	Purchases, payables, payroll, payments process, capitalization of assets
Income tax payable	Income tax provision preparation
Interest-bearing loan	Finance charges, bank reconciliation process
Capital and reserves	Issuance/redemption of capital, dividends
Sales	Revenue, receivables, receipts process (including cash scrap sale, Internet sales, catalog, and custom sales orders)
Cost of goods sold	Purchases, payables, payroll, payments process, inventory adjustments
Distribution costs	Purchases, payables, payroll, payments.
Administrative costs	Purchases, payables, payroll, payments
Depreciation	Depreciation and amortization calculations
Finance cost	Finance charges, bank reconciliation process
Income taxes	Income tax provision preparation

Prepared by: FJ **Date:** February 18, 20X3

Reviewed by: LF **Date:** March 5, 20X3

Case Study B—Kumar & Co.

Memo to File: Scoping material financial statement areas (FSAs) and processes

Entity Level and General IT

- Raj prepares an annual budget each period for the bank.
- Raj communicates with the bank manager quarterly when the financial statements are sent to the bank.
- Raj usually reviews these with Suraj and Jawad since Dephta is a shareholder, but also because Raj appreciates their input and Jawad's accounting and financial knowledge.

There is no formal IT structure or process. Raj decides what software and hardware to replace on an as-needed basis. Although Raj ensures that Ruby backs up the accounting data weekly, there is no disaster recovery plan or documented IT process.

Material financial statement areas

With the exception of cash and cash equivalents, which seem to fluctuate from period to period, all FSAs on the financial statements are material and in scope. Therefore, the following business processes will need to be examined as part of our audit:

Business Process	Material Financial Statement Areas Affected
Receivables/receipts	Revenue, trade receivables & other, cash and cash equivalents
Valuation of overdue accounts receivable	Trade receivables & bad debt expense
Sales process (cash sales, sales orders)	Revenue
Purchases, payables, payments	Trade payables & other, property, plant and equipment, inventories, income statement expense categories
Payroll	Payroll expenses
Taxes payable and remittances	Income, payroll, and sales taxes
Inventory valuation and management	Purchases and inventories
Bank account reconciliations	Cash and cash equivalents, interest-bearing loan, interest expense
Calculation of depreciation and amortization	Property, plant, and equipment, and depreciation/ amortization expense

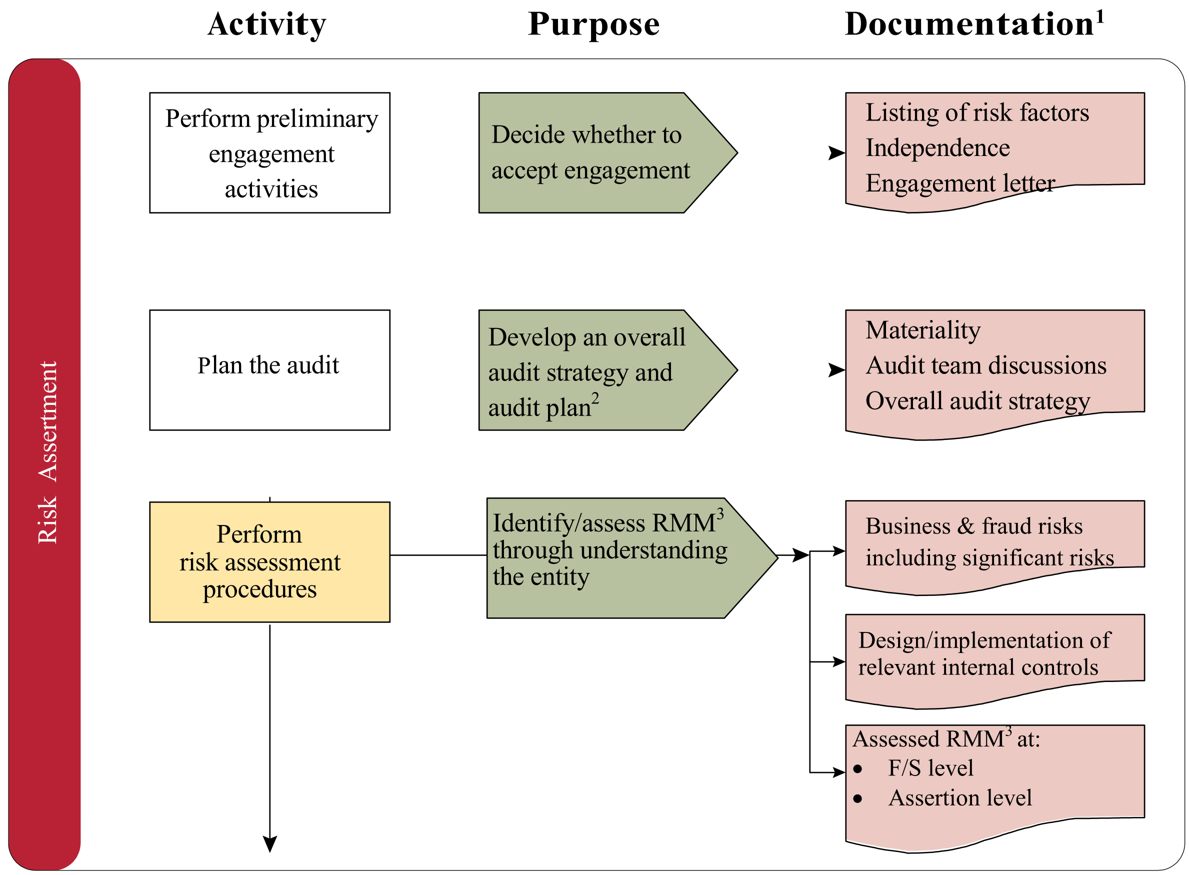
Prepared by: FJ **Date:** February 18, 20X3

Reviewed by: LF **Date:** March 5, 20X3

12. Evaluating Internal Control

Chapter Content	Relevant SLAuS
Guidance on the four key steps involved in evaluating control design and implementation, and on documenting the results.	315

Exhibit 12.0-1



Notes:
1. Refer to SLAuS 230 for a more complete list of documentation required.
2. Planning (SLAuS 300) is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Paragraph #	Relevant Extracts from SLAuSs
315.13	When obtaining an understanding of controls that are relevant to the audit, the auditor shall evaluate the design of those controls and determine whether they have been implemented, by performing procedures in addition to inquiry of the entity's personnel. (Ref: Para. A66-A68)
315.29	If the auditor has determined that a significant risk exists, the auditor shall obtain an understanding of the entity's controls, including control activities, relevant to that risk. (Ref: Para. A124-A126)
315.32	The auditor shall include in the audit documentation: (a) The discussion among the engagement team where required by paragraph 10, and the significant decisions reached; (b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph 11 and of each of the internal control components specified in paragraphs 14-24; the sources of information from which the understanding was obtained; and the risk assessment procedures performed; (c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 25; and (d) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 27-30. (Ref: Para. A131-A134)

12.1 Overview

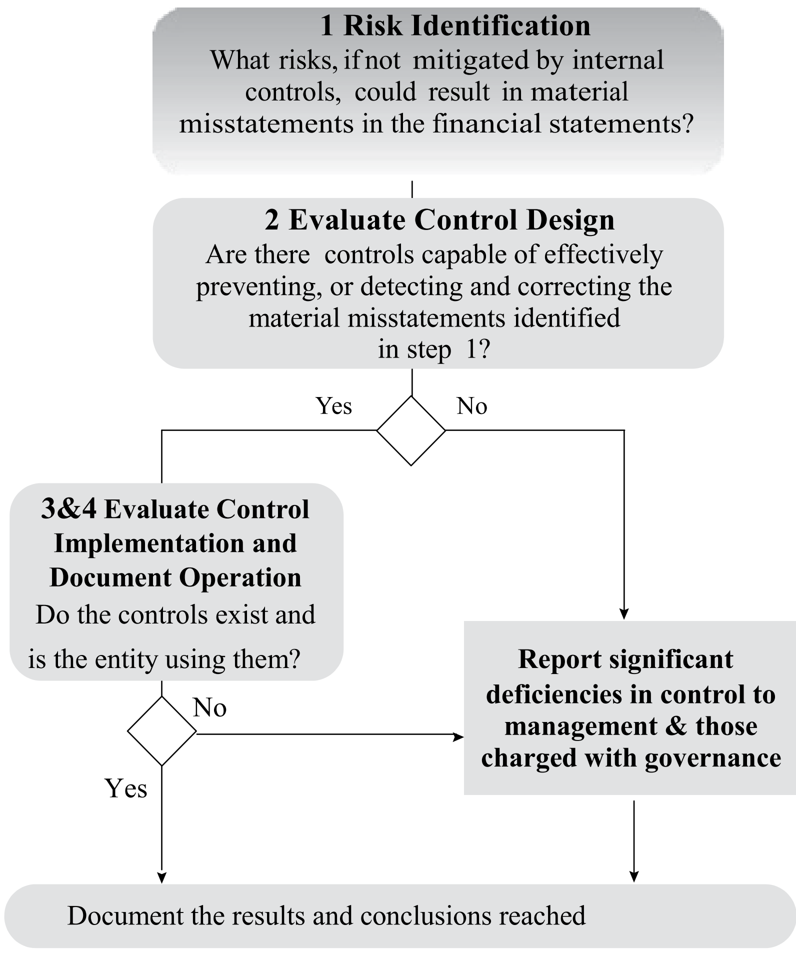
Regardless of whether tests of controls will ultimately be performed to gather audit evidence, it is still necessary for the auditor on every engagement to evaluate control design and implementation. This involves a four-step process, which can be summarized as follows.

Exhibit 12.1-1

	Description
Step 1 **What Risks Require Mitigation?**	Identify the inherent risks of material misstatement (business and fraud risks), and whether they are pervasive risks affecting all assertions, or specific risks that affect particular financial statement areas and assertions.
Step 2 **Do the Controls Designed by Management Mitigate the Risk?**	Identify what business processes are in place (if any). • Interview entity personnel to identify what controls mitigate the risks identified in **Step 1** above. • Review results and assess whether the controls do in fact mitigate the risks. • Communicate any significant deficiencies identified in the entity's internal control to management and those charged with governance. In larger entities, this step may require reference to or preparation of some system documentation (see **Step 3** below) to provide some context regarding the operation of certain controls.
Step 3 **Are the Controls That Mitigate the Risks Factors in Operation?**	Observe or inspect the operation of relevant internal controls to ensure that they have indeed been implemented. Note that inquiry of management is not sufficient to evaluate whether a relevant control has in fact been implemented. This step can often be combined with **Step 2** above.

	Description
Step 4 Has the Operation of Relevant Controls Been Documented?	This step can consist of a simple narrative description of the major processes (prepared by the entity's management or auditor), describing the operation of the relevant internal controls identified. This documentation does not have to include: • A detailed description of the business process or the way paper flows through the entity; or • Internal controls that may exist but are not relevant to the audit.

Exhibit 12.1-2



Note: Regardless of how well a control is designed and implemented, it can only provide reasonable assurance about the achievement of an entity's objectives with regard to reliability of financial reporting due to certain inherent limitations. These are described below.

Exhibit 12.1-3

	Description
Internal Control Limitations	• Human judgments and simple human failures such as errors or mistakes. • Circumvention of internal control by the collusion of two or more people. • Inappropriate management override of internal control, such as revising the terms of a sales contract or overriding a customer's credit limit.

Volume 2, Chapter 11 addresses the understanding of internal control required. Volume 1, Chapter 5 addresses the nature of internal control and provides a detailed description of the five components of internal control.

12.2 Step 1—What Risks Require Mitigation?

Exhibit 12.2-1

Identify what risks require mitigation

A Risk Assessment Procedure
What risks exist (pervasive or specific) that, if not mitigated by controls could cause a material misstatement to occur?

Before the auditor begins to document the controls that may exist, the first step is to identify and then assess the significant and other risk factors that are present. Otherwise, the internal control evaluation will take place without an understanding of what risks need to be mitigated by internal control.

The identification of risks has been addressed in Volume 2, Chapter 8. Risks requiring mitigation can be pervasive, relating to many financial statement areas and assertions, or specific, relating to particular financial statement areas and assertions.

The following exhibit summarizes some typical sources of risk and the types of control that could mitigate such risks.

Exhibit 12.2-2

What can go wrong?	Sources of risk	Mitigating controls
Unreliable financial reports *(pervasive risks)*	External industry factors Nature of entity Accounting policies Objectives and goals Performance measures Fraud	Entity-level controls and processes General IT controls Transactional controls
Misstatements arising from financial statement preparation *(pervasive risks)*	Accounting estimates Provisions Accounting policies Use of spreadsheet Non-routine transactions Journal entries, reconciliations Information necessary for financial statement disclosures	Entity-level controls General IT controls Transactional controls
Transactions not processed or recorded accurately *(specific risks)*	Identification/recording of authorized transactions Transaction classification Measurement, cut off Safeguarding of assets	Transactional controls IT application controls Some specific entity-level controls

When a listing of risk factors by business process has been prepared, it would be useful (but not required) to:

- Eliminate any risk factor that would be unlikely to result in a material misstatement even if it was not mitigated at all. Controls that address such risks would not be relevant to the audit;
- Customize the wording of the risk factors to make it relevant for the particular entity;
- Ensure that all relevant assertions have been addressed; and
- Consider whether there are any additional risks (entity- and transactional-level) that could result in a material misstatement if not mitigated.

CONSIDER POINT

Some entities may use an internal control framework (such as that published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)) that provide generic listings of internal control objectives and internal control procedures. If such a tool is used in the audit, the same steps outlined above would be followed:

- Remove the control objectives (or risk factors) that are unlikely to result in a material misstatement even if no internal control existed;
- Add any other additional control objectives (risk factors) that could result in a material misstatement for the entity if not mitigated; and
- Identify the financial statement areas and assertions affected by the risk factors.

12.3 Step 2—Do the Controls Designed by Management Mitigate the Risk?

Exhibit 12.3-1

Assess control design	**Identify/assess controls to mitigate risks** Address each of the 5 control components Do significant control deficiencies exist?

Evaluating whether a control has been designed properly by management involves an assessment of whether the controls identified (individually or in combination with other controls) will actually mitigate the risk factor. This involves considering whether the control(s) is capable of effectively:

- Preventing material misstatements from occurring in the first place; or
- Detecting and correcting material misstatements after they have occurred.

It is recommended that an evaluation of control design begin with the pervasive controls. These types of controls form the all-important foundation for assessing the design and operation of specific (transactional) controls.

At this point, some auditors (particularly when auditing larger and more complex entities) may find it helpful to obtain some information, preferably prepared by the entity, that describes the business process, the way paper flows through the entity, and where controls exist. However, this is not a specific requirement in the SLAuSs.

There are two common ways to match internal controls to the risk factors (or control objectives) that they are designed to mitigate. For the purposes of this Audit Manual, these approaches have been called:

- One-risk-to-many controls; and
- Many-risks-to-many controls.

One-Risk-to-Many Controls

Under this approach, each risk factor is considered by itself. All the controls that address that particular risk factor are identified. This approach is particularly useful for mapping the pervasive (entity-level) risk factors to controls. The approach is illustrated below.

Exhibit 12.3-2

Risk/Control Objective	Assertion	Mitigating Controls
1. Risk factor	C	1. Control procedure A 2. Control procedure B 3. Control procedure C 4. Control procedure D

Risk/Control Objective	Assertion	Mitigating Controls
2. Risk factor	EA	1. Control procedure E 2. Control procedure F 3. Control procedure G 4. Control procedure H
3. Risk factor	A	1. Control procedure I 2. Control procedure J 3. Control procedure K 4. Control procedure L
4. Risk factor	CA	1. Control procedure M 2. Control procedure N 3. Control procedure O 4. Control procedure P

This one-risk-to-many controls approach has often been used for mapping all types of control, including transactional controls. However, because a single transactional control can often address more than one risk (and therefore get repeated many times in this approach), the many-to-many matrix (see Exhibit 12.3-4) is generally considered more effective for transactional controls.

The following example illustrates how the one-risk-to-many controls approach can work. An objective of the control environment is the need for management, with the oversight of those charged with governance, to create and maintain a culture of honesty and ethical behavior. This objective stated as a risk factor could mean that management has not created or maintained a culture of honesty and ethical behavior.

Some of the controls that management may design and implement to address this pervasive risk could include:

- Management continually demonstrates, through words and actions, a commitment to high ethical standards;
- Management removes or reduces incentives or temptations that might cause personnel to engage in dishonest or unethical acts;
- A code of conduct or equivalent exists that sets out expected standards of ethical and moral behavior;
- Employees clearly understand what behavior is acceptable and unacceptable and know what to do when they encounter improper behavior; and
- Employees are always disciplined for improper behavior.

The auditor would first read the risk or control objective and then identify, possibly from a list such as that above, what, if any, controls exist to mitigate the risk. The resulting documentation could take the following form.

Note: The column on control design outlines the steps the auditor could take to assess control design.

Exhibit 12.3-3

Internal Control (IC) Component	Risk Factor	Control Identified	Control Design
Control Environment	No emphasis on integrity or ethics	*Code of conduct is signed by employees each year and enforced through staff*	*Have read the Code and it does emphasize need for integrity and ethics.*
	Incompetent employees could be hired	Required knowledge and *skills specified for each employee position.*	*Reviewed the job specifications for key positions including accounting and they appear to be acceptable.*
Risk Assessment	Management often surprised by predictable events	*Business risks are identified and assessed each year as part of business planning.*	*Reviewed the business plan and risks have been identified, updated, and assessed.*

Once the controls have been identified, the auditor would use professional judgment to conclude whether the control design is sufficient to address the risk factor.

When forming a conclusion on the control environment, the auditor is required by SLAuS 315.14 to evaluate whether:

- Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and
- The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment.

This wording could be used as the overall conclusion by the auditor on all entity-level controls. Such a conclusion will also have a major impact on the auditor's assessment of risk at the financial statement level.

Many-Risks-to-Many Controls

For specific and transactional risks, the most common approach to evaluating design is through the use of what is sometimes called a "control design matrix." These matrices enable the auditor to see at a glance:

- The many-to-many relationships that exist between risks and controls;
- Where internal control is strong;
- Where internal control is weak; and
- The key controls that address many risks/assertions and could be tested for operating effectiveness.

An example of a simple control design matrix is illustrated below.

Exhibit 12.3-4

Process = Sales						
Material Risk Factors		**Risk A**	**Risk B**	**Risk C**	**Risk D**	**Key Controls**
	Assertions	**C**	**EA**	**AC**	**CE**	
Controls	*Internal Control Component*					
Procedure #1	*Control Environment*	D				
Procedure #2	*Information Systems*		D			
Procedure #3	*Control Activity*	P	P		P	Yes
Procedure #4	*Monitoring*	D				
Procedure #5	*Control Activity*		P		P	Yes
Procedure #6	*Control Activity*					
Procedure #7	*Information Systems*	D	D		D	
Is control design OK? That is, will the identified controls mitigate the risk factors?		Yes	Yes	No	Yes	

Key:

P = Prevent control

D = Detect and correct control

Note: The above matrix contains the following information:

- Risk factors that, if not mitigated, could result in a material misstatement in the financial statements;
- The assertions addressed by the risk factors; and
- Where the internal control procedure addresses (intersects with) the risk on the matrix, it is recorded as either preventing (P) a misstatement or detecting (D) and then correcting a misstatement after it has occurred.

Such a matrix can also be expanded to include other information including:

- The frequency with the control is operated, e.g., continuously, weekly, or monthly;
- Whether the control is manual or automated; and
- The expected reliability of the internal control over a period of time. This could include, for example, assessing the competence (and independence from other functions) of the person who performs the control, whether the control is performed on a timely basis, and any history of errors occurring.

CONSIDER POINT

Multiple control procedures
Note that any one control procedure by itself is unlikely to mitigate a key risk factor. Often, a combination of control activities, working together with other components of internal control (such as the control environment), will be sufficient to address the risk factor.

Start with the risks
Avoid the temptation to list all the known controls and then match them to risks. Risks come first, then controls to mitigate the risks. It is more efficient to address each risk (or control objective) in turn and then identify what controls exist to address that risk. Once enough controls have been identified to address the risk, there is no point in spending more time to identify any additional controls.

Matching controls with risks not only helps to evaluate control design, but will also identify key controls (over relevant assertions) that could potentially be tested. It will also help the auditor identify control deficiencies that may require:

- Communication to management and those charged with governance about the significant deficiency on a timely basis, so that corrective action can be taken; and
- Development of an appropriate audit response.

The control design matrix (see Exhibit 12.3-4) can be used to identify both control strengths and control deficiencies. This process is described below.

Exhibit 12.3-5

Identify	Description—Using the Control Design Matrix
Internal Control Deficiencies	Look down each risk column (in the control design matrix above) to see what internal control procedures exist to mitigate the risks. If sufficient controls exist, then there is no control deficiency. Where few or no internal control procedures exist to mitigate the risk, a significant internal control deficiency may exist. Refer to Risk C in the matrix above, where it appears that a significant deficiency exists. In this case, the auditor would: • Inquire about any other internal control procedures or compensating internal control procedures that might exist. If none exists, a significant deficiency may exist that would be communicated to management and those charged with governance as soon as possible, so that corrective action may be taken; and • Consider what further audit procedures may be necessary to respond to the risk identified. Compensating controls may be activities that indirectly impact on the risk factor. For example, the risk of shipping goods but not invoicing for them could be detected by the sales manager when he reviews sales results each quarter. Such a control would obviously not be sufficient by itself to mitigate the risk.

Identify	Description—Using the Control Design Matrix
Internal Control Strengths	Look across the rows of the control design matrix above to identify internal control procedures that would prevent or detect and correct misstatements arising from a number of risk factors. Note that Control Procedure 3 in the example matrix above addresses three risks and three assertions. This is an example of a type of control (often referred to as a key control) that, if considered reliable, could be considered for testing operational effectiveness, particularly where this testing could be used to reduce other more detailed tests.

12.4 How to Identify Relevant Internal Controls

Controls are usually identified through discussion (interviews) with the person(s) who are responsible for managing the risk or the particular process. In smaller entities, this will often be the owner-manager or the senior manager. A typical approach for identifying controls would be as follows.

Exhibit 12.4-1

Action	Description
Identify the Inherent Risks	Identify the pervasive (entity-level) and specific (transactional) risks that require mitigation through internal control to prevent or detect and correct material misstatements.
Ask about Internal Control Procedures That Address the Inherent Risk *(Address Each Risk Factor, One at a Time)*	Ask the owner-manager or the responsible person what internal control procedures exist in the entity to mitigate each particular risk factor one by one. Document the controls identified in the words of the person being interviewed. When (based on professional judgment) enough controls have been identified to effectively mitigate the risk, stop asking for any more controls. There is no need to list all of the other controls that may exist to mitigate the risk, unless specifically requested for another purpose.
Document the Results	The controls identified can be documented in a number of ways. They can be listed under each risk factor they address, or listed on a control matrix and linked to all the various risk factors they address. The key is to ensure that the control procedures identified are linked to the risk factor they were designed to mitigate. This enables an assessment to be made as to whether the controls identified do actually mitigate the risk. If the control matrix is used: • Record the internal control procedures identified directly onto the matrix, and indicate (where they intersect with the risk) whether they would prevent or detect and correct potential misstatements for risk factors; and • Consider whether the control would also be effective in mitigating other risk factors. It is quite possible that some internal control procedures will prevent or detect a number of the risk factors. Where controls have not been identified to address a risk, the auditor would immediately alert management to the control deficiency (likely significant) that may need to be addressed.

CONSIDER POINT

Avoid using generic controls
Avoid the temptation to use generic lists of internal control activities that are appropriate for the so- called "typical" entity. Listings of "standard" or "typical" controls can take time to read and understand, and are often too complex or simply irrelevant for smaller entities. Instead, use them as a reference source, but only when needed. It is much better to document the nature of each control identified using the client's own description.

Multi-task
Evaluating control design can be combined with control documentation (see Step 3 below) and with the inspection/observation of documents to support control implementation (see Step 4 below). For example, if there is a policy identified that no non-routine journal entries can be made without authorization, ask to see the actual policy (assess control design) and some journal entries for evidence of approval (control implementation).

Risk management
Many entities assign risk management responsibilities by process (such as sales or purchasing) instead of by risk. As a result, there may be a number of important risk factors that fall between departments (such as sales, purchasing, and accounting), and no one is directly accountable. If risks are not specifically identified and responsibility assigned to someone, there is often a lot of finger pointing when something goes wrong. Staff may blame each other by saying something like, "I thought that risk was being managed by Mary or Jack, or the accounting, IT, or sales department," etc.

Concluding on Control Design

The final step in assessing control design is to draw a conclusion on whether the controls identified actually mitigate the particular risk factor. This requires the use of professional judgment. For each relevant assertion or risk factor, consider whether management's response is sufficient to reduce the risk of material misstatement to an acceptably low level. If the control design matrix approach is used, the bottom row of the matrix could be used to document the conclusion as to whether the controls are sufficient or not to mitigate each risk factor.

A summary of the overall control evaluation (that addresses the five control components) is set out in the following exhibit.

Exhibit 12.4-2

	Entity-level processes	Sales process	Purchasing process	Payroll process
Key financial reporting risks are identified	Yellow	Green	Green	Green
Accounting policies are applied consistently	Green	Red	Yellow	Green
Staff are competent and knowledgeable	Green	Green	Green	Green
Clear lines of authority and responsibility exist	Green	Green	Green	Green
Control activities are appropriately designed and implemented	Green	Green	Yellow	Green
Anti-fraud controls exist to address fraud risks	Red	Yellow	Yellow	Green
Information systems provide reliable data	Yellow	Green	Green	Green
Controls are monitored	Red	Yellow	Yellow	Green

Key:

Green = the underlying risks have been appropriately mitigated

Yellow = some problems may exist

Red = potentially significant deficiencies

CONSIDER POINT

For smaller entities, there is an even simpler way of assessing transactional controls. First, identify the risk factors (see Step 1 above) and the assertion(s) affected. Then, instead of mapping identified controls to each individual risk factor, identify controls that address the assertions affected by the risk.

If no controls are identified for a particular assertion, a substantive audit response would need to be developed. If the controls identified are expected to operate reliably, the audit response could include a test of relevant key controls. For example, the risk of unrecorded sales addresses the completeness assertion. Identification of relevant controls could be limited to those that address the completeness assertion in general, rather than the one specific risk.

12.5 Step 3—Are Controls That Mitigate the Risk Factors in Operation?

Exhibit 12.5-1

Assess control implementation

Risk Assessment Procedure
Ensure identified (relevant) controls are actually operating as designed

Inquiry of management alone is not sufficient to evaluate the design of internal control procedures or to determine whether they have been implemented. This is because people may genuinely believe or hope that certain controls exist, when in fact they do not. A documented description of controls (however good) that do not exist or do not operate is of no value to the audit.

Some of the reasons for observing internal control in action are:

- **Change Processes**
  Processes change over time, resulting from revised/new products or services, efficiencies in operation, changes in personnel, and implementation of new supporting IT applications;
- **Wishful thinking**
  The entity's personnel may explain to the auditor how a system should operate, rather than how it actually operates in practice; and
- **Lack of knowledge**
  Some aspects of the system may have been inadvertently overlooked in obtaining the understanding of internal control.

CONSIDER POINT

If there is any doubt about whether some controls identified in Step 2 above have not in fact been implemented, do not assess control design or document the operation of the controls until some work has been performed to determine that they exist and operate. Alternatively, do not take time to assess controls that are unlikely to be relevant to the audit or have been inappropriately designed.

Risk assessment procedures required to obtain audit evidence about control implementation would include those listed below.

Exhibit 12.5-2

	Description
Assessing Control Implementation	• Inquiring of entity personnel; • Observing or re-performing the application of specific controls; • Inspecting documents and reports; and • Tracing one or two transactions through the information system relevant to financial reporting. This is often called a walkthrough.

Note: A walkthrough is not a test of the operating effectiveness of a control.

Implementation of controls provides evidence about whether a control was actually in operation at a particular point in time. It does not address operating effectiveness throughout the period being audited. Evidence of operating effectiveness (if this is part of the audit strategy being developed) would be achieved through a test of controls that gathers evidence about control operation over a period of time, such as a year.

Only when it has been established that the internal control relevant to the audit has been properly designed and implemented is it worth considering:

- What tests of the operating effectiveness of controls (if any) will reduce the need for other substantive testing; and
- What controls require testing because there is no other way of obtaining sufficient appropriate audit evidence.

CONSIDER POINT

Ensure that the audit team has a clear understanding of the difference between control design, control implementation, and tests of controls. These are summarized as follows:

Control design
Have controls been designed that will mitigate the inherent risks?

Control implementation
Are the designed controls actually in operation? Control implementation procedures should be performed each period to identify any system changes.

Tests of controls
Did the controls operate effectively over a specified period of time? There is no requirement to test the operating effectiveness of controls unless there is no alternative way (such as in a highly automated and paperless system) to gain the necessary audit evidence. The decision to test the operating effectiveness of controls is therefore a matter of professional judgment.

Do not ignore the linkage between control design and implementation
If there is any doubt about whether some of the controls identified in Step 2 above have in fact been implemented, do not assess control design until some work has been performed to determine if they exist and operate. Also, if the auditor concludes that control design is inadequate, there is no point going on and evaluating the control implementation. It is likely that a significant deficiency already exists.

Assess implementation every period
After the initial audit engagement, first evaluate the control implementation to determine what has changed. Use the control design documentation already obtained in the previous period as the starting point. If a change in internal control is identified, consider whether the revised or new controls continue to mitigate the risk factor, or whether there are now new risks that have to be mitigated.

12.6 Step 4—Has the Operation of Relevant Controls Been Documented?

Exhibit 12.6-1

Document relevant controls

Document operation of relevant controls
Provide context for the operation of controls from inception to financial reporting

The purpose of this step is to provide some information about the operation of the relevant controls identified in Step 2 above. The extent of documentation required is determined by professional judgment.

The resulting documentation will help the auditor to:

- Understand the nature, operation (initiation, processing, recording, etc.), and context (such as who performs the control, where the control is performed, how often and the resulting documentation) of the identified controls; and

- Determine whether the controls are likely to be reliable and operate effectively. If so, they could be tested as part of the audit response to assessed risks. If a decision is made to test the operating effectiveness of controls, this documentation will also help the auditor in designing the test, such as what population to use in selecting the sample, what control attributes to examine, who performs the control, and where the necessary documentation may be found.

CONSIDER POINT

Documentation of controls does not have to be complex or comprehensive. There is no requirement for the auditor to document an entire business process, or to describe the operation of any controls that are not relevant to the audit.

Some of the matters to be considered when documenting relevant internal controls are identified in the exhibit below.

Exhibit 12.6-2

Documenting Relevant Internal Controls
• How significant transactions are initiated, authorized, recorded, processed, and reported; • The flow of transactions in sufficient detail to identify the points at which material misstatements caused by error or fraud could occur; and • Internal controls over the period-end financial reporting process, including significant accounting estimates and disclosures.

The most common forms of documentation prepared by management or the auditor are:

- Narrative descriptions or memoranda;
- Flow charts;
- A combination of flow charts and narrative descriptions; and
- Questionnaires and checklists.

The nature and extent of the documentation required is a matter of professional judgment. Factors to consider include:

- The nature, size, and complexity of the entity and its internal control,
- Availability of information from the entity, and
- Audit methodology and technology used in the course of the audit.

The extent of documentation may also reflect the experience and capabilities of the audit team. An audit undertaken by a less experienced team may require more detailed documentation to assist them in obtaining an appropriate understanding of the entity than a team composed of more experienced individuals.

12.7 Updating Control Documentation in Subsequent Periods

The auditor may use documentation prepared or obtained in a prior audit period when planning the audit of a subsequent period. This will involve the following documentation.

Exhibit 12.7-1

	Description
Updating Control Documentation Prepared in Previous Periods	• Make a copy of the previous period's working papers on controls as the starting point for updating in the current year. If nothing has changed, evaluate control implementation before design. If the control has been implemented and the risk did not change, the design will be acceptable; • Update the listing of risks that require mitigation by control; • Identify changes in internal control at the entity and transactional levels. This is achieved by procedures that address control implementation; • Where changes are identified (risk or controls), determine whether new internal controls have been designed and implemented; • Update the linkage of internal controls with the appropriate risk factor; and • Update the conclusions on control risk.

Where the audit strategy is likely to involve reliance on the effective operation of certain controls (such as through tests of controls) and control changes have occurred, there will be a need to walk through transactions that were processed both before and after the change took place.

CONSIDER POINT

Changes in pervasive (entity-level) controls
When updating control documentation, carefully consider the changes in pervasive (entity-level) controls. These changes could have a significant impact on the effectiveness of other specific (transactional) controls, and may affect the audit response to assessed risks. For example, management's decision to hire a qualified professional to prepare the financial statements may considerably reduce the risk of errors in the financial information and enhance the effectiveness of transactional controls that might previously have been undermined. Alternatively, management's failure to replace an incompetent IT manager or commit sufficient resources to address IT security risks may undermine other internal control procedures in effect. In either case, these changes could trigger a significant change in the appropriate audit response.

12.8 Written Representations about Internal Control

Written representations should be obtained from management acknowledging its responsibility 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.

12.9 Case Studies—Internal Control Evaluation

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

The following extracts from internal control documentation provide an example of the information that would be obtained from using the four-step process described above.

Case Study A—Dephta Furniture, Inc.

Step 1 — Risk Identification

The first and most important step in evaluating internal control is to identify what risks need to be mitigated by internal control. This will include the risks identified as a result of obtaining an understanding of the entity, other pervasive risk factors and the usual transactional risk factors associated with business processes such as sales purchasing and payroll etc.

Step 2 — Control Design

The second step is to inquire about, and evaluate, the controls management has put in place to address the risks that have been identified in step 1 above.

Entity-Level Controls

The structured format below addresses each of the four steps outlined in this chapter. It can be used to document the following:

- the risk factors to be addressed by the various elements of internal control (Risk Identification – step 1 (above));
- what (if any) controls exist to mitigate the risks (Control design –step 2 (above));
- the evidence obtained that the controls identified actually exist and are being used. (Control implementation - step 3 (below)); and
- the context and operation of the controls that have been identified and implemented (Control documentation – step 4 (below)).

Control Environment	Control Exists?	Describe the Nature of Supporting Documentation or Management Actions	Describe Inquiries/ Observations to Ensure Controls identified were implemented
1. Risk: No emphasis is placed on need for integrity and ethical values			
Possible controls *(choose those that apply):*			
a) Management continually demonstrates, through words and actions, a commitment to high ethical standards.	Yes	*Suraj and the management team consistently reinforce the need for adherence to safety and ethical standards through daily communication with employees.*	*Interviewed two employees, Jon and Amad, who confirmed.*
b) Management removes or reduces incentives or temptations that might cause personnel to engage in dishonest or unethical acts.	Yes	*Suraj accepted our recommendation last period and prepared a code of conduct outlining expected behaviors by staff.*	*Employees have been given a copy of the code of conduct and attended a meeting on May 13, where the guidelines were explained.*
c) A code of conduct or equivalent exists that sets out expected standards of ethical and moral behavior.	Yes	*See response to b) above.*	*Reviewed code of conduct.*

Control Environment	Control Exists?	Describe the Nature of Supporting Documentation or Management Actions	Describe Inquiries/ Observations to Ensure Controls identified were implemented
d) Employees clearly understand what behavior is acceptable and unacceptable and know what to do when they encounter improper behavior.	Yes	*Employees have been disciplined in the past for improper behavior.*	*Suraj fires people immediately if they are caught stealing or acting unethically. Two such cases occurred last year among temporary workers.*
e) Employees are always disciplined for improper behavior.	Yes	*Suraj will not tolerate illegal or unethical behavior among employees, customers or suppliers.*	*Noted that a new employee was quickly fired after being caught stealing office supplies.*
f) Other (explain).	No		
2. Risk: Incompetent employees may be hired or retained			
Possible controls *(choose those that apply):*			
a) Company personnel have the competence and training necessary for their assigned duties.	Yes	*All staff are trained on the job and adequately supervised.*	*Interviewed two employees, Jon and Amad, who:* • *Clearly understood their roles and responsibilities in the absence of a written job description.* • *Indicated that they receive instruction whenever a machine or process changes.* • *Receive praise when things go better than expected, and are told immediately when a job was not done well.* *Inquiries of admin staff (Mirelli and Cliff) indicated that staffing levels remained constant during period.*
b) Management specifies the requisite knowledge and skills required for employee positions.	Yes	*Management is skilled in manufacturing, sales, and administration. Ravi and Parvin offer advice on business, marketing, and legal issues.*	
c) Job descriptions exist and are effectively used.	No		
d) Management provides personnel with access to training programs on relevant topics.	No		
e) Adequate staffing levels are maintained to effectively perform required tasks.	Yes	*There were no vacancies during year in any of the positions that affect financial reporting.*	
f) Initial and ongoing matching of staff skills to their job descrip-tions.	No		
g) Staff are compensated and rewarded for good performance.	No	*Employees are encouraged when they do a good job. There is no bonus structure other than for salespeople.*	

Control Environment	Control Exists?	Describe the Nature of Supporting Documentation or Management Actions	Describe Inquiries/ Observations to Ensure Controls identified were implemented
h) Other (explain).	No		
3. Risk: Management has a poor attitude toward internal control and/or managing business risks			
Possible controls (choose those that apply): Management demonstrates positive attitudes and actions toward: a) The establishment and maintenance of sound internal control over financial reporting, (including management override and other fraud): – Appropriate selection/ application of accounting policies, – Information-processing controls, and – The treatment of accounting personnel.	Yes	*Management is very responsive to recommendations that are not costly or disruptive to implement, and has a good attitude towards internal control.*	*Reviewed the business plan, which included:* • *Sales and cash-flow forecast.* • *Anticipated capital expenditures.* • *Discussion of how recession may affect their business in terms of sales and the possibility of one supplier going bankrupt.* *Our management letter recommendations have always been accepted if they were feasible.*
b) Management emphasizes appropriate behavior to operating personnel.	Yes	*See comments above on attitudes and the code of conduct.*	*Based on our employee interviews (see Step 2), employees understand what is required and that rules should be followed.*
c) Management has established procedures to prevent unauthorized access to, or destruction of, assets, documents, and records.	Yes		

Control Environment	Control Exists?	Describe the Nature of Supporting Documentation or Management Actions	Describe Inquiries/ Observations to Ensure Controls identified were implemented
d) Management analyzes business risks and takes appropriate action.	Some	*Although risk management is informal, business risks are discussed at management meetings and reflected in the business plan.*	*During our interview with Jawad, he indicated that Suraj was open to discussing issues and that he did not feel pressured to manipulate the financial statements. In Suraj's words, "The numbers are what they are, whether they are good this month or bad."*

Key: Assertions
C = Completeness
E = Existence
A = Accuracy
V = Valuation

Internal Control (IC) Component
CE = Control environment
CA = Control activities
IS = Information and communication
MO = Monitoring

Type of control
P = Prevent
D = Detect and correct

Risk factors: what can go wrong

	Internal Control Component	Receipts are partially or not deposited or recorded	Cash sales are partially recorded or not recorded	Recorded receipts are credited to the wrong customer or account (fraud or error)	Receipts are recorded in wrong period	Overdue receivables are not followed up on a timely basis							Control Tested (Y/N)	WP ref.
Assertions addressed by risk factor		**CAE**	**CAE**	**CAE**	**CAE**	**AV**								
Karla prepares the deposit slips but Jawad makes the cash deposit to ensure functions are segregated.	CA	P												
When opening the mail, checks are stamped "for deposit only" with Dephta's account number. Bank is instructed not to cash checks.	CA	P												
Checks received are listed, totalled and reveiewed before deposit.	CA	P												
Accounts over 90 days are investigated by Suraj and Jawad and actions taken documented.	CA					D								
Cutoff procedures exist to ensure receipts are recorded in the correct period.	CA				P									
An aged accounts receivable listing is prepared regularly and distributed monthly to Suraj and Jawad.	IS					D								
Regular review of aged accounts receivable and follow up of overdue accounts by Suraj. Accounts in default put on COD terms.	MO					P								
Do the control procedures mitigate the risk factor?			No	No										
Key: Y = Risk mitigated S = Some mitigation No = Material weakness exists														
Weaknesses identified														
Since statements are not sent to customers, a control weakness exists that a wrong customer's account could be credited.														
Since most showroom sales are for cash and receipts are given when requested, a risk exists that not all cash sales are recorded.														

Business Process or Transactional Controls

The above control design matrix addresses two of the four steps. It matches the transactional risks with identified controls, and could also be used to cross-reference work on implementation.

Step 3—Control implementation

The third step is to determine whether the controls exist and are in use by the entity.

Extract from the revenue/receivables control implementation procedures

Make inquiries of the personnel processing the transaction.
Persons interviewed:

Karla Date *February 16, 20X3*

Dameer Date *February 17, 20X3*

Maria Ho Date *February 17, 20X3*

Describe the procedures performed related to the transaction. Address initiation, authorization, recording in the accounting records, and reporting in the financial statements.	*System works as described in the systems documentation. See WP 530 for copies of documents that demonstrate the internal controls in action. However, we noted Maria Ho is a new employee and knows little about the system at present.*
Describe the process for any information transfers from one person (process owner) to the next.	*There is a handover from sales to accounting. Based on the walkthrough, the transfer worked well.*
Note the frequency and timing of the internal control procedures performed.	*Noted on the control design matrix.*
Identify any general IT controls required to protect the transaction data files and ensure the proper functioning of application internal controls.	*General IT controls are minimal due to small size of entity.*
Document the procedures in place to cover illnesses and vacations of personnel. If vacations have not been taken in last 12 months, document why.	*There was a sales clerk vacancy for four months during the period before Maria was hired. This meant less segregation of duties during that time.*
Ask about the extent and nature of errors found in the past period.	*Most errors were due to mistakes in pricing, which is mostly a manual process at present.*
Ask whether any person has been required to deviate from documented procedures.	One request made by the sales manager to substantially *reduce the price on a bedroom set for a friend was denied.*

Step 4—Control documentation

Extract From Business Process Documentation Using a Narrative Approach—
Dephta Furniture, Inc.

Business Process—Revenue/receivables/receipts system

Key Risks to be Addressed and Relevant Control Procedures

1. Goods shipped/services performed not invoiced
When the sales order is signed by the customer for approval, the order is entered into the accounting system, which automatically assigns a sequential number. When the order is ready for shipment, a shipping document is prepared, entered into the system and matched with the order. An invoice is then prepared by Karla from the accounting system, which automatically assigns a sequential number. It is a strict rule that no shipments can be made without the shipping document number being entered into the system. The system can then track which orders have been filled and which ones are still pending by delivery date.

2. Revenues incorrectly/not recorded (i.e., cash sales) in the accounts
Sales orders are prepared for each order received and entered into the accounting system, which automatically assigns the order a sequential number. The only exception is furniture sold directly from the shop or other small items on hand.

3. Related-party transactions not identified
No controls in place at present.

4. Revenue recognition policies not followed
Revenue is recorded when invoice is submitted. All orders over Rs.500 , or where the sales price is below the minimum sales price, must be reviewed and approved by Arjan.

5. Fictitious sales/sales credits recorded in accounts
All orders over Rs.500, or where the sales price is below the minimum sales price, must be reviewed and approved by Arjan.

6. Goods shipped/services provided to a bad credit risk
Arjan does not do a credit check on customers unless he does not know them or the order is large. He relies mostly on his previous experience with the customer when granting credit.

7. Sales/services recorded in wrong accounting period
Karla prepares a month end report of revenue and cash receipts for the month. This is reviewed by Suraj.

8. Receipts are partially or not deposited/recorded (fraud or error)
Cheques received are listed, totaled and reviewed before deposit. Karla prepares the daily deposit slips but Jawad makes the cash deposit to ensure functions are segregated.

9. Receipts are credited to the wrong account (fraud or error)
Could be noticed during the review of monthly sales and receivables.

10. *Receipts are recorded in wrong accounting period*
Karla checks for proper cut off each month to ensure receipts are recorded in the correct period.

11. *No allowance is recorded for doubtful or uncollectible balances*
Accounts over 60 days are followed up for payment but no allowance is made for doubtful accounts other than at year end.

12. *Overdue receivables are not followed up on a timely basis*
Jawad prepares an aged accounts receivable listing and gives the listing to Suraj for his review. Accounts over 60 days are followed up each month and comments are made on the listing as to when the customer has agreed to pay the balance. For customers who are over 90 days and have not made alternative payment arrangements, future sales are made on a cash-on-delivery basis.

See separate memo 545-6 (not included) for controls over Internet sales.

Case Study B—Kumar & Co.

Step 1 - Risk Identification

The first and most important step in evaluating internal control is to identify what risks need to be mitigated by internal control. This will include the risks identified as a result of obtaining an understanding of the entity, other pervasive risk factors and the usual transactional risk factors associated with business processes such as sales purchasing and payroll etc.

Step 2 — Control Design

The second step is to inquire about, and evaluate, the controls management has put in place to address the risks that have been identified in step 1 above.

Pervasive (Entity-Level) and General IT Controls

The format below addresses each of the 4 steps outlined in this chapter. It can be used to document the following:

- the risk factors to be addressed by the various elements of internal control (Risk Identification – step 1 (above));
- what (if any) controls exist to mitigate the risks (Control design – step 2 (above));
- the evidence obtained that the controls identified actually exist and are being used. (Control implementation - step 3 (below)); and
- the context and operation of the controls that have been identified and implemented (Control documentation – step 4 (below)).

Entity-Level Controls	
Risks to Consider	Relevant Controls
Control Environment: • No emphasis placed on importance/need for integrity and ethical values. • No commitment to employee competence. • Ineffective management oversight by those charged with governance. • Management has a poor attitude toward internal control and/or managing business risks. • Ineffective/inappropriate organizational structure for planning, controlling, and achieving objectives. • No policies/procedures to ensure effective HR management.	*Raj continually communicates the need for integrity and ethical dealings in day-to-day communications with employees and by his actions.* *He has a good attitude for internal control—has implemented audit recommendations in past that were feasible.* *No formal governance structure, but Raj meets with Suraj and Jawad (Dephta) regularly.*

Entity-Level Controls	
Risks to Consider	Relevant Controls
Do controls mitigate the risk factors?	*Yes*
Describe inquiries/observations to ensure controls identified were implemented.	*Interviewed Ruby, who confirmed Raj's commitment to treating suppliers and customers ethically and fairly.* *Reviewed the minutes from the last meeting which had been prepared by Jawad.*
Risks assessment: • Management is often surprised by events that were not previously identified/assessed or is continually reacting to events rather than planning ahead.	*Business plan prepared annually. Raj monitors monthly cash flows and sales trends.*
Do controls mitigate the risk factors?	*Yes*
Describe inquiries/observations to ensure controls identified were implemented.	*Reviewed a copy of the business plan, which did highlight the potential for the economy to impact sales.* *Reviewed a folder containing monthly cash flows given to Raj. Evidence of Raj's review by comments on the documents and changes requested.*
Financial reporting risks: • Events and conditions (other than transactions) that are significant to the financial statements may not be captured or recorded; • Poor oversight/control over financial reporting, journal entries, and preparation of significant estimates/disclosures could result in material misstatements in the financial statements; and • Significant matters relating to financial reporting may not be communicated to the board of directors or external parties such as bankers or regulators.	*Raj meets with Suraj and Jawad (Dephta) to review financial statements and business plans.* *Raj reviews financial statements but only reviews journal entries when he has time. (Risk increased by lack of segregation of duties, and gives Ruby ability to book entries undetected.)*
Do controls mitigate the risk factors?	*No. Control weaknesses include the risk of management override and the lack of segregation of duties in such a small entity.*
Describe inquiries/observations to ensure that controls identified were implemented.	*Reviewed a folder containing the monthly financials given to Raj. However, no evidence seen that Raj actually reviewed the statements.*
Fraud prevention: • Management has not considered or assessed the risks of fraud occurring (including management override).	*Raj keeps cash and valuables locked.* *Raj is involved in every step of the operations, including production, so oversight of all operations minimizes fraud risk.*
Do controls mitigate the risk factors?	*No. Valuables are kept safe, but Raj was absent quite a bit this year, which reduced the extent of management oversight. In addition, the bookkeeper is known to have personal financial problems.*
Describe inquiries/observations to ensure that controls identified were implemented.	*Inspected where the cash is kept locked and verified that only Raj has the key.*

General IT	
Risks to Consider	Relevant Controls
Risks to consider: • No policies/procedures exist to ensure effective IT management or IT staff supervision; • No alignment exists between business objectives, risks, and IT plans; • Reliance is placed on systems/programs that are inaccurately processing data or processing inaccurate data; and • Unauthorized access to data. Possible destruction of data, improper changes, unauthorized or non- existent transactions, or inaccurate recording of transactions.	*No IT policies and procedures.* *IT expenses and capital purchases part of annual budget (if foreseen).* *Raj ensures that software is up to date and that Ruby runs a back-up of the data.*
Do controls mitigate the risk factors?	*Yes, given small size of operations.*
Describe inquiries/observations to ensure controls identified were implemented.	*Reviewed the annual budget with an IT expense line. No major capital purchases were planned for the period.*

Business Process or Transactional Controls

This form (revenue, receivables, receipts) addresses two of the four steps in the process. It matches the transactional risks by assertion with the relevant internal control procedures (RICPs). It could also be used to cross-reference work on the implementation of controls.

Entity: Kumar & Co. Period ended: December 31, 20XX

	Step 1 - Describe the Transactional Risks	Assertions affected	Step 2 - Describe the RICPs (If multiple controls exist consider using the control design matrix)	Evaluate control		Residual Risk (H, M, L)
				Design	Implem'tion	
1	Goods shipped/ services performed not invoiced.	C	Shipping log is matched to the sales log each week to ensure all shipments were invoiced.	OK	545-2	L
2	Revenues partially or not recorded (i.e., cash sales).	CA	Bookkeeper reconciles sales invoices issued to revenues recorded in accounting records each month.	OK	545-2	L
3		CE	Raj reviews monthly sales, A/R and cash receipts journals. (Note: few customers, majority of sales are to Cambridge).	OK	545-2	L

4	Revenue recognition policies not followed.	CEA	Revenue is recorded when goods are shipped and invoiced. However no real controls over cut off.	Partial	545-2	M
5	Revenue/receipts recorded in wrong accounting period.	A	Review by Ruby and Raj of the sales each month	Partial	545-2	M
6	Receipts are partially/not deposited or recorded.	CA	Undeposited revenue would likely be noticed by Raj in his monthly review of receivables	No	No	M
7	No allowance for doubtful or uncollectible balances.	V	Made at year end only	No	No	H
8	Related-party transactions are not identified.	CEAV	Sales to Dephta are recorded in a separate account and reviewed by Raj monthly. But other Related Parties not identified	Partial	545-2	M
9						

Use professional judgement (based on a review of the above information) to assess the risks of material misstatement (RMM) by assertion.

Assertion	RMM	Describe the Audit Procedures (such as tests of detail or tests of control) that respond to assessed risks	W/P Ref
Completeness	Low	See the sales and receivables audit program.	705 - C.100
Existence	Low	See the sales and receivables audit program.	705 - C.100
Accuracy	Moderate	Perform additional work on cut off and revenue recognition, Details are on audit plans for sales and receivables	705 - C.100
Valuation	Moderate	Carefully review allowance for doubtful accounts as outlined in C.100	705 - C.100

Note : RMM at the assertion level will be based on the “assertions affected” by transactional risks (above) and the extent of “residual risk” remaining after mitigation.

Step 3—Control implementation

Transactional control implementation

Extract from the revenue/receivables control implementation procedures

Persons interviewed:

Ruby Date *February 22, 20X3*

Raj Date *February 22, 20X3*

Describe the procedures performed related to the transaction. Address initiation, authorization, recording in the accounting records, and reporting in the financial statements.	*System works as described in the systems documentation. See WP 535 for copies of documents that demonstrate the internal controls in action.*
Describe the process for any information transfers from one person (process owner) to the next.	*There is a handover from sales to accounting. Based on the walkthrough, the transfer worked well.*
Note the frequency and timing of the internal control procedures performed.	*Noted on the control design matrix.*
Identify any general IT controls required to protect the transaction data files and ensure the proper functioning of application internal controls.	*General IT controls are minimal due to small size of entity.*
Document the procedures in place to cover illnesses and vacations of personnel. If vacations have not been taken in last 12 months, document why.	*As a part-time employee, Ruby catches up on all record- keeping whenever she gets back to the office. Due to the minimal number of transactions, this has been sufficient.*
Ask about the extent and nature of errors found in the past period.	*Most errors were due to mistakes in quantities of items ordered and shipped. The sales and order log matching is Raj's control to catch those errors and appears to be working effectively in our walk-through testing.*
Ask whether any person has been required to deviate from documented procedures.	*None noted.*

Step 4—Internal control documentation

Note: the controls are identified in bold type.

**Extract From Business Process Documentation Using a Narrative Approach—
Kumar & Co.**

Business Process—Revenue/receivables/receipts system

Sales orders

Sales orders are prepared for each order received and entered into the accounting system, which **automatically assigns the order a sequential number**. The only exception is furniture sold directly from the shop or other small items on hand.

Raj maintains an **order log** that tracks the date of the order, the amount, the type of product, date promised, price, etc. He also maintains a **sales log** with customer name, order details, price, etc. Raj **matches and reviews** the order and sales logs at the end of the month for accuracy.

When items are assembled and ready for shipment, Ruby prepares **an invoice**, which is sent along with the order to the customer.

Shop sales
For all sales out of the shop, invoices are prepared at the time of sale by Raj and entered into the accounting system. The system automatically generates an **invoice number** for each sale. Invoices are given to customers.

The majority of the shop sales are for cash, so there is little credit risk.

Accounts receivable
Ruby opens all of the mail and **segregates** the payments received for deposit. Raj goes to the bank on his way home and makes the deposit. Ruby then enters the payments into the accounting system and applies the payment to the invoices indicated.

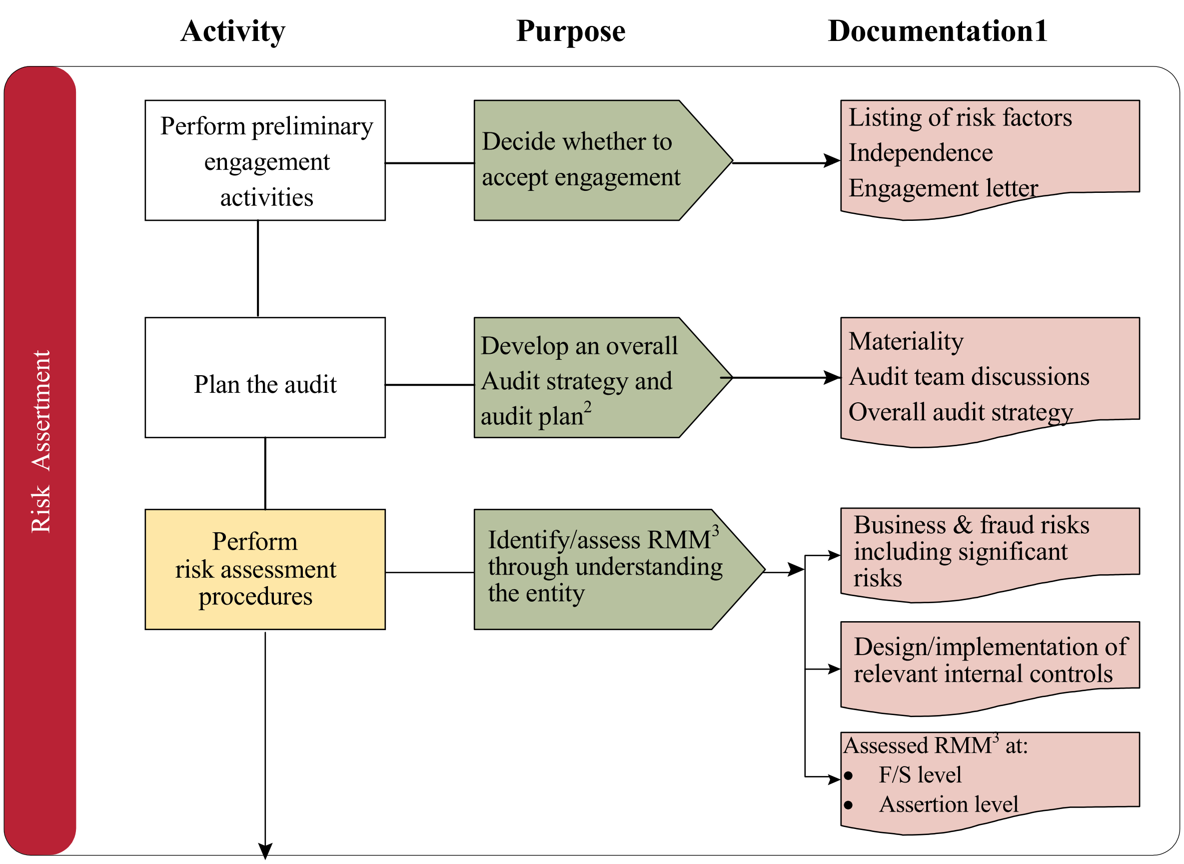
Ruby prepares **an aged accounts receivable listing** and gives the listing to Raj for review.

Accounts **over 90 days are followed up by Ruby** each month, and **comments** are made on the listing as to when the customer has agreed to pay the balance.

13. Communicating Deficiencies in Internal Control

Chapter Content	Relevant SLAuS
Guidance on communicating deficiencies identified in internal control that, in the auditor's professional judgment, merit the attention of management and those charged with governance.	265

Exhibit 13.0-1



Notes:

1. Refer to SLAuS 230 for a more complete list of documentation required.
2. Planning (SLAuS 300) is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Paragraph #	Relevant Extracts from SLAuSs
260.10	For purposes of the SLAuSs, the following terms have the meanings attributed below: (a) Those charged with governance—The person(s) or organization(s) (e.g., a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager. For discussion of the diversity of governance structures, see paragraphs A1-A8. (b) Management—The person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.
265.6	For purposes of the SLAuSs, the following terms have the meanings attributed below: (a) Deficiency in internal control—This exists when: (i) A control is designed, implemented or operated in such a way that it is unable to prevent, or detect and correct, misstatements in the financial statements on a timely basis; or (ii) A control necessary to prevent, or detect and correct, misstatements in the financial statements on a timely basis is missing. (b) Significant deficiency in internal control—A deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance. (Ref: Para. A5)
265.7	The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. (Ref: Para. A1-A4)
265.8	If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies. (Ref: Para. A5-A11)
265.9	The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. (Ref: Para. A12-A18, A27)
265.10	The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis: (Ref: Para. A19, A27) (a) In writing, significant deficiencies in internal control that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances; and (Ref: Para. A14, A20-A21) (b) Other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. (Ref: Para. A22-A26)

Paragraph #	Relevant Extracts from SLAuSs
265.11	The auditor shall include in the written communication of significant deficiencies in internal control: (a) A description of the deficiencies and an explanation of their potential effects; and (Ref: Para. A28) (b) Sufficient information to enable those charged with governance and management to understand the context of the communication. In particular, the auditor shall explain that: (Ref: Para. A29-A30) (i) The purpose of the audit was for the auditor to express an opinion on the financial statements; (ii) The audit included consideration of internal control relevant to the preparation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of internal control; and (iii) The matters being reported are limited to those deficiencies that the auditor has identified during the audit and that the auditor has concluded are of sufficient importance to merit being reported to those charged with governance.

13.1 Overview

During the course of the audit, deficiencies in internal control may be identified. This may occur as a result of understanding and evaluating internal control (see Volume 2, Chapters 11 and 12), in making risk assessments, performing audit procedures, or from other observations made at any stage of the audit process.

There is no restriction on what control deficiencies can be communicated with those charged with governance and with management. However, where an identified deficiency is assessed by the auditor as being significant, the auditor would first discuss it with management, and is then required to communicate it (and any other significant deficiencies) in writing to those charged with governance.

Some of the more common control deficiencies are listed in the exhibit below.

Exhibit 13.1-1

	Potential Internal Control Deficiencies
Pervasive (Entity-Level) Controls	Weak control environment (entity-level) controls such as ineffective oversight, poor attitude toward internal control, or instances found of management override or fraud
	Changes in personnel that have resulted in key positions being unfilled, or where current personnel (such as in accounting) are not competent to perform the required tasks.
	Deficiencies identified in general IT controls.
	Inadequate controls implemented to address significant non-routine events such as the introduction of a new accounting system, the automation of a system such as sales, or the acquisition of a new business.

	Potential Internal Control Deficiencies
Pervasive (Entity-Level) Controls (con'd)	Inability by management to oversee the preparation of the financial statements. This could include the lack of: • General monitoring controls (such oversight of financial accounting personnel); • Controls over the prevention and detection of fraud; • Controls over the selection and application of significant accounting policies; • Controls over significant transactions with related parties; • Controls over significant transactions outside the entity's normal course of business; and
	Significant deficiencies previously communicated to management or those charged with governance remain uncorrected after some reasonable period of time.
Specific (Transactional) Controls	An ineffective management response to identified significant risks (e.g., absence of controls over such a risk).
	Misstatements were detected by the auditor when they should have been prevented, or detected and corrected, by the entity's internal control.
	The existing internal controls were not: • Sufficient to mitigate the risk (poor design); and/or • Operating as designed (poor implementation). This could result from poor training, lack of staff competence, or inadequate resources to perform the required tasks.

13.2 Fraud

If evidence is obtained that fraud exists or may exist, the matter should be brought to the attention of the appropriate level of management as soon as is practicable. This should be done even if the matter might be considered inconsequential.

The appropriate level of management is a matter of professional judgment, but would be at least one level above the persons who appear to be involved with the suspected fraud. It would also be affected by the likelihood of collusion and the nature and magnitude of the suspected fraud. Where the fraud involves senior management, communication is also required with those charged with governance. This may be made orally or in writing.

CONSIDER POINT

Fraud perpetrated by the owner-manager or those charged with governance
When fraud occurs at the very top of an organization, there is no one within the entity to whom it can be reported. In these situations, the auditor may obtain legal advice to determine the appropriate course of action in the circumstances. The purpose of obtaining such advice is to ascertain what steps (if any) are necessary in considering the public-interest aspects of the identified fraud.

In most countries, the auditor's professional duty is to maintain the confidentiality of client information. This may preclude reporting fraud to an external party. However, the auditor's legal responsibilities vary by country and, in certain circumstances, the duty of confidentiality may be overridden by statute, the law, or courts of law. In some countries, the auditor of a financial institution has a statutory duty to report the occurrence of fraud to supervisory authorities. Also, in some countries, the auditor has a duty to report misstatements to authorities in those cases where management and those charged with governance fail to take corrective action.

13.3 Assessing the Severity of a Deficiency

A significant deficiency is defined as a deficiency or combination of deficiencies in internal control that, in the auditor's professional judgment, is of sufficient importance to merit the attention of those charged with governance.

In evaluating internal control (see Volume 2, Chapter 12), it is suggested that risk factors that are unlikely to result in a material misstatement in the financial statements be eliminated (scoped out) from the auditor's understanding of internal control. If this guidance is followed, most of the control deficiencies identified by the auditor are likely to be significant.

The criteria for determining whether a deficiency is significant or not is similar to that for any other risk (see Volume 2, Chapter 9). Professional judgment is used to assess the likelihood that a misstatement could occur, and the potential magnitude of the misstatement if it did occur. If a misstatement has in fact occurred, the assessment would be based on the extent of the actual misstatement.

Less serious or even minor control deficiencies may also be identified during the course of the audit. These could result from interviews with management and staff, observation of internal controls in operation, performing further audit procedures, and any other information that may be obtained. It is a matter of professional judgment whether these matters are of sufficient importance to be reported to management and those charged with governance.

Some matters that could be considered by the auditor in assessing the severity of a deficiency are outlined in the following exhibit.

Exhibit 13.3-1

	Identifying a Significant Deficiency
Deficiency Assessment Criteria	Likelihood of deficiencies leading to material misstatements in the financial statements in the future.
	The susceptibility of an asset or liability to loss or fraud.
	The subjectivity and complexity of determining estimated amounts, such as fair value accounting estimates.
	The financial statement amounts exposed to the deficiencies.
	The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
	The importance of the controls to the financial reporting process.
	The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
	The interaction of the deficiency with other deficiencies in internal control.

13.4 Smaller Entities

When assessing control deficiencies in smaller entities, the auditor would pay attention to the following factors.

Exhibit 13.4-1

	Consider
Control in a Small Entity	Controls may operate with less formality and with less evidence of their performance than in larger entities.
	Certain types of control activities may not be necessary at all. The risks may be mitigated through the controls applied by senior management (e.g., entity-level controls, such as the control environment, that would prevent or detect a specific error from occurring).
	There will be fewer employees, which may limit the extent to which segregation of duties is practicable. This can be offset by the owner-manager exercising more effective oversight (e.g., entity-level controls such as the control environment) than is possible in a larger entity.
	Greater potential exists for management override of controls.

In addition, the communication of deficiencies with those charged with governance may be less structured than in the case of larger entities.

13.5 Documenting Control Deficiencies

There are no specific requirements in the SLAuSs as to how control deficiencies are to be documented. The extent of documentation is a matter requiring professional judgment. Where the audit team is less experienced, more detailed documentation and guidance may be required than where the team consists of highly experienced individuals.

A possible approach to documenting deficiencies as they are identified is outlined below. This documentation can be used for:

- Discussing deficiencies with management;
- Assessing the severity of the deficiencies;
- Considering the need for any additional audit procedures to respond to the unmitigated risk; and
- Preparing the required communication to management and those charged with governance.

An example of such documentation is illustrated below (without the references to supporting and other working papers).

Exhibit 13.5-1

What is the risk factor or assertion affected?	Describe the deficiency identified.	What is the potential effect on the financial statements?	Significant deficiency? (Yes/No)	Audit response
Management has not considered or assessed the risks of fraud occurring.	Members of the management team trust each other and are reluctant to introduce costly policies, etc. that address the risk of fraud.	Management could override controls and materially manipulate the financial statements.	Yes	See the specific procedures performed on journal entries, related parties, and revenue recognition.
Sales/services recorded in wrong accounting period.	There are no controls to prevent this from occurring and we found a number of cutoff errors in our tests of details.	Revenues could be materially misstated in the financial statements.	Yes	See the additional procedures performed relating to cut off.
Poor oversight and documentation to support the preparation of estimates.	The client provides virtually no back-up documents to support their estimates.	Given the size of the estimates, an error could result in a material error in the financial statements.	Yes	Obtain evidence to support the assumptions and perform the calculations again.

CONSIDER POINT

Record deficiencies in a single place

Designate one particular audit form to record pertinent details of control deficiencies as they are identified. This will ensure that all identified deficiencies are recorded on a consistent basis and in one place. If scattered through the file, deficiencies could be missed. This could result in an incomplete audit response to the risks involved, and incomplete communication to management and those charged with governance.

Describe the implications

When documenting deficiencies, take time to describe the implications of the deficiency ("what could go wrong") and the proposed audit response (if any) to the unmitigated risk.

What is the recommended course of action?

Providing management with a recommended course of action to correct identified control deficiencies is not a requirement. However, recommendations can be useful for management in determining the appropriate course of corrective action. Where recommendations are likely to be provided to management, document the suggestions for improvement at the same time that the deficiencies are recorded. If this step is left until later, it may lead to additional time being incurred to become acquainted with the facts again.

13.6 Oral Discussions with Management

Before issuing a written communication, it is generally considered best practice to discuss the findings orally (such as a discussion based on a draft letter) with the appropriate person or level of management, and possibly with those charged with governance. The appropriate person is the one who can evaluate the deficiencies and take the necessary remedial action. This step helps the auditor to ensure that the findings are factually correct and appropriately worded in the circumstances. It may also enable the auditor to obtain a preliminary indication of management's response to the findings.

For significant deficiencies, the appropriate level of management would be the highest in the entity, such as the owner-manager, chief executive officer, or chief financial officer (or equivalent). For other deficiencies, the appropriate level may be operational management with direct involvement in the control areas affected. Note that, if all of those charged with governance are also involved in managing the entity, communication with the most senior management may not adequately inform all those with governance responsibilities.

If the deficiency is directed at management directly (e.g., a question about its integrity or competence), it would not be appropriate to discuss this with management directly. The discussion of such findings would normally be with those charged with governance.

CONSIDER POINT

If a significant deficiency is directed at the conduct or competence of the owner-manager or those charged with governance, there is no higher level in the entity to whom to report the findings. In these situations, the auditor would consider his/her ability to continue performing the audit. This may involve the auditor seeking legal advice.

The discussion with management provides an opportunity to discuss the findings and obtain management's reaction before the findings are finalized and communicated in writing, as illustrated below.

Exhibit 13.6-1

	Benefits
Discussions with Management	Alerts management, on a timely basis, to the existence of deficiencies.
	Opportunity to obtain relevant information for further consideration, such as: • Confirmation that the description of the deficiency and related facts (such as the extent of an actual misstatement) is accurate; • Existence of other possibly compensating controls; • Management's reaction and understanding of the actual or suspected causes of the deficiencies; and • Existence of exceptions arising from the deficiencies that management has noted.
	Obtain a preliminary management response to the findings.

13.7 Written Communications

Significant deficiencies are to be reported in writing. This reflects the importance attached to such matters, and may assist management and those charged with governance in fulfilling their various responsibilities.

The requirement to communicate significant deficiencies in writing applies to all sizes of entity, including owner-managed and very small entities. Communicating such matters in writing ensures that those charged with governance have indeed been informed of the problems.

As soon as practicable after concluding that significant deficiencies exist, the auditor would discuss them with management and then communicate them in writing to those charged with governance. Although not required, the communication letter may also contain some suggested recommendations for remedial action. By taking these steps, management can take corrective action on a timely basis.

13.8 Management's Response to the Communication

It is the responsibility of management and those charged with governance to respond appropriately to the auditor's communication about significant deficiencies in internal control, and any recommendations for remedial action. This may take the form of:

- Initiating remedial action to correct the deficiencies identified by the auditor;
- A decision not to take any action. Management may already be aware of the significant deficiencies, and has chosen not to remedy them because of the costs or other considerations; or
- No action at all. This may be indicative of a poor attitude toward internal control, which has implications for assessing risk at the financial statement level. In some situations, such non-action may constitute a significant deficiency in itself.

Regardless of what action is taken by management, the auditor is required to communicate all significant deficiencies in writing. This includes significant deficiencies already reported in prior periods. It is not the auditor's role to determine whether the cost of mitigating a deficiency outweighs the benefit to be obtained. However, some consideration of proportionality to the size of the entity and the application of common sense in the circumstances is appropriate.

If a previously communicated significant deficiency remains, the current period's communication may repeat the description or simply refer to the previous communication.

If the deficiency is not significant, there is no need to put it in writing or to repeat the communication in the current period. However, it may be appropriate for the auditor to re-communicate the other deficiencies if there has been a change in management, or if new information has come to the auditor's attention.

Content of Communication

The communication of significant deficiencies would normally include:

- Description of the nature of each significant deficiency and the potential effects. There is no need to quantify those effects;
- Any suggestions for remedial action on the deficiencies;
- Management's actual or proposed responses; and
- A statement as to whether or not the auditor has undertaken any steps to verify whether management's responses have been implemented.

Significant deficiencies may be grouped together for reporting purposes where it is appropriate to do so.

As additional context for the communication, the letter would also include the following:

- An indication that, if the auditor had performed more extensive procedures on internal control, the auditor might have identified more deficiencies to be reported, or concluded that some of the reported deficiencies need not in fact have been reported; and
- An indication that such communication has been provided for the purposes of those charged with governance, and that it may not be suitable for other purposes.

Local Reporting Requirements

Laws or regulations in some jurisdictions may establish additional requirements for the auditor to communicate one or more specific types of deficiency in internal control identified during the audit. Where this occurs:

- The requirements of SLAuS 265 remain applicable, notwithstanding that law or regulation may require the auditor to use specific terms or definitions; and
- The auditor would use the defined terms and definitions for the purpose of communicating in accordance with the applicable legal or regulatory requirements.

13.9 Timing of the Written Communication

The auditor is required to communicate, in writing, significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. Factors to consider include:

- Would undue delay in the reporting of information cause it to lose its relevance?
- Would the information be an important factor in enabling those charged with governance to discharge their oversight responsibilities?

Unless local requirements specify a particular date, the latest date that a written communication may be issued is before the date of the auditor's report or shortly thereafter. As the written communication forms part of the audit file, this enables the auditor to complete the assembly of the final audit file on a timely basis.

CONSIDER POINT

Where possible, communicate deficiencies in internal control well before the period-end audit work commences. Early notification could enable management to take corrective action that may assist the auditor by lowering the assessed risk of material misstatement at the financial statement or assertion level. For example, a recommendation to replace or redeploy an incompetent accountant/bookkeeper could significantly reduce the work required in reviewing the preparation of the period-end financial statements.

13.10 Case Studies—Communicating Deficiencies in Internal Control

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

Deficiencies in internal control are identified throughout all phases of the audit (risk assessment, risk response, and reporting), and the auditor must accumulate them for subsequent reporting to management. Significant internal control deficiencies (both in design and operation) would be reported to management using a letter such as the ones below.

Case Study A — Dephta Furniture, Inc.

Jamel, Woodwind & Wing LLP
55 Kingston St., Cabetown, United Territories 123-53004

March 15, 20X3
Suraj Dephta

Dephta Furniture Inc.
[Address]

Re: Audit of 20X2 Financial Statements

Dear Suraj:

The objective of our audit was to obtain reasonable assurance that the financial statements were free of material misstatement. Our audit was not designed for the purpose of identifying matters to communicate. Accordingly, our audit would not usually identify all such matters that may be of interest to you, and it is inappropriate to conclude that no such matters exist.

During the course of our audit of Dephta Furniture, Inc. for the period ended December 31, 20X2, we identified the following deficiencies in internal control that, in our opinion, are significant. A significant deficiency or combination of deficiencies in internal control is one that, in our professional judgment, is of sufficient importance to merit the attention of those charged with governance.

Unauthorized Journal Entries
There are currently no controls over manual journal entries made throughout the period. Without any segregation of duties and review controls over entries made, errors or misstatements can go undetected. Although our audit found no such material errors or misstatements, this current unrestricted and unmonitored access by all company personnel presents a risk to accuracy of the financial statements.

We recommend that proper segregation of duties be allocated based on roles and responsibilities. Further, a formalized review process should be established. All significant entries should be approved prior to entry, and a secondary review should be conducted by management on a monthly basis.

Poor Inventory Controls
There are currently very limited controls over inventory. Without proper controls, inventory could be incomplete, improperly valued, or stolen.

We recommend Dephta implement formalized controls over the tagging and periodic counting of inventory. Inventory records should be compared to actual products in the warehouse on a monthly basis. A visual inspection on a monthly basis of obsolete and damaged goods should also be performed to ensure that any inventory write-downs are recorded as required.

This communication is prepared solely for the information of management and is not intended for any other purpose. We accept no responsibility to a third party who uses this communication.

Yours truly,

Jamel, Woodwind & Wing, LLP

Case Study B—Kumar & Co.

Jamel, Woodwind & Wing LLP
55 Kingston St., Cabetown, United Territories 123-53004

March 15, 20X3
Rajesh Kumar

Kumar & Co.
[Address]

Re: Audit of 20X2 Financial Statements

Dear Rajesh:

The objective of our audit was to obtain reasonable assurance that the financial statements were free of material misstatement. Our audit was not designed for the purpose of identifying matters to communicate. Accordingly, our audit would not usually identify all such matters that may be of interest to you, and it is inappropriate to conclude that no such matters exist.

During the course of our audit of Kumar & Co. for the period ended December 31, 20X2, we identified the following deficiency in internal control that, in our opinion, is significant. A significant deficiency or combination of deficiencies in internal control is one that, in our professional judgment, is of sufficient importance to merit the attention of those charged with governance.

Lack of Segregation of Duties

There is currently a lack of segregation of duties at Kumar & Co. The part-time bookkeeper has total access to and control over all the record-keeping at Kumar. Without separating duties across multiple employees, there is a risk that the bookkeeper may make unintentional or intentional errors that go undetected.

We recommend that Kumar & Co. consider hiring another part-time staff person to split functions with the bookkeeper. Given the small size of the organization and cost restraints, if that is not practicable, we recommend that Raj Kumar become more involved in the record-keeping aspect of the business to provide adequate oversight of the bookkeeper's work.

This communication is prepared solely for the information of management and is not intended for any other purpose. We accept no responsibility to a third party who uses this communication.

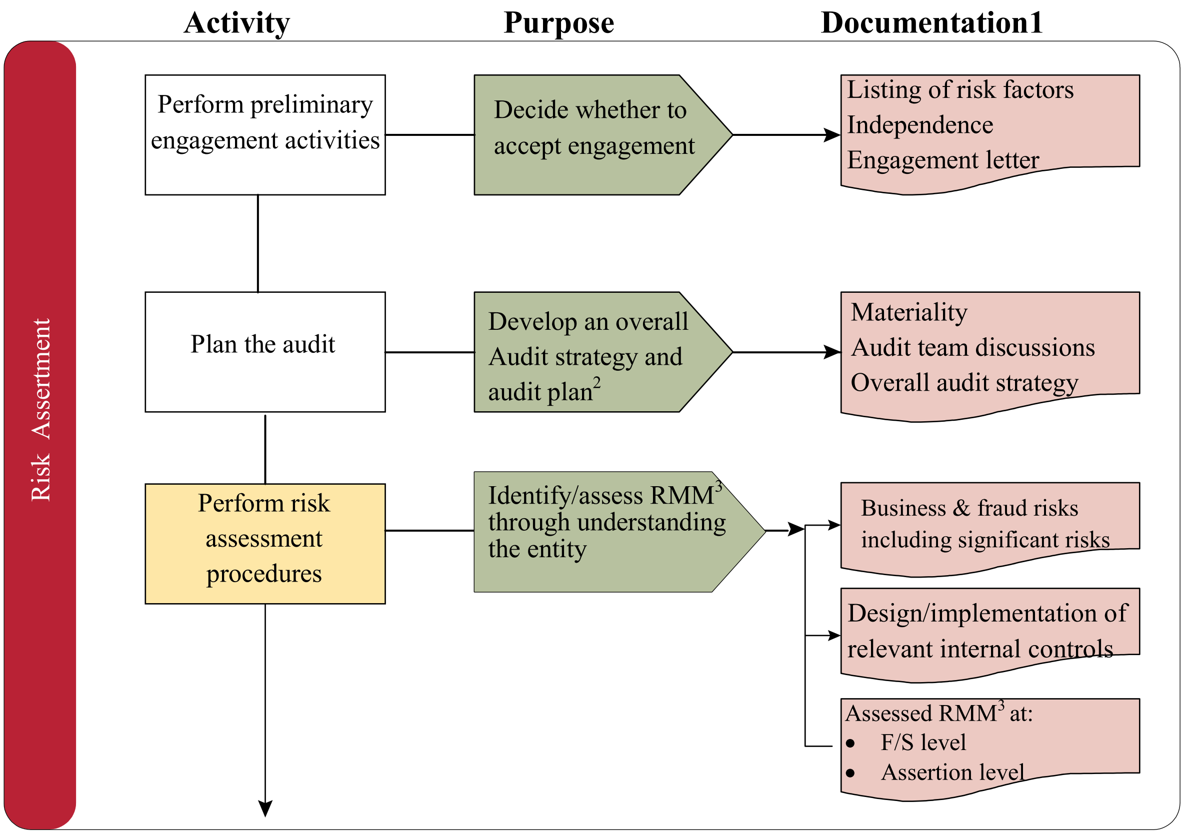
Yours truly,

Jamel, Woodwind & Wing, LLP

14. Concluding the Risk Assessment Phase

Chapter Content	Relevant SLAuS
Concluding the risk assessment phase of the audit by documenting the assessed risks at the financial statement and assertion levels.	315

Exhibit 14.0-1



Notes:
1. Refer to SLAuS 230 for a more complete list of documentation required.
2. Planning (SLAuS 300) is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Paragraph #	Relevant Extracts from SLAuSs
315.25	The auditor shall identify and assess the risks of material misstatement at: (a) the financial statement level; and (Ref: Para. A105-A108) (b) the assertion level for classes of transactions, account balances, and disclosures (Ref: Para. A109-A113) to provide a basis for designing and performing further audit procedures.
315.26	For this purpose, the auditor shall: (a) Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements; (Ref: Para. A114-A115) (b) Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions; (c) Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and (Ref: Para. A116-A118) (d) Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.
315.32	The auditor shall include in the audit documentation: (a) The discussion among the engagement team where required by paragraph 10, and the significant decisions reached; (b) Key elements of the understanding obtained regarding each of the aspects of the entity and its environment specified in paragraph 11 and of each of the internal control components specified in paragraphs 14-24; the sources of information from which the understanding was obtained; and the risk assessment procedures performed; (c) The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 25; and (d) The risks identified, and related controls about which the auditor has obtained an understanding, as a result of the requirements in paragraphs 27-30. (Ref: Para. A131-A134)

14.1 Overview

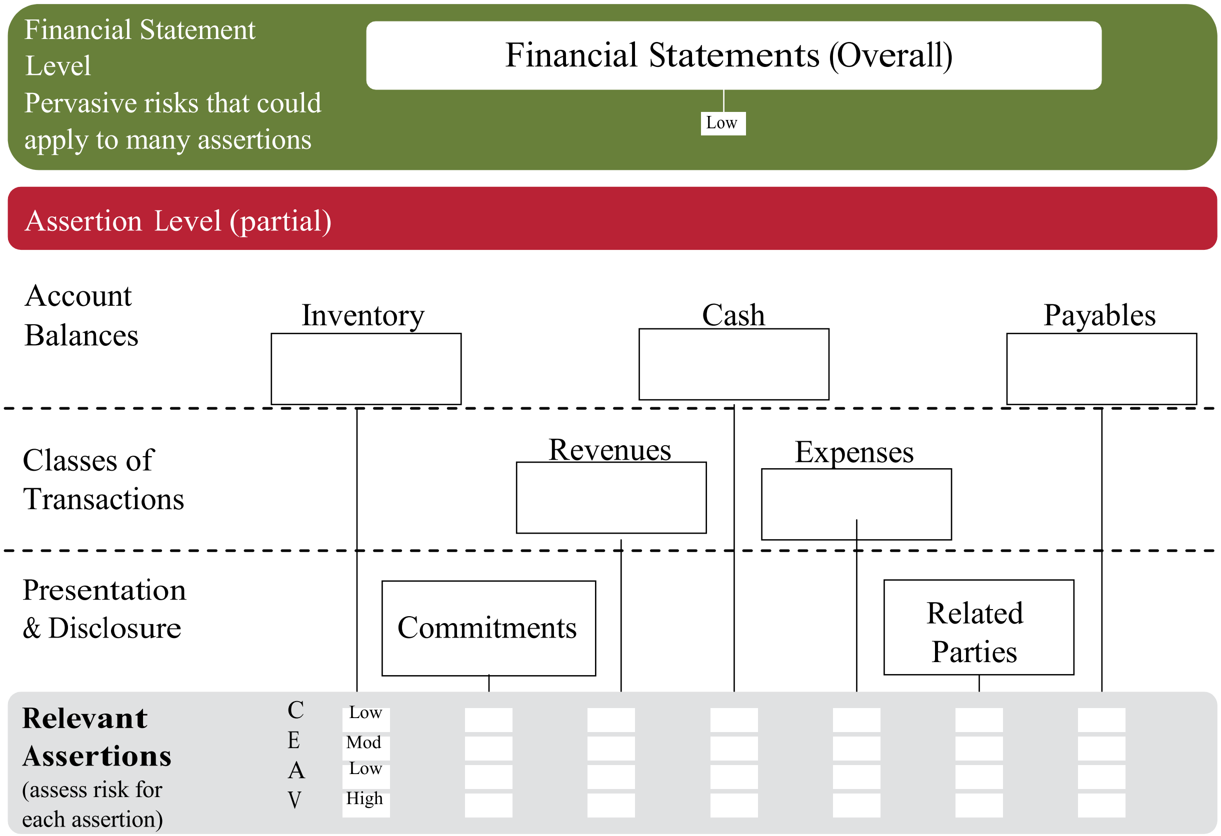
The final step in the risk assessment phase of the audit is to review the results of the risk assessment procedures performed, and then assess (or, if already assessed, summarize) the risks of material misstatements at:

- The financial statement level; and
- The assertion level for classes of transactions, account balances, and disclosures.

The resulting list of assessed risks will form the foundation for the next phase in the audit, which is to determine how to respond appropriately to the assessed risks through the design of further audit procedures.

The two levels of risk assessment are illustrated in the following exhibit:

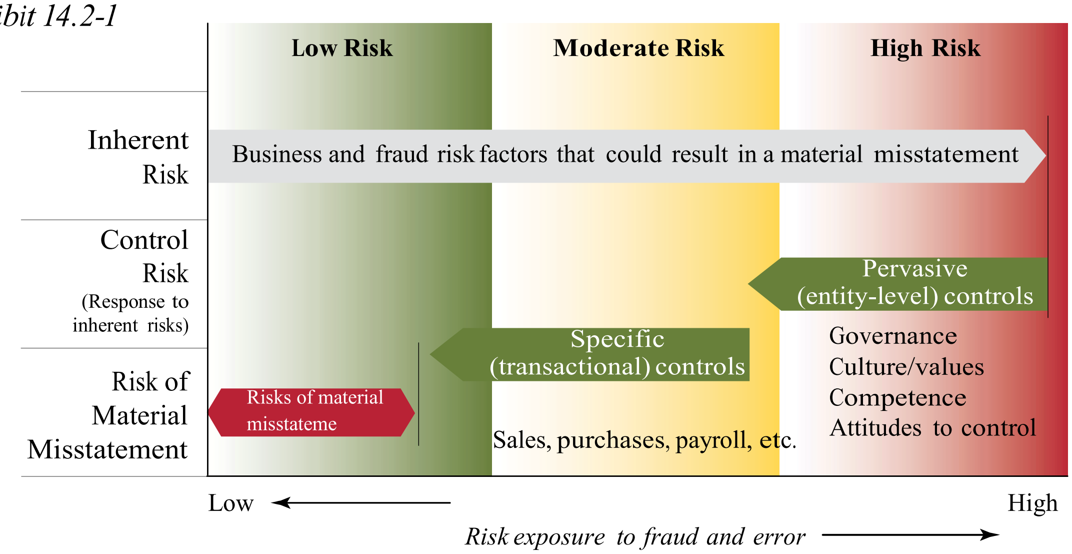
Exhibit 14.1-1



14.2 Audit Evidence Obtained to Date

The evidence obtained to date, by performing risk assessment procedures, consists of identification and assessment of inherent risks, and the design and implementation of internal controls that address those risks. What is left is the risk of material misstatement. This is simply the remaining risk after taking into account the effect of internal controls put in place to mitigate the inherent risks. This is illustrated in the exhibit below.

Exhibit 14.2-1



Note: The length of the horizontal bars in this exhibit is purely for illustrative purposes and would vary from entity to entity.

Sources of audit evidence that may be relevant in summarizing and assessing risks at the two levels are listed below.

Exhibit 14.2-2

Audit Evidence	Volume and Chapters
The overall audit strategy	V2 - 5
Materiality and identification of material financial statement areas and disclosures	V2 - 6
Audit team discussions	V2 - 7
Results of performing risk assessment procedures	V1 - 3 and V2 - 3 to 14
Inherent risk identification and assessment	V2 - 8 and 9
Significant risks	V2 - 10
Understanding and evaluation of internal control	V2 - 11 and 12
Significant deficiencies identified	V2 - 13

14.3 Summarizing the Various Risk Assessments

The purpose of assessing risks is to provide the foundation and a reference point for what is needed to respond appropriately with well-designed and efficient further audit procedures.

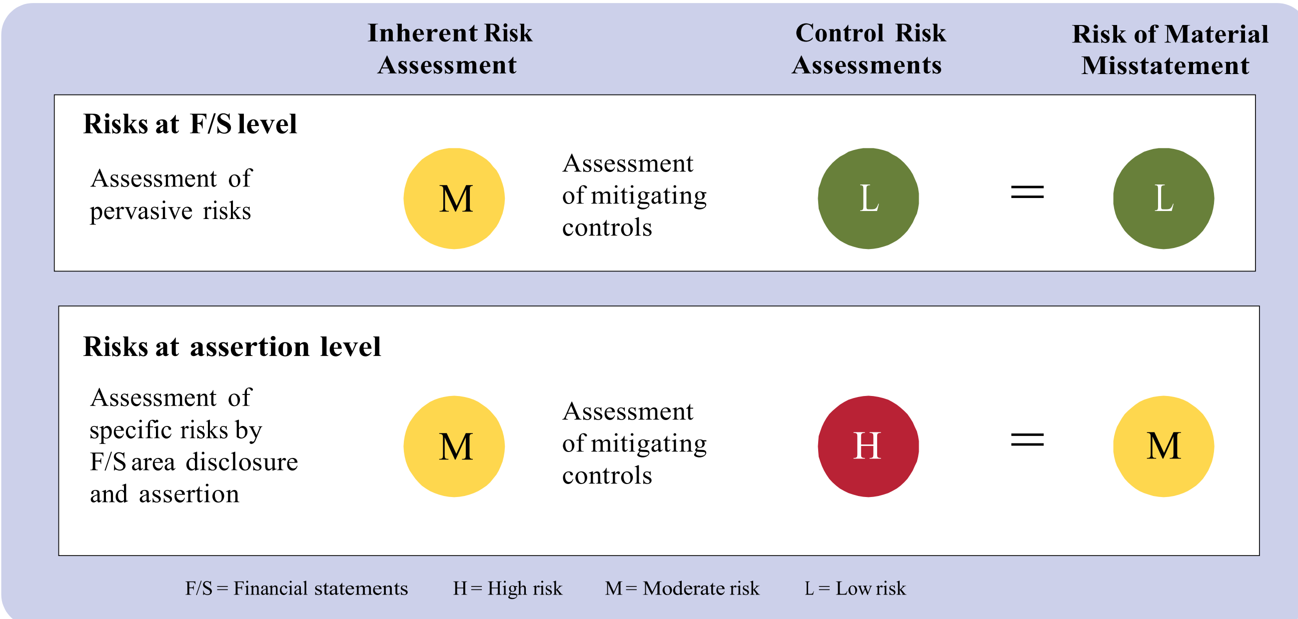
If risks identified to date have already been documented and assessed in a consistent manner, it will be relatively straightforward to review and summarize them.

The summary of assessed risks brings together the inherent risk factors identified and the evaluation of any internal control designed to mitigate such risks. This is illustrated in Exhibit 14.3-1.

Note: There is a moderate level of risk at the financial statement level which is mitigated by good entity-level and possibly other controls. The result is a low assessed risk at the financial statement level.

The summary of assessed risks at the assertion level is a combination of the assessment of inherent and control risks that apply to individual financial statement balances, transactions, and disclosures. In the case below, the inherent risks are moderate, and there are no relevant internal controls, so the control risk is high. The result is therefore a moderate residual risk for this particular assertion.

Exhibit 14.3-1



Notes:

- Before concluding there are no particular risks for a financial statement area or disclosure, consider the existence of other relevant factors, such as history of known errors, susceptibility of the asset/liability to fraud, potential for management override, and the previous period's experience.
- If the auditor plans to rely on a control risk that has been assessed as low (e.g., reduce the extent of substantive procedures), there need to be tests of the operational effectiveness of the controls to support such an assessment.
- In some cases, the entity may have some internal controls, but the auditor has deemed them not relevant to the audit and therefore no assessment has been made. In these cases, the control risk would be assessed as high.
- Specific (transactional) controls generally work (resulting in a low assessed risk) or do not work (resulting in a high assessed risk). This would imply that there is no assessment of control risk as being moderate. However, some auditors assess control risk as moderate when a control may not be totally reliable in operation, but is expected to work most of the time. This can often be the case in smaller entities.
- The determination of residual risk resulting from the combination of inherent and control risk is a matter of professional judgment. The exhibit below shows various combinations of risk, but is not a substitute for professional judgment based on the particular circumstances.

Exhibit 14.3-2

Inherent Risk	Control Risk	Risk of material misstatement
H	H	H
H	M	M
H	L	M or L
M	H	M
M	M	M
M	L	L
L	H	M/L
L	M	L
L	L	L

Key: H = High M = Moderate L = Low

CONSIDER POINT

Document the reasoning behind risk assessments
When summarizing assessed risks, be sure to provide a short description of the reasons for each assessment or a cross-reference to where they can be found. This is often more important than the assessment itself, because it helps to design tailored and cost-effective responses.

Assessing inherent risks
Remember that the assessment of inherent risk is always completed before any consideration of controls that may mitigate the risk. Assuming most financial statement areas to be audited will exceed overall materiality, it is likely (in most instances) that the inherent risk of misstatement (before internal control) for most assertions will be high.

Low risk for all assertions
When a financial statement area has been assessed as low risk for all assertions, there is no need to repeat the same reasoning for each individual assertion. However, the reason why all the assessments are low would be documented.

14.4 Revision of Risk Assessments

The assessment of risk does not end at a point in time. New information may be gained as the audit progresses, and the performance of audit procedures may identify additional risks, or that internal control is not operating as intended. When this occurs, the original risk assessment should be revised and the impact on the nature and extent of further audit procedures considered.

14.5 Documentation

The summary of assessed risks can be documented in a number of ways. Three possible approaches are outlined below:

- **A stand-alone document.**
  A separate document that summarizes the inherent and control risk assessments, and the key reasons for the combined risk assessments. This document could also be used for outlining (in general terms) the risk response.
- **Include with the overall audit strategy and audit plan.**
  The first part of each section of the audit plan (such as for receivables, payables, etc.) could outline the risk assessments and the impact on the planned audit procedures.
- **Incorporate risk assessments as part of the auditor's documentation of further procedures.**
  In this case, the risk assessments, audit plans, and the results of work performed could all be documented in one comprehensive working paper for each financial statement area.

The form and extent of the documentation supporting risk assessments would be influenced by:

- The nature, size, and complexity of the entity and its internal control;
- Availability of information from the entity; and
- The audit methodology and technology used in the course of the audit.

Other factors to consider when designing documentation include:

- Ease of understandability;
- Cross-references to the design and implementation of an appropriate audit response;
- Ability to facilitate updating in subsequent periods; and
- Ease of review. A reviewer should be able to determine whether key risks have been identified and that the resulting audit response was appropriate.

A well-documented summary of assessed risks will also be useful in the team planning meetings in subsequent periods where the nature of the risks and the audit response can be discussed.

An approach using a stand-alone document but closely linked to the audit plan is illustrated in the following exhibit. Note that this illustration uses the four "combined" assertions (used for the purposes of this Audit Manual), as defined in Volume 1, Chapter 6.

Exhibit 14.5-1
Assessed Levels of Risk

		Assertio	IR	CR	RMM	Document the key risks and other contributing factors to risk assessment
						The industry is in a general decline as new technologies emerge. However, sales are still strong and the entity is investing in R&D.
Financial Statement Level		P	M	L	L	*Management's attitude to internal control is good. Competent people fill the key positions.*
						Management override possible but new policies in place should deter the most common practices.
						The governance board is made up of family members.
Assertion Level						
	FSA or financial statement disclosure					
1	Sales	C	H	L	M	*Owner wants to save on taxes. Revenue recognition has been inconsistent.*
		E	M	L	L	*Relevant internal controls were identified. Tests of internal control for this assertion are a possibility.*
		A	M	L	L	*Relevant internal controls were identified and there has been no history of errors.*
		V	NA	L	NA	
2	Receivables	C	L	L	L	*Relevant controls were identified and there has been no history of errors.*
		E	H	M	M	*Salesperson's bonuses are based on recorded sales.*
		A	L	L	L	*Relevant internal controls were identified and there has been no history of errors.*
		V	H	M	M	*Recovery of receivables could be an issue in declining industry.*
3	Inventory	C	L	L	L	*Relevant controls were identified and there has been no history of errors.*
		E	H	H	H	*Inventory theft and poor physical internal control in warehouse.*
		A	L	L	L	*Relevant controls were identified and there has been no history of errors.*
		V	H	H	H	*New technology will make some parts and even whole products obsolete.*

Key:

H = High	NA = Not applicable	FSA = Financial statement area	A = Accuracy
M = Moderate	IR = Inherent risk	P = Pervasive risks	V = Valuation
L = Low	CR = Internal control risk	C = Completeness	
D = Detect and correct control	RMM = Risks of material misstatement (combined risk)	E = Existence	

Documentation of assessed risks could also make reference to:

- Details of significant risks that require special attention; and
- Risks for which substantive procedures alone will not provide sufficient appropriate audit evidence.

14.6 Case Studies—Concluding the Risk Assessment Phase

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

The final step in the risk assessment process is to assess the combined risks of material misstatement at the financial statement and assertion levels.

The risk assessments can be summarized using an approach such as outlined below. Supporting information (where the assessments of inherent and control risk were documented) has not been shown. In practice, cross- references would be made to the supporting data.

Case Study A—Dephta Furniture, Inc.

Assessed Levels of Risk

		Assertions	IR	CR	RMM	Document the key risks and other contributing factors to risk assessment
						Management's attitude to internal control is good and competent people fill the key positions.
Financial Statement Level		P	M	L	L	*Management override is possible but we have not found any instances where this occurred and management's attitude toward control is good.*
						The monthly meeting to review performance provides some accountability to management.
Assertion Level						
	FSA or financial statement disclosure					
1	Sales	C	H	L	M	*Revenue recognition policies are inconsistent.*
		E	L	L	L	*Revenue recognition policies are inconsistent. Pressure to inflate sales due to sales bonuses and market pressures.*
		A	L	L	L	*Sales system operates well.*
		V	NA	L	NA	
2	Receivables	C	L	L	L	*No significant risks identified.*
		E	H	M	M	*Salespersons' bonuses are based on recorded sales.*
		A	L	L	L	
		V	H	M	M	*Large retailer receivables collection could be an issue if there is concern over product quality or returns made. Additionally, despite the declining economy, no credit checks are performed before credit is granted.*

Key:

H = High	NA = Not applicable	FSA = Financial statement area	A = Accuracy
M = Moderate	IR = Inherent risk	P = Pervasive risks	V = Valuation
L = Low	CR = Internal control risk	C = Completeness E	
D = Detect and correct control	RMM = Risks of material misstatement (combined risk)	= Existence	

At this point, it would be good practice to prepare a communication for management that outlines the significant weaknesses identified in internal control.

Case Study B—Kumar & Co.

Concluding the Risk Assessment Phase

Assessed Levels of Risk

		Assertions	IR	CR	RM	Document the key risks and other contributing factors to risk assessment
						Management's attitude to internal control is good and competent people fill the key positions.
Financial Statement Level					M	*Management override is possible due to pressures to meet bank covenants and minimize taxes. The bookkeeper's work was not reviewed by Raj on a consistent basis throughout the period. The bookkeeper appears disgruntled and may have opportunity to misstate the figures. Therefore, both unintentional error and intentional fraud could go undetected.*
						The monthly meeting to review performance provides some accountability to management.
Assertion Level						
	FSA or financial statement disclosure					
1	Sales	C	H	L	M	*Relevant internal controls were identified for this*
		E	H	L	M	*Relevant internal controls were identified for this assertion but related party transactions are of concern.*
		A	H	L	M	*Relevant internal controls were identified for this assertion but related party transactions are of concern.*
		V	M	M	M	*Potential for sales returns due to state of industry.*
2	Receivables	C	H	L	M	*Majority of receivables balance is with Dephta. No other specific risks identified.*
		E	H	M	M	*Majority of receivables balance is with Dephta. No other specific risks identified.*
		A	M	M	M	*Majority of receivables balance is with Dephta. No other specific risks identified.*
		V	H	M	M	*The smaller customers may have difficulty paying their bills in these tougher economic times.*

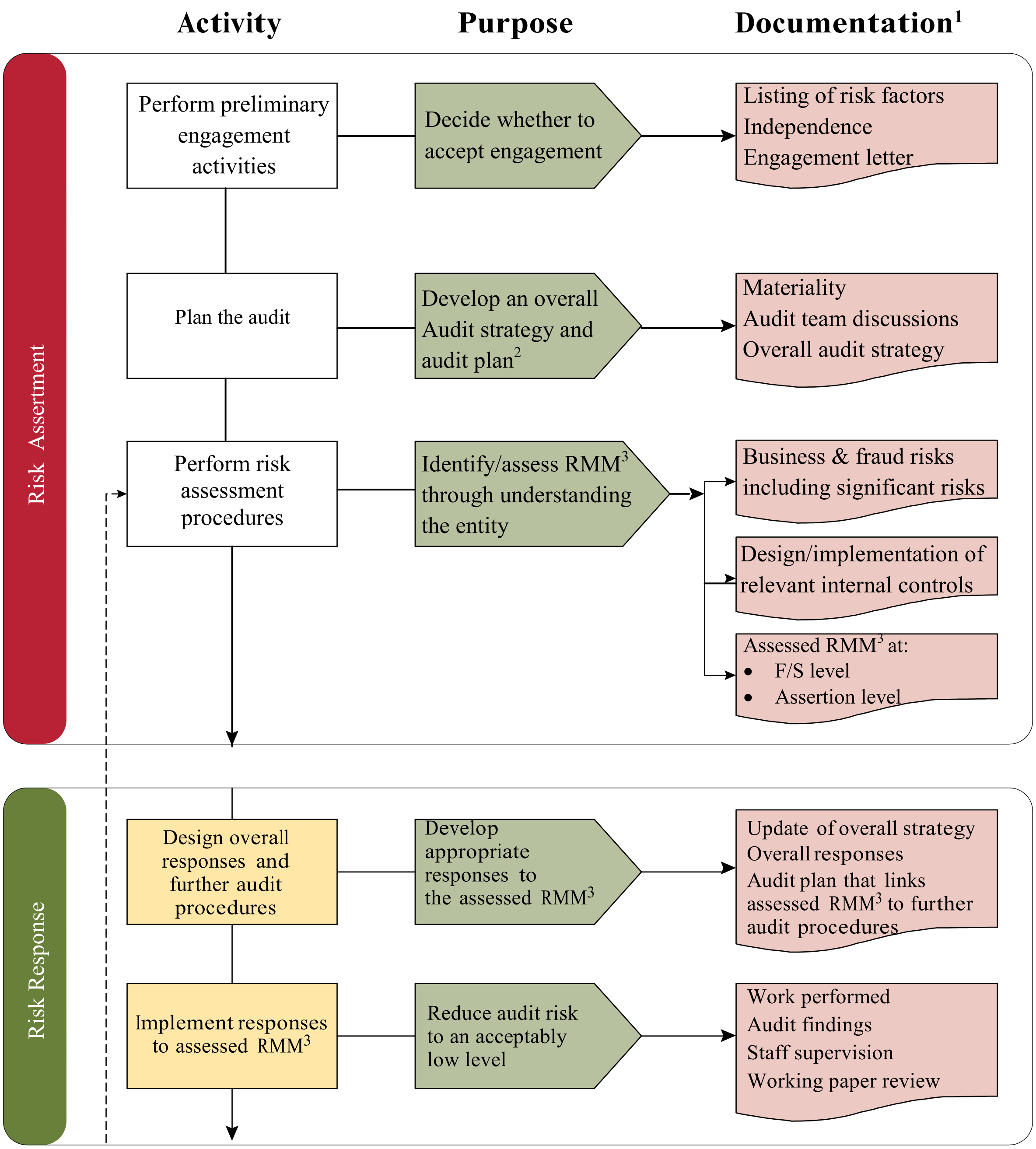
Key:

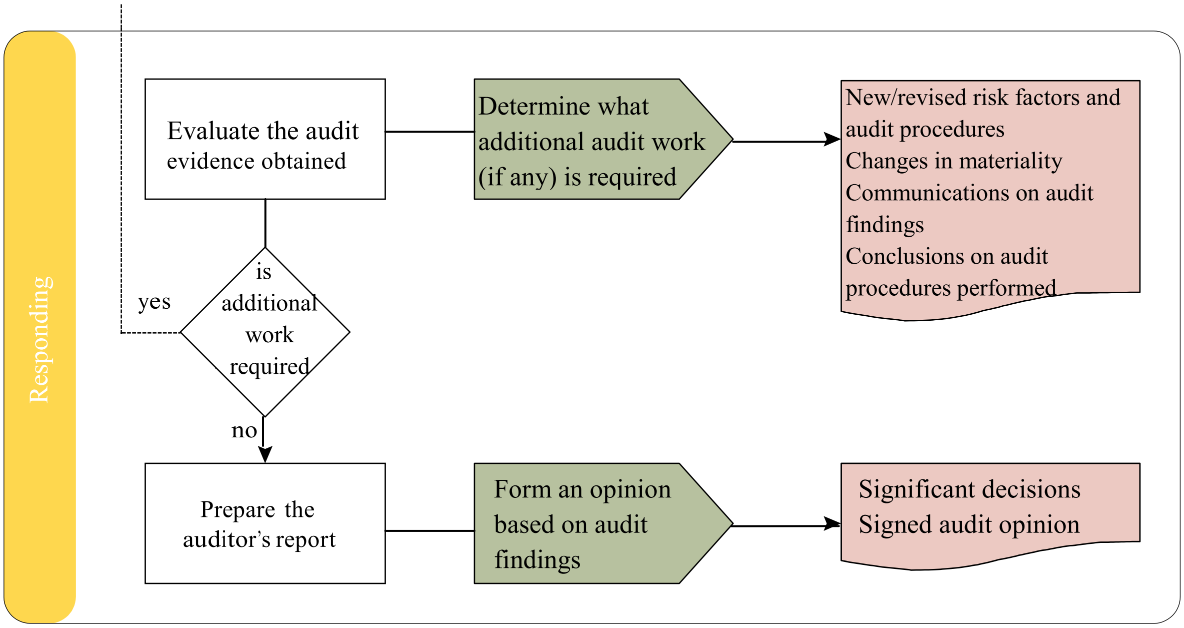
H = High	NA = Not applicable	FSA = Financial statement area	A = Accuracy
M = Moderate	IR = Inherent risk	P = Pervasive risks	V = Valuation
L = Low	CR = Internal control risk	C = Completeness	
D = Detect and correct control	RMM = Risks of material misstatement (combined risk)	E = Existence	

At this point, it would be good practice to prepare a communication for management that outlines the significant weaknesses identified in internal control.

15. Risk Response—An Overview

Exhibit 15.0-1



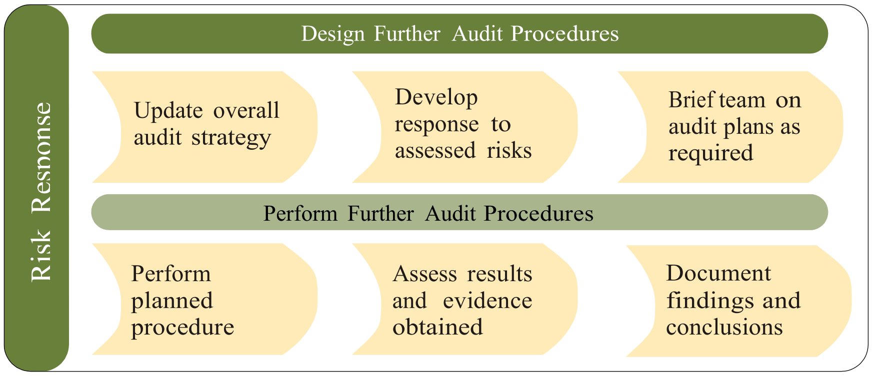


Notes:
1. Refer to SLAuS 230 for a more complete list of documentation required.
2. Planning (SLAuS 300) is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Paragraph #	Relevant Extracts from SLAuSs
330.5	The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. (Ref: Para. A1-A3)
330.6	The auditor shall design and perform further audit procedures whose nature, timing, and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level. (Ref: Para. A4-A8)

The risk response phase includes the steps outlined below:

Exhibit 15.0-2



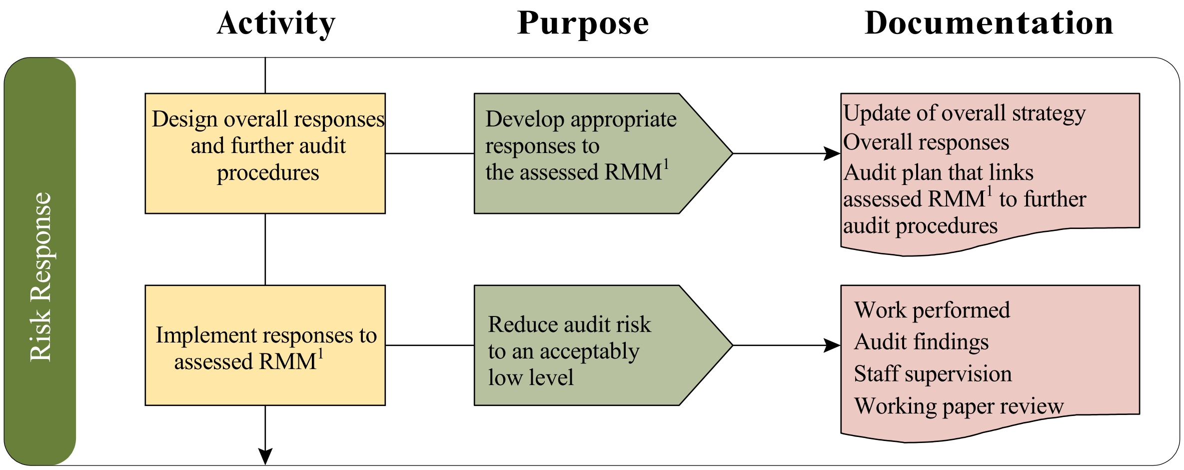
The basic concepts addressed in the risk response phase are listed below.

	Volume and Chapters
Responding to Assessed Risks	V1 - 9
Further Audit Procedures	V1 - 10
Accounting Estimates	V1 - 11
Related Parties	V1 - 12
Subsequent Events	V1 - 13
Going Concern	V1 - 14
Summary of Other SLAuS Requirements	V1 - 15
Audit Documentation	V1 - 16

16. The Responsive Audit Plan

Chapter Content	Relevant SLAuSs
How to plan an effective audit response to assessed risks.	260, 300, 330, 500

Exhibit 16.0.-1



Notes:
1. RMM = Risks of material misstatement.

Paragraph #	Relevant Extracts from SLAuSs
260.15	The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit. (Ref: Para. A11-A15)
300.9	The auditor shall develop an audit plan that shall include a description of: (a) The nature, timing and extent of planned risk assessment procedures, as determined under SLAuS 315. (b) The nature, timing and extent of planned further audit procedures at the assertion level, as determined under SLAuS 330 (c) Other planned audit procedures that are required to be carried out so that the engagement complies with SLAuSs. (Ref: Para. A12)
300.10	The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit. (Ref: Para. A13)

Paragraph #	Relevant Extracts from SLAuSs
300.11	The auditor shall plan the nature, timing and extent of direction and supervision of engagement team members and the review of their work. (Ref: Para. A14-A15)
300.12	The auditor shall include in the audit documentation: (a) The overall audit strategy; (b) The audit plan; and (c) Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes. (Ref: Para. A16-A19)
330.5	The auditor shall design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. (Ref: Para. A1-A3)
330.6	The auditor shall design and perform further audit procedures whose nature, timing, and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level. (Ref: Para. A4-A8)
330.7	In designing the further audit procedures to be performed, the auditor shall: (a) Consider the reasons for the assessment given to the risk of material misstatement at the assertion level for each class of transactions, account balance, and disclosure, including: (i) The likelihood of material misstatement due to the particular characteristics of the relevant class of transactions, account balance, or disclosure (that is, the inherent risk); and (ii) Whether the risk assessment takes account of relevant controls (that is, the control risk), thereby requiring the auditor to obtain audit evidence to determine whether the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); and (Ref: Para. A9-A18) (b) Obtain more persuasive audit evidence the higher the auditor's assessment of risk. (Ref: Para. A19)
330.8	The auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if: (a) The auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (that is, the auditor intends to rely on the operating effectiveness of controls in determining the nature, timing and extent of substantive procedures); or (b) Substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level. (Ref: Para. A20-A24)
330.9	In designing and performing tests of controls, the auditor shall obtain more persuasive audit evidence the greater the reliance the auditor places on the effectiveness of a control. (Ref: Para. A25)
330.10	In designing and performing tests of controls, the auditor shall: (a) Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including: (i) How the controls were applied at relevant times during the period under audit. (ii) The consistency with which they were applied. (iii) By whom or by what means they were applied. (Ref: Para. A26-A29) (b) Determine whether the controls to be tested depend upon other controls (indirect controls) and, if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls. (Ref: Para. A30-A31)

Paragraph #	Relevant Extracts from SLAuSs
330.15	If the auditor plans to rely on controls over a risk the auditor has determined to be a significant risk, the auditor shall test those controls in the current period.
330.18	Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure. (Ref: Para. A42-A47)
330.19	The auditor shall consider whether external confirmation procedures are to be performed as substantive audit procedures. (Ref: Para. A48-A51)
330.20	The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process: (a) Agreeing or reconciling the financial statements with the underlying accounting records; and (b) Examining material journal entries and other adjustments made during the course of preparing the financial statements. (Ref: Para. A52)
330.21	If the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor shall perform substantive procedures that are specifically responsive to that risk. When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details. (Ref: Para. A53)
330.22	If substantive procedures are performed at an interim date, the auditor shall cover the remaining period by performing: (a) substantive procedures, combined with tests of controls for the intervening period; or (b) if the auditor determines that it is sufficient, further substantive procedures only, that provide a reasonable basis for extending the audit conclusions from the interim date to the period end. (Ref: Para. A54-A57)
330.24	The auditor shall perform audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with the applicable financial reporting framework. (Ref: Para. A59)
500.6	The auditor shall design and perform audit procedures that are appropriate in the circumstances for the purpose of obtaining sufficient appropriate audit evidence. (Ref: Para. A1-A25)
500.7	When designing and performing audit procedures, the auditor shall consider the relevance and reliability of the information to be used as audit evidence. (Ref: Para. A26-A33)
500.10	When designing tests of controls and tests of details, the auditor shall determine means of selecting items for testing that are effective in meeting the purpose of the audit procedure. (Ref: Para. A52-A56)

16.1 Overview

In the risk response phase of the audit, the objective is to obtain sufficient appropriate audit evidence regarding the assessed risks. This is achieved by designing and implementing appropriate responses to the assessed risks of material misstatement at the financial statement and assertion levels.

The auditor would approach this task in various ways, such as:

- Addressing each assessed risk in turn according to its nature (i.e., a downturn in the economy) and designing the appropriate audit response in the form of further audit procedures;

- Addressing the assessed risks by material financial statement area or disclosure affected. The auditor would then design an appropriate response in the form of further audit procedures; or
- Starting with a standard list of audit procedures for each material financial statement area and assertion and tailoring it (adding, modifying, and eliminating procedures) to design an appropriate response to the assessed risks.

Responding to assessed risks implies more than using a standard ("one size fits all") audit program which may address each assertion, but has not been tailored to address the assessed risk for the financial statement area by assertion for a particular entity. Audit programs should generally be tailored (to the extent necessary) to the entity's level of risk and its particular circumstances.

16.2 The Starting Point

The starting point for designing an effective audit response is the listing of assessed risks that was developed at the conclusion of the risk assessment phase of the audit (see Volume 2, Chapter 14).

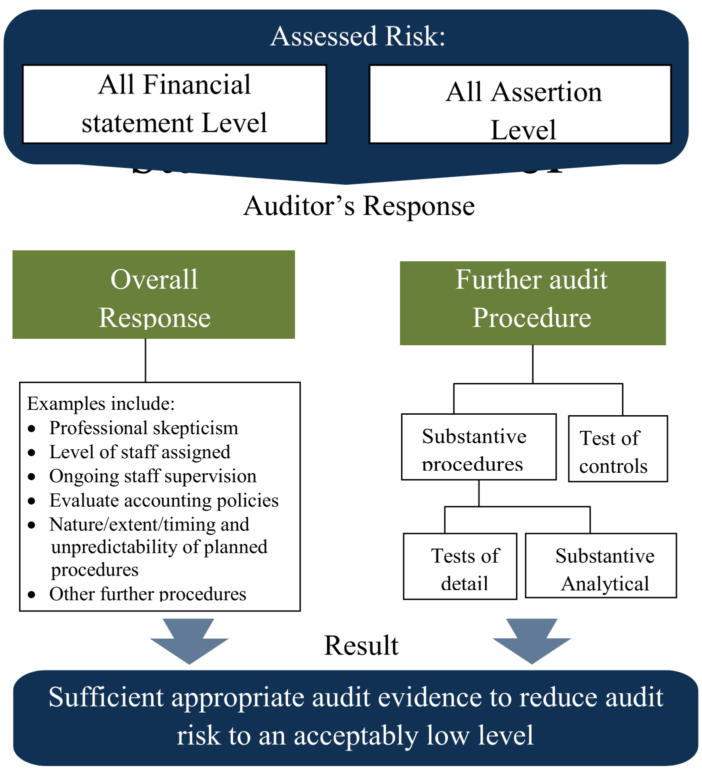
Risks will have been identified and assessed at:

- The financial statement level; and
- The assertion level for financial statement areas and disclosures.

Smaller financial statement areas could be grouped together and treated as one larger area for developing an appropriate audit response.

Volume 1, Chapter 9 outlines possible responses to risks assessed at the two levels. The types of response required are summarized in the following exhibit.

Exhibit 16.2-1



16.3 Overall Responses

Pervasive risks at the financial statement level (risks such as a deficient control environment and/or the potential for fraud that could affect many assertions) are addressed through the design and implementation of an overall response by the auditor, as illustrated in the following exhibit. Refer to Volume 2, Chapter 8 for additional information on pervasive risks.

Areas that the auditor would address in developing an overall response include determining:

- The extent that the audit team needs to be reminded about the use of professional skepticism;
- Which staff to assign, including those with special skills, or whether to use experts;
- The extent of supervision required throughout the audit;
- The need for incorporating some elements of unpredictability in the selection of further audit procedures to be performed; and
- Any general changes that need to be made to the nature, timing, or extent of audit procedures. These could include the timing of procedures (interim or period-end), or new/extended procedures to address specific risk factors such as fraud.

Exhibit 16.3-1

Risk Assessment	Possible Overall Response
An Effective Control Environment	This allows the auditor to have more confidence in internal control and the reliability of audit evidence generated internally within the entity. An overall response could include some audit procedures being performed at an interim date rather than at the period end.
An Ineffective Control Environment *(Deficiencies Exist)*	This will likely require the auditor to perform some additional work such as: • Assigning more experienced audit staff. • Conducting more audit procedures at the period end rather than at an interim date. • Obtaining more extensive audit evidence from substantive procedures. • Making changes to the nature, timing, or extent of audit procedures to be performed.

CONSIDER POINT

Where possible, develop an initial assessment of risk at the financial statement level at the planning stage. This will enable an initial overall response to be developed that addresses matters such as what staff to assign (including those with specialist skills), the level of supervision needed, and what audit procedures are to be performed. This initial assessment of risk would require updating as the audit progresses, and corresponding changes would be made in the overall response.

However, this may not be possible in smaller entities that do not have interim or monthly financial information available for performing analytical procedures and identifying/assessing the risks of material misstatement. Unless limited analytical procedures can be performed or information can be obtained through inquiry to plan the audit, the auditor may need to wait until an early draft of the entity's financial statements is available.

16.4 Use of Assertions in Test Design

An assessment of the risks of material misstatement is required at the financial statement and assertion levels. The objective in designing an appropriate audit response is to obtain evidence that addresses the risk assessments developed for each relevant assertion. Refer to Volume 1, Chapter 6 for more information about assertions.

When developing a response to specific transaction streams, the auditor would note that the assertions also provide the common link between internal control testing and substantive procedures. This is important for identifying when a combination of tests of controls and substantive procedures may be appropriate to reduce the risks of material misstatement to an acceptably low level.

For example, audit procedures for "existence" of inventory will focus on testing the validity of items already recorded as part of the inventory balance and the testing of controls that would mitigate the risk of there being non-existent items in the inventory balance. A test of "completeness" of inventory would focus on testing items not included in the inventory balance, but would provide possible evidence of missing items. This could include purchase orders for goods, and testing controls that would mitigate the risk of missing inventory.

16.5 Use of Materiality in Test Design

A key factor in considering the extent of an audit procedure deemed necessary is the performance materiality that has been established. Performance materiality is based on the materiality established for the financial statements as a whole, but may be modified to address particular risks relating to an account balance, transaction stream, or financial statement disclosure.

The extent of audit procedures judged necessary is determined after considering the performance materiality, the assessed risk, and the degree of assurance the auditor plans to obtain. In general, the extent of audit procedures (such as a sample size for a test of details, or the level of detail necessary in a substantive analytical procedure) would increase as the risk of material misstatement increases. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk. See Volume 1, Chapter 7 and Volume 2, Chapters 6 and 17 for more information on the use of materiality in test design.

16.6 The Auditor's Toolbox

In developing the detailed audit plan, the auditor would use his/her professional judgment to select the appropriate types of possible audit procedures. Refer to Volume 1, Chapters 10 to 15 for a more detailed description of further audit procedures.

An effective audit program will be based on an appropriate mix of procedures that collectively reduce audit risk to an acceptably low level. For the purposes of this Audit Toolkit, the various types of audit procedures available to the auditor have been categorized as illustrated in the following exhibit.

Exhibit 16.6-1

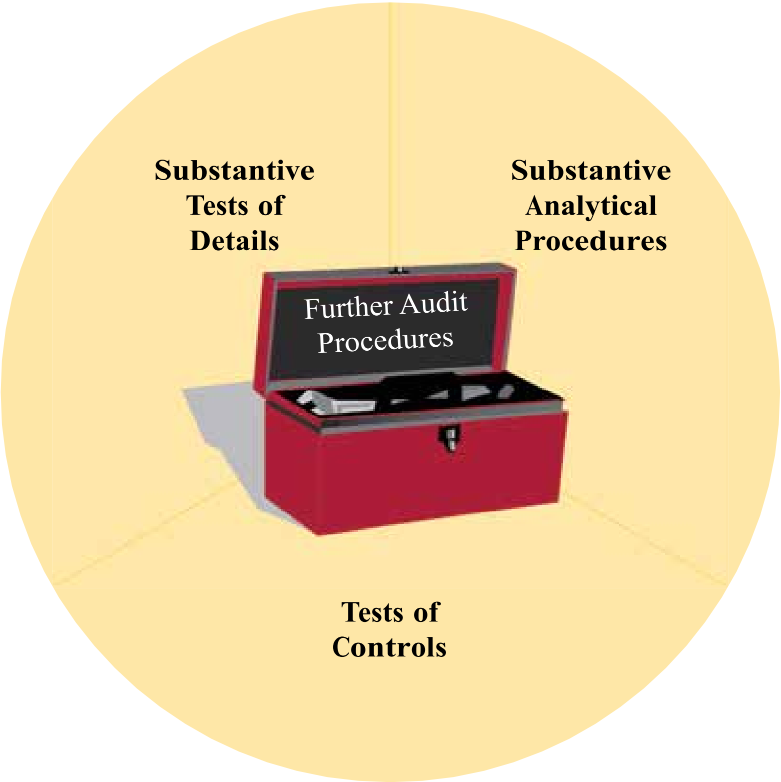


Exhibit 16.6-2

Procedure Type	Description
Substantive Procedures	Paragraph 18 of SLAuS 330 requires substantive procedures to be performed for each material class of transactions, account balance, and disclosure irrespective of the assessed risks of material misstatement (RMM). This reflects the fact that: • The auditor’s assessment of risk is judgmental and so may not identify all risks of material misstatement; and • There are inherent limitations to internal control, including management override. Where the **RMM is very low**, some limited substantive procedures, for example tests of details or analytical review, may well be all that is required to obtain sufficient and appropriate evidence for a particular assertion.

<table>
<tr><th>Procedure Type</th><th>Description</th></tr>
<tr><td>- Analytical Procedures</td><td>Substantive analytical procedures involve evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. They require the development of precise expectations for certain amounts (such as sales) that, when compared to actual recorded amounts, would be sufficient to identify a misstatement.

Analytical procedures can be categorized as follows:
• Simple comparisons of data that would typically be included in basic substantive procedures. These procedures would normally be combined with other tests of details at the assertion level. They would not provide sufficient audit evidence by themselves.
• Predictive models that by themselves (or in combination with tests of controls or other substantive procedures) would be sufficient to reduce audit risk to an acceptably low level. For example, if an entity had six employees at fixed rates of pay throughout the period, it could be possible to estimate the total payroll costs for the period with a high degree of accuracy. Assuming the number of employees and the rates of pay were accurate, this procedure could provide the entire audit evidence for payroll. There may be no need for other substantive procedures (basic or extended) to be performed.</td></tr>
<tr><td>- Tests of Details</td><td>When addressing a significant risk through substantive procedures alone, those substantive procedures are required to include tests of details.

See Volume 2, Chapter 10 for a more detailed description of significant risks and the appropriate audit response.</td></tr>
<tr><td>Tests of Controls</td><td>Where key controls are in place (that are likely to operate effectively) to address certain assertions, tests of controls may be performed to obtain the necessary evidence about an assertion.

Tests of controls performed to reduce risk to a low level (requiring a larger sample size) may provide the majority of evidence required for a particular assertion. Alternatively, tests of controls could be performed to reduce risk to a moderate level (requiring a slightly smaller sample size). In this latter case, to obtain the required evidence, the auditor would supplement the tests of controls with substantive procedures that address the same assertion.

Under certain criteria, internal controls need only be tested every third audit. Refer to the discussion on tests of controls in Volume 1, Chapter 10.5.</td></tr>
</table>

16.7 Developing the Responsive Audit Plan

Professional judgment and careful thought are required to develop an audit plan that responds appropriately to the assessed risks. The time spent developing an appropriate plan will almost certainly result in a more effective and efficient audit and less time being spent by staff.

There are three general steps the auditor would take in developing the plan:

- Respond to assessed risks at the financial statement level (the overall response);
- Identify any specific procedures required for material financial statement areas; and
- Determine what audit procedures (tools from the toolbox) and the extent of testing are required.

Step 1—Respond to assessed risks at the financial statement level

The first step is to develop an appropriate overall response to assessed risks at the financial statement level. Because these risks are pervasive, a moderate or high level of risk assessment will generally result in additional work being required for virtually every financial statement area. Refer to the discussion on overall responses in Volume 2, Chapter 16.3.

Step 2—Identify specific procedures required for material financial statement areas

Before developing the detailed response to assessed risks, the auditor may find it helpful to consider (for each material financial statement area) the questions set out in the exhibit below.

Exhibit 16.7-1

	For Each Material or Potentially Material Financial Statement Area
Questions to Consider When Developing an Appropriate Audit Response	Are there assertions that cannot be addressed by substantive tests alone? If so, tests of controls will be required. This may occur when: • There is no documentation to provide audit evidence about an assertion such as sales completeness; or • An entity conducts its business using IT, and no documentation of transactions is produced or maintained other than through the IT system.
	Are internal controls over related transaction streams/processes expected to be reliable? If so, a test of controls may be possible unless the number of transactions is so small that substantive procedures would still be more efficient.
	Are substantive analytical procedures available (such as on related transaction streams)?
	Is an element of unpredictability required (to address fraud risks, etc.)?
	Are there “significant risks” (i.e., fraud, related parties, etc.) to be addressed that require special consideration?

Step 3—Determine the nature and extent of audit procedures required

The third step is to use professional judgment to choose the appropriate mix of procedures and extent of testing required to respond appropriately to the assessed risks at the assertion level.

Outlined below is one possible approach for determining the appropriate mix of procedures to address the existence of receivables at low, moderate, and high levels of assessed risk.

Receivables —Low Level of Assessed Risk

Performance materiality = Rs.12,000

Planned Audit Response

Assessed Risk for Existence Assertion	Low	**Comments**
Substantive Procedures	√	These procedures would be considered adequate by themselves to address the assessed risk. They would include the typical tests of details and/or simple analytical procedures that would be performed in virtually any audit of receivables. These procedures would often be included in a standard audit program for receivables.

Receivables—Moderate Level of Assessed Risk

Performance materiality = Rs.10,000

Planned Audit Response

Assessed Risk for Existence Assertion	Moderate	**Comments**
Substantive Procedures	√	These procedures would be performed to address the existence risk in general (i.e. as for low risk, above) and also to: • Address the specific risks identified in relation to the existence of receivables (such as a fraud risk); and • Perform sufficient tests of detail to reduce the assessed risk to an acceptably low level.

If the entity had internal controls (such as over sales) that addressed the existence of receivables, an alternative to performing only substantive procedures would be a test of the operating effectiveness of such controls.

Receivables—High Level of Assessed Risk

Performance materiality =Rs.10,000

Planned Audit Response

Assessed Risk for Existence Assertion	High	**Comments**
Substantive Procedures	√	These procedures would be performed to address the existence risk in general (i.e. as for low risk, above) and also to: • Address the specific risks identified in relation to the existence of receivables (such as a fraud risk); and • Perform sufficient tests of detail to reduce the assessed risk to an acceptably low level..
Tests of Controls (Operating Effectiveness)	√	To reduce the sample size required for a test of details that would have reduced risk to a low level, the internal controls that address existence would be tested to obtain a moderate level of risk reduction. This combined with the tests of details outlined above will reduce the assessed risk to an acceptably low level.

In the above example, it may also be possible to obtain the majority of required evidence from performing a test of controls that reduces the risk to an acceptably low level. This may eliminate the need for many of the substantive procedures.

When developing an audit strategy on particular account balances or transactions, the auditor would always consider the work performed on other parts of the transaction stream.

Another example is the completeness of sales for an entity that owns an apartment building and rents out the units.

Receivables—Moderate Level of Assessed Risk

Performance materiality = Rs.6,000

Planned Audit Response

Assessed Risk for Existence Assertion	Moderate	**Comments**
Substantive Tests of Details	–	In light of the substantive analytical procedure outlined below, these procedures may not be necessary at all, or limited to obtaining evidence to corroborate the assumptions used.
Substantive Analytical Procedures	√	The known number of rental units is 64 and the rent is Rs.1,000 a month for the 46 two-bedroom suites and Rs.800 for the 18 one-bedroom suites. • The predicted rental income can be calculated as Rs.724,800. • Actual income recorded in the accounting records was Rs.718,800, a difference of Rs.6,000. The difference was verified as being due to the fact that six of the two-bedroom units were vacant for a month during the year.

CONSIDER POINT

Avoid defaulting to generic or standard audit procedures where possible
The most effective audit procedures are those that specifically address the causes of the assessed risks.

Multiple assertions
Where possible, choose audit procedures that address multiple assertions. This will reduce the need for other tests of detail.

Low-risk areas
Use the information obtained from assessing the risks of material misstatement to reduce the need for substantive procedures in low-risk areas.

Consider using tests of controls
Use the information obtained about internal control to identify key controls that could be tested for operating effectiveness. Testing controls (some of which may only require testing once every three years) can often result in much less work than performing extensive tests of detail. See also Volume 2, Chapter 17.

Do not ignore IT controls
The sample size for testing an automated control can be as little as one item because an automated control is likely to operate in the same manner every time, making it representative of all other items in the population. However, this would be based on the assumption that the entity has effective general IT controls in operation.

Dual-purpose tests
Where tests of controls are planned on the same class of transactions as substantive tests, consider the potential for dual-purpose tests. This is where a test of controls is performed concurrently with a test of details on the same transaction. Although the purpose of a test of controls is different from a test of details, both objectives may be accomplished concurrently. For example, an invoice could be examined to determine whether it has been approved (a test of control) and whether the transaction was properly recorded in the accounting records (a test of details).

Consider work performed on all parts of a transaction stream
Take credit for work performed on other parts of the transaction stream. For example, a test of controls over sales completeness would provide evidence for the completeness of receivables.

Decide on audit strategy and procedures at the planning phase
Where possible, develop the nature and extent of audit procedures during the planning phase of the audit, a time at which the team can agree on the approach to be followed. This avoids junior staff having to design audit procedures by themselves or simply performing the same procedures as last year.

CONSIDER POINT (continued)

Remember to use analytical procedures
Analytical procedures are used in each phase of the audit.

- At the beginning of the audit, analytical procedures are used as a risk assessment procedure.
- During the audit, analytical procedures are performed to analyze variances in data and to substantiate certain transaction streams and account balances.
- Near the end of the audit, analytical procedures are performed to determine whether the financial statements are consistent with the auditor's understanding of the entity, or to indicate a previously unrecognized risk of material misstatement due to fraud.

16.8 Responding to the Risk of Fraud

The risk of fraud (including management override) can exist in virtually any entity, and needs to be addressed when developing the audit plan. The first step is to assess the potential risk from fraud, and then to design an appropriate overall and detailed response.

Note: The auditor is required to treat assessed risks of material misstatement due to fraud as significant risks. A significant risk requires the auditor to:

- Obtain an understanding of the entity's related controls, including control activities, relevant to such risks; and
- Perform substantive procedures that are specifically responsive to that risk.

When the approach to a significant risk consists only of substantive procedures, those procedures shall include tests of details.

In assessing the potential risk and appropriate response to fraud, the auditor would consider the following:

- Overall responses already developed to address risks assessed at the financial statement level;
- Specific responses already developed in relation to other risks assessed at the assertion level;
- The fraud scenarios (if any) developed during the planning discussions;
- Fraud risks (opportunities, incentives, and rationale) identified as a result of performing risk assessment procedures;
- Susceptibility of certain financial statement balances and transactions to fraud;
- Any known instances of actual fraud in the past or in the current period; and
- Risks relating to management override.

The following exhibit outlines some possible responses to the risks identified above.

Exhibit 16.8-1

Overall Responses to Fraud	
Pervasive Risks at the Financial Statement Level	Consider need for: • Heightened professional skepticism when examining certain documentation or corroborating significant management representations; • People with specialized skills/knowledge, such as information technology (IT); • Development of specific audit procedures to identify the existence of fraud; and • An element of unpredictability in the selection of audit procedures to be used. Consider adjusting the timing of certain audit procedures, using different sampling methods, or performing procedures on an unannounced basis.

Specific Responses to Potential Fraud Risks	
Specific Risks at the Assertion Level	Consider: • Changing the nature, timing, and extent of the auditing procedures to address the risk. Examples include the following: – Obtain more reliable and relevant audit evidence or additional corroborative information to support management's assertions, – Perform a physical observation or inspection of certain assets, – Observe inventory counts on an unannounced basis, and – Perform further review of inventory records to identify unusual items, unexpected amounts, and other items for follow-up procedures. • Performing further work to evaluate the reasonableness of management's estimates and the underlying judgments and assumptions. • Increasing sample sizes or performing analytical procedures at a more detailed level. • Using computer-assisted audit techniques (CAATs). For example, – Gather more evidence about data contained in significant accounts or electronic transaction files, – Perform more extensive testing of electronic transactions and account files, – Select sample transactions from key electronic files, – Sort transactions with specific characteristics, and – Test an entire population instead of a sample. • Requesting additional information in external confirmations. For example, on a receivables confirmation, the auditor could ask for confirmation on the details of sales agreements, including the date of the agreement, any rights of return, and the delivery terms. However, consider whether a request for additional information might delay the response time significantly. • Changing the timing of substantive procedures from an interim date to one near the period end. However, if a risk of intentional misstatement or manipulation exists, audit procedures to extend audit conclusions from an interim date to the period end would not be effective.

Risks Related to Management Override	
Source of Risk	**Consider**
Journal Entries	Identifying, selecting, and testing journal entries and other adjustments based on the following: • An understanding of the entity's financial reporting process and design/ implementation of internal control. • Consideration of the: − Characteristics of fraudulent journal entries or other adjustments; − Presence of fraud risk factors that relate to specific classes of journal entries and other adjustments; and − Inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity.
Management's Estimates	Reviewing estimates relating to specific transactions and balances to identify possible biases on the part of management. Further procedures could include the following: • Reconsidering the estimates taken as a whole; • Performing a retrospective review of management's judgments and assumptions related to significant accounting estimates made in the prior period; and • Determining whether the cumulative effect of bias in management's estimates amounts to a material misstatement in the financial statements.
Significant Transactions	Obtaining an understanding of the business rationale for significant transactions that are unusual or outside the normal course of business. This includes an assessment as to whether: • Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction; • The arrangements surrounding such transactions appear overly complex; • Management has discussed the nature of, and accounting for, such transactions with those charged with governance; • The transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit; • Transactions that involve non-consolidated related parties, including special purpose entities, have been properly reviewed and approved by those charged with governance; and • There is adequate documentation.

Risks Related to Management Override	
Related Party Transactions	Obtain an understanding of the business relationships that related parties may have established directly or indirectly with the entity through: • Inquiries of, and discussion with, management and those charged with governance; • Inquiries of the related party; • Inspection of significant contracts with the related party; and, • Appropriate background research, such as through the Internet or specific external business information databases. Based on the findings above: • Identify and assess the risks of material misstatement associated with related party relationships; • Treat identified significant related party transactions outside the entity's normal course of business as giving rise to significant risks; and • Determine the need for substantive audit procedures that are responsive to the risks identified.
Revenue Recognition	Performing substantive analytical procedures. Consider computer-assisted audit techniques (CAATs) to identify unusual or unexpected revenue relationships or transactions.
	Confirming the relevant contract terms with customers (acceptance criteria, delivery and payment terms) and the absence of side agreements (such as offering a customer the right to return the goods immediately after the period end).

16.9 Risk of Misstatements in Presentation and Disclosure

Some assessed risks may arise from financial statement presentation and disclosures in accordance with the applicable financial reporting framework. As a result, specific procedures may need to be designed to respond appropriately to the risks involved.

These audit procedures would address whether:

- The individual financial statements are presented in a manner that reflects the appropriate classification and description of financial information;
- The presentation of financial statements includes adequate disclosure of material matters and uncertainties. This includes the form, arrangement, and content of the financial statements and their appended notes (including terminology used), the amount of detail given, the classification of items in the statements, and the bases of amounts set forth; and
- Management has disclosed particular matters in light of the circumstances and facts of which the auditor is aware at the time of signing the auditor's report.

16.10 Determining Whether the Audit Plan Is Complete

Before concluding that the audit is complete, the auditor would consider whether the following factors have been appropriately addressed.

Exhibit 16.10-1

Procedure Type	Description
Have All Material Financial Statement Areas Been Addressed?	Substantive procedures are required to be designed and performed for all material classes of transactions, account balances, and disclosures. This is irrespective of the assessed risks of material misstatement.
Is There a Need for External Confirmations?	Consider whether external confirmation procedures are to be performed as substantive audit procedures. Examples could include: • Bank balances; • Receivables; • Inventories and investments held by third parties; • Amounts due to lenders; • Terms of agreements; • Contracts; and • Transactions between the entity and other parties. External confirmation may also be used to address the absence of certain conditions. For example, there are no "side agreements on sales" that could affect revenue cut off.
Can Evidence Obtained in Prior Periods Be Used?	Assuming the evidence does not address a significant risk and certain other criteria apply (such as no change in controls and no significant manual element in the control operation), the tests of operating effectiveness of controls may only need to be performed once every third audit (see Volume 1, Chapter 10.5 for more information).
Is There a Need for an Auditor's Expert?	Is expertise in a field other than accounting or auditing required to obtain sufficient appropriate audit evidence?
Has the Financial Statement Closing Process Been Addressed?	The following substantive procedures are required in relation to the financial statement closing process: • Agreeing or reconciling the financial statements with the underlying accounting records; and • Examining material journal entries and other adjustments made during the course of preparing the financial statements.
Have Significant Risks Been Addressed?	For each risk assessed as significant, the auditor is required to design and perform substantive procedures (possibly supplemented by tests of controls). Substantive analytical procedures cannot be used alone and would be supplemented with tests of details. Where reliance is placed on internal controls over a significant risk, the auditor is required to test those controls in the current period.

Procedure Type	Description
Has Evidence Obtained from Interim Testing Been Updated?	Update interim substantive procedures by covering the remaining period. This would include: • Substantive procedures combined with tests of controls for the intervening period; or • Further substantive procedures that provide a reasonable basis for extending the audit conclusions from the interim date to the period end.
Have the Potential Risks of Fraud Been Addressed?	For example, heightened professional skepticism, an element of unpredictability in the design of audit procedures, etc. (See Volume 2, Chapter 16.8.)

16.11 Documenting the Overall Response and Detailed Audit Plans

The overall responses may be documented as a stand-alone document or, more typically, as part of the overall audit strategy.

The detailed plan is often documented in the form of an audit program that outlines the nature and extent of procedures and the assertion(s) being addressed. Space can then be provided to record details about who performed each step, and the findings.

CONSIDER POINT

Timing
Consider whether some of the planned further audit procedures can be carried out at the same time as the risk assessment procedures.

Changes to plan
If planned procedures need to be modified as a result of audit evidence or other information obtained, update the overall strategy and audit plan and provide the reasons for the change.

Review
Ensure that audit procedures and related working papers are signed and dated by the preparer and the reviewer prior to the completion of the audit.

16.12 Communication of the Audit Plan

The overall audit strategy, overall responses, and the audit plan are entirely the auditor's responsibility. However, it is often useful to discuss some elements of the detailed audit plan (such as timing) with management. Such discussions often result in minor changes to the plan to coordinate timing and facilitate the performance of certain procedures.

The exact nature, timing, and scope of the planned procedures would not be discussed in detail with management, or changed or scaled back to accommodate a management request. Such requests could compromise the effectiveness of the audit, make audit procedures too predictable, and could constitute a scope limitation.

SLAuS 260 sets out a number of matters that the auditor is required to communicate with those charged with governance. (Refer to Volume 2, Chapter 5.3 for a listing of such matters.) These requirements are designed to ensure an effective two-way communication between or among the auditor, management, and those charged with governance.

CONSIDER POINT

Auditors should consider having periodic, regular status updates with management to inform them of any preliminary findings, request any additional documentation, request any assistance required, and/or discuss other issues.

Any significant changes to the audit plan should also be communicated to management and those charged with governance.

16.13 Case Studies—The Responsive Audit Plan

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

The following case study examples outline the considerations and possible audit procedures that could be used in developing a detailed audit plan for accounts receivable. Since the purpose of the audit plan is to reduce the risk of a material misstatement to an acceptably low level, it is important to review the risks identified in the risk assessment phase for the revenue/receivables/receipts cycle.

Case Study A—Dephta Furniture, Inc.

According to the risk assessment in Volume 2, Chapter 14.6—Concluding the Risk Assessment Phase, the assessed risks were:

Assessed risks at financial statement level (High, Moderate or Low)	*Low*			
Assertions (**C**ompleteness, **E**xistence, **A**ccuracy, and **V**aluation)	C	E	A	V
Assessed risks at assertion level (High, Moderate, or Low)	L	M	L	M
Changes in assessed risks from the previous period. None				

Questions to be considered in developing the receivables audit plan:

Planning Considerations	Response
1. Are there assertions that cannot be addressed by substantive tests alone?	*Completeness of sales will be addressed through a combination of tests of controls and analytical procedures. Note for next year—if the Internet sales continue to grow, additional tests of controls may be required due to the loss of paper trail.*
2. Is internal control over related transaction streams/processes expected to be reliable? If so, could the controls be tested to reduce need/scope for other substantive procedures?	*Tests of controls could be used to reduce the level of risk reduction required from other substantive procedures (confirmations) in accounts receivable. But we are not totally certain as to the reliability of control operation, so only substantive procedures will be used.*
3. Are there substantive analytical procedures available that would reduce need/scope for other audit procedures?	*No.*
4. Is there a need to incorporate an element of unpredictability or further audit procedures (such as to address fraud, risk, etc.)?	*Some extended audit procedures will be performed to address the risks identified for management override.*
5. Are there significant risks that require special attention?	*There are some possible fraud risks (volume 2, Chapter 9) in relation to revenue recognition. These will be addressed by suitably tailored substantive tests of details.* *valuation of accounts receivable is a specific risk requiring special attention. Additional analysis and review of subsequent payments will be done.* *Need to be mindful of undisclosed related party transactions outside of the normal course of business throughout the audit.*

Based on the auditor's professional judgment, an appropriate mix of procedures is required to reduce the risks of material misstatement (RMM) to an acceptably low level for relevant assertions (applicable to the receivable balance). The following is a sample audit response to the assessed level of risk for accounts receivable.

Summary of Proposed Audit Response (Check the applicable boxes under CEAv)	*C*	*E*	*A*	*V*
A. Substantive tests of details - all material classes of transactions, balances and disclosure	*X*	*X*	*X*	*X*
B. Substantive tests of details - tailored to specific risks *(sampling, fraud, significant risks, etc.)*				*X*
C. Substantive analytical procedures *(proof in total, etc.)*		*X*		
D. Tests of controls (operating effectiveness)	*X*			
Based on professional judgment, are the procedures outlined above sufficient to address the assessed risks? (Yes/No) If no, explain below.	*Yes*	*Yes*	*Yes*	*Yes*
Comments:				

A sample audit program that responds to the risks identified is outlined in the case study notes for Volume 2, Chapter 17.7.

Case Study B—Kumar & Co.

According to the risk assessment in Volume 2, Chapter 14.6—Concluding the Risk Assessment Phase, the assessed risks were:

Assessed risks at financial statement level (High, Moderate or Low)	*Moderate*			
Assertions (**C**ompleteness, **E**xistence, **A**ccuracy, and **V**aluation)	C	E	A	V
Assessed risks at assertion level (High, Moderate, or Low)	L	M	M	L
Changes in assessed risks from the previous period. *None* *Increased risks related to related party transactions and possible fraud resulting from Raj's absence.*				

Questions to be considered in developing the receivables audit plan:

Planning Considerations	Response
1. Are there assertions that cannot be addressed by substantive tests alone?	*No*
2. Is internal control over related transaction streams/processes expected to be reliable? If so, could the controls be tested to reduce need/scope for other substantive procedures?	*Due to the small size of the company, there are limited controls. We obtained an understanding of internal control, but we will not test controls or place any reliance on them.*
3. Are there substantive analytical procedures available that would reduce need/scope for other audit procedures?	*The completeness of sales will be addressed by a combination of substantive analytical review and tests of details.*
4. Is there a need to incorporate an element of unpredictability or further audit procedures (such as to address fraud, risk, etc.)?	*Not considered necessary, as the receivables balance at year-end relates primarily to Dephta.*
5. Are there significant risks that require special attention?	*The possibility of inconsistent revenue recognition or fraud will be addressed through suitably tailored substantive tests of details.* *Need to be mindful of undisclosed related party transactions outside of the normal course of business throughout the audit.*

The following is a sample audit response to the assessed level of risk for accounts receivable.

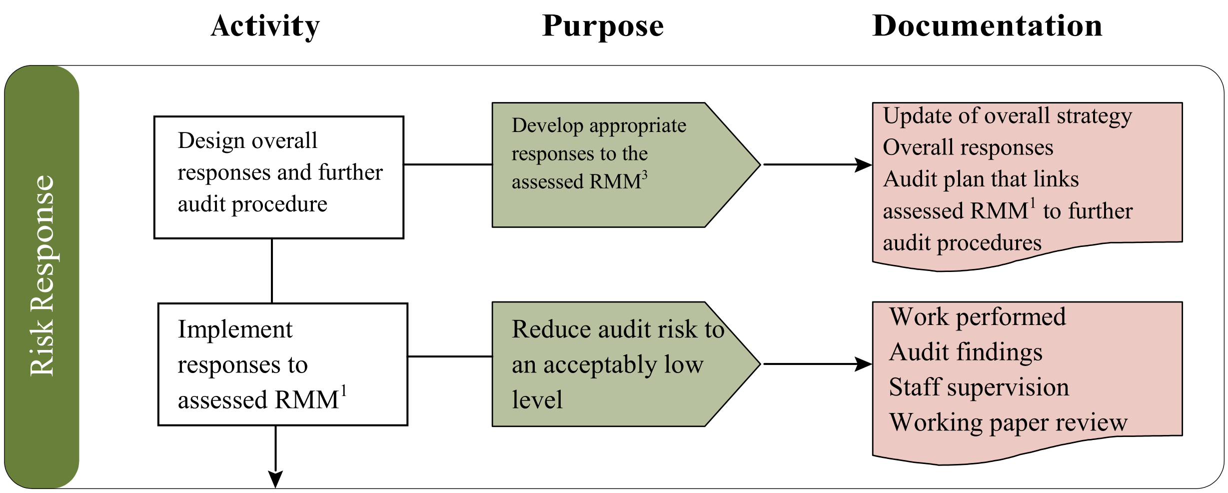
Summary of Proposed Audit Response *(Check the applicable boxes under CEAV)*	C	E	A	V
A. Substantive tests of details - all material classes of transactions, balances and disclosure	*X*	*X*	*X*	*X*
B. Substantive tests of details - tailored to specific risks *(sampling, fraud, significant risks, etc.)*	*X*	*X*	*X*	
C. Substantive analytical procedures *(proof in total, etc.)*		*X*		
D. Tests of controls *(operating effectiveness)*				
Based on professional judgment, are the procedures outlined above sufficient to address the assessed risks? (Yes/No) If no, explain below.	*Yes*	*Yes*	*Yes*	*Yes*
Comments: *None*				

A sample audit program that responds to the risks identified is outlined in the case study notes for Volume 2, Chapter 17.7.

17. Determining the Extent of Testing

Chapter Content	Relevant SLAuSs
Guidance on determining the extent of testing required to be responsive to the assessed risks of material misstatement.	330, 500, 530

Exhibit 17.0-1



Notes:
1. RMM = Risks of material misstatement.

Paragraph #	Relevant Extracts from SLAuSs
330.12	If the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor shall: (a) Obtain audit evidence about significant changes to those controls subsequent to the interim period; and (b) Determine the additional audit evidence to be obtained for the remaining period. (Ref: Para. A33-A34)

Paragraph #	Relevant Extracts from SLAuSs
330.13	In determining whether it is appropriate to use audit evidence about the operating effectiveness of controls obtained in previous audits, and, if so, the length of the time period that may elapse before retesting a control, the auditor shall consider the following: (a) The effectiveness of other elements of internal control, including the control environment, the entity's monitoring of controls, and the entity's risk assessment process; (b) The risks arising from the characteristics of the control, including whether it is manual or automated; (c) The effectiveness of general IT-controls; (d) The effectiveness of the control and its application by the entity, including the nature and extent of deviations in the application of the control noted in previous audits, and whether there have been personnel changes that significantly affect the application of the control; (e) Whether the lack of a change in a particular control poses a risk due to changing circumstances; and (f) The risks of material misstatement and the extent of reliance on the control. (Ref: Para. A35)
330.14	If the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit. The auditor shall obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls, and: (a) If there have been changes that affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the controls in the current audit. (b) If there have not been such changes, the auditor shall test the controls at least once in every third audit, and shall test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely in a single audit period with no testing of controls in the subsequent two audit periods. (Ref: Para. A37-A39)
530.5	For purposes of the SLAuSs, the following terms have the meanings attributed below: (a) Audit sampling (sampling)—The application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population. (b) Population—The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions. (c) Sampling risk—The risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure. Sampling risk can lead to two types of erroneous conclusions: (i) In the case of a test of controls, that controls are more effective than they actually are, or in the Paragraph # Relevant Extracts from SLAuSs case of a test of details, that a material misstatement does not exist when in fact it does. The auditor is primarily concerned with this type of erroneous conclusion because it affects audit effectiveness and is more likely to lead to an inappropriate audit opinion. (ii) In the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material misstatement exists when in fact it does not. This type of erroneous conclusion affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

Paragraph #	Relevant Extracts from SLAuSs
530.5 (continued)	(d) Non-sampling risk—The risk that the auditor reaches an erroneous conclusion for any reason not related to sampling risk. (Ref: Para A1) (e) Anomaly—A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population. (f) Sampling unit—The individual items constituting a population. (Ref: Para A2) (g) Statistical sampling—An approach to sampling that has the following characteristics: (i) Random selection of the sample items; and (ii) he use of probability theory to evaluate sample results, including measurement of sampling risk. A sampling approach that does not have characteristics (i) and (ii) is considered non-statistical sampling. (h) Stratification—The process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value). (i) Tolerable misstatement—A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of risk reduction that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population. (Ref: Para A3) (j) Tolerable rate of deviation—A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of risk reduction that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

17.1 Overview

Sufficient appropriate audit evidence may be obtained by selecting and examining the following.

Exhibit 17.1-1

Selecting and Examining	
All Items (100% Examination)	This is appropriate when: • The population constitutes a small number of large-value items; • There is a significant risk, and other means do not provide sufficient appropriate audit evidence; and • CAATs can be used in a larger population to electronically test a repetitive calculation or other process.

Selecting and Examining	
Specific Items	This is appropriate for: • High-value or key items that could individually result in a material misstatement; • All items over a specified value; • Any unusual or sensitive items or financial statement disclosures; • Any items that are highly susceptible to misstatement; • Items that will provide information about matters such as the nature of the entity, the nature of transactions, and internal control; and • Items to test the operation of certain control activities.
Representative Sample of Items from the Population	This is appropriate for reaching a conclusion about an entire set of data (population) by selecting and examining a representative sample of items within the population. Sampling enables the auditor to obtain and evaluate audit evidence about specified characteristics. The determination of sample size may be made using either statistical or non-statistical methods.

The decision as to which approach to use will depend on the circumstances. The application of any one or combination of the above means may be appropriate in particular circumstances.

Choosing sampling as the most efficient method of obtaining the necessary risk reduction for an assertion has a number of advantages as illustrated below.

Exhibit 17.1-2

	Benefits
Use of Representative Samples	Valid conclusions can be drawn. The auditor's objective is obtaining reasonable risk reduction and not absolute certainty.
	Results can be combined with results from other tests. Evidence obtained from one source can be corroborated by evidence obtained from another source to provide increased risk reduction.
	An examination of all of the data would not provide absolute certainty. For example, unrecorded transactions will never be detected.
	Cost savings. The cost of examining every entry in the accounting records and all supporting evidence would be uneconomical.

Volume 1, Chapter 10 outlines the nature and use of further audit procedures. This chapter focuses on the extent of testing and use of sampling techniques.

Sampling Techniques

Sampling does not have to be selected as an audit procedure but where it is used, all the sampling units in a population (such as sales transactions or receivables balances) are required to have a chance of selection. This is necessary to enable the auditor to draw reasonable conclusions about the entire population.

In any sample of less than 100% of the population, there is always the risk that a misstatement may not be identified and that it might exceed the tolerable level of misstatement or deviation. This is called sampling risk. Sampling risk can be reduced by increasing the sample size, while non-sampling risk can be reduced by proper engagement planning, supervision, and review.

There are two types of sampling commonly used in auditing, as set out below.

Exhibit 17.1-3

	Sample Attributes
Statistical Sampling	Sample is selected on a random basis. This means that every item in the population has a known (statistically appropriate) chance of being selected.
	Results can be mathematically projected. Probability theory can be used to evaluate the sample results, including measurement of sampling risk.
Non-Statistical or Judgmental Sampling	A sampling approach that does not have the characteristics outlined above for statistical sampling.

In determining the sample size, the auditor would determine the tolerable rate of deviation (exceptions) that would be acceptable.

- **Substantive Procedures**
  Performance materiality (whether overall or for a specific item) is set in relation to overall materiality (whether overall or for a specific item, respectively). The tolerable misstatement level is set in relation to performance materiality (either overall or for the specific item, as the case may be). The higher the tolerable misstatement level is set, the smaller the sample size. The lower the tolerable level of misstatement is set, the larger the sample size. Note that the tolerable level of misstatement will often be the same as performance materiality.
- **Tests of Controls**
  For tests of controls, the tolerable rate of deviation is likely to be very small, often allowing for no deviations or possibly only one. Tests of controls provide evidence as to whether the controls work or not. Consequently, they would only be used where the operation of the control was expected to be reliable.

17.2 Use of Sampling

Paragraph #	Relevant Extracts from SLAuSs
530.6	When designing an audit sample, the auditor shall consider the purpose of the audit procedure and the characteristics of the population from which the sample will be drawn. (Ref: Para. A4-A9)
530.7	The auditor shall determine a sample size sufficient to reduce sampling risk to an acceptably low level. (Ref: Para. A10-A11)
530.8	The auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection. (Ref: Para. A12-A13)
530.9	The auditor shall perform audit procedures, appropriate to the purpose, on each item selected.
530.10	If the audit procedure is not applicable to the selected item, the auditor shall perform the procedure on a replacement item. (Ref: Para. A14)
530.11	If the auditor is unable to apply the designed audit procedures, or suitable alternative procedures, to a selected item, the auditor shall treat that item as a deviation from the prescribed control, in the case of tests of controls, or a misstatement, in the case of tests of details. (Ref: Para. A15-A16)

Paragraph #	Relevant Extracts from SLAuSs
530.12	The auditor shall investigate the nature and cause of any deviations or misstatements identified, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit. (Ref: Para. A17)
530.13	In the extremely rare circumstances when the auditor considers a misstatement or deviation discovered in a sample to be an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. The auditor shall obtain this degree of certainty by performing additional audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.
530.14	For tests of details, the auditor shall project misstatements found in the sample to the population. (Ref: Para. A18-A20)
530.15	The auditor shall evaluate: (a) The results of the sample; and (Ref: Para. A21-A22) (b) Whether the use of audit sampling has provided a reasonable basis for conclusions about the population that has been tested. (Ref: Para. A23)

Building a Foundation

Whenever statistical or non-statistical sampling techniques are being considered, the auditor would address and document the following matters.

Exhibit 17.2-1

Factors to Consider	Comments
Purpose of Test?	The starting point for the test design is to establish the purpose of the test and what assertions will be addressed.
Primary Source of Evidence?	What is the primary source of evidence for each assertion to be addressed, and what is secondary? This differentiation will help to ensure that audit effort is directed to the right place.
Previous Experience?	What was the experience (if any) in performing similar tests in previous periods? Consider the effectiveness of the test, and the existence and disposition of deviations (errors), if any, found in the samples selected.
What Population?	Ensure that the population of items to be tested is appropriate to achieve the test objectives. Sampling will not identify or test items that are not already included within the population. For example, a sample of receivable balances may be used to test the existence of receivables, but such a population would not be appropriate for testing the completeness of receivables. Also consider the size of the population. In some cases, a statistical conclusion may not be drawn if the population to be tested is too small to sample.
What Sampling Unit to Use?	Consider the purpose of the test and the assertion being addressed. This decision will determine what items will be selected to test. Examples include sales invoices, sales orders, and customer account balances.

Factors to Consider	Comments
Statistical or Non- Statistical?	Statistical conclusions can be drawn from statistical samples. Conclusions based on professional judgment can be made from judgmental non-statistical samples. Non- statistical samples are often used in combination with other audit procedures that address the same assertion.
Definition of a Deviation	Failure to properly define a deviation will result in time wasted by staff in reviewing minor exceptions that may not constitute a deviation. Also, determine how the reasons and implications of deviations found will be followed up by audit staff.
Any High-Value Items to Exclude?	If there are larger transactions or balances in the population that can be evaluated separately, it may result in smaller sample sizes from remaining items in the population. In some cases, the evidence gained from testing the larger transactions or balances may be sufficient to eliminate the need for sampling altogether.
Use of CAATs	Could computer-assisted audit techniques (CAATs) provide a better or more efficient result? For many tests, 100% of the population can be tested by CAATs (as opposed to just a sample), and custom reports can be prepared that identify unusual items for follow-up.
Any Stratification Possible?	Consider whether the population can be stratified by dividing it into discrete subpopulations which have an identifying characteristic. For example, if a population contained a number of high-value transactions, the population (for a test of details) could be stratified by monetary value. This allows greater audit effort to be directed to the larger-value items, as these items may contain the greatest potential misstatement in terms of overstatement. A population may also be stratified according to a particular characteristic that indicates a higher risk of misstatement. When testing the adequacy of the allowance for doubtful accounts (valuation of accounts receivable), the receivable balances may be stratified by age. Where subpopulations are tested separately, the misstatements will be projected for each stratum separately. Projected misstatements for each stratum can then be combined to consider the possible effect of misstatements on the account balance or class of transactions.
What Precision is Required?	Performance materiality is often used as the basis for tolerable misstatement. This also represents the precision for a statistical test. Performance materiality would be set at an amount that allows for the possible existence of undetected and immaterial misstatements aggregating to a material amount.

Factors to Consider	Comments
What Confidence Level is Required?	Confidence is the level of acceptable risk (detection risk) that the test will not produce accurate results. Is a high level of confidence (resulting in a larger sample) or a lower confidence level (resulting in a smaller sample) required? The confidence level required in a particular test will be based on factors such as: • Evidence obtained from other sources such as analytical review, other substantive procedures, and testing the operational effectiveness of related controls; and • The importance of the financial statement assertion or line item compared with overall materiality. For example, a 95% level of confidence indicates that if a particular test was performed 100 times (selecting representative transactions at random), the results would be accurate (within the margin of misstatement) 95 times out of the 100 tests. There is a risk that 5 tests out of the 100 will produce inaccurate results.

When statistical sampling is planned, the tolerable misstatement or deviation rate would also be addressed.

Exhibit 17.2-2

Factors to Consider	Comments
What is the Tolerable Misstatement or Tolerable Deviation Rate?	**Tolerable misstatement** is used in sampling tests of details to address the risk that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and to provide a margin for possible undetected misstatements. Tolerable misstatement is the application of performance materiality to a particular sampling procedure. Tolerable misstatement may be the same amount as or an amount lower than performance materiality.
	Tolerable rate of deviation is used for tests of controls where the auditor sets a rate of deviation from prescribed internal control procedures to obtain an appropriate level of assurance. The auditor seeks to obtain an appropriate level of assurance that the set rate of deviation is not exceeded by the actual rate of deviation in the population.

17.3 Extent of Substantive Procedures (Using statistical sampling)

The greater the risks of material misstatement, the greater the extent of substantive procedures required. The extent of substantive procedures may be reduced by testing the operating effectiveness of internal control. However, if the results are unsatisfactory, the extent of substantive procedures may actually need to be increased.

Determining Sample Sizes—Monetary-Unit Sampling

The most common method of sampling for tests of details is monetary-unit sampling. Under this method, the probability of an item (for example, an accounts receivable balance) being selected for testing is directly proportional to the monetary value of the item. Thus, an accounts receivable balance of Rs.6,000 is three times as likely to be selected as an accounts receivable balance of Rs.2,000. Under this method, it would not be appropriate to select physical units such as every 50th invoice or transaction.

Although monetary-unit sampling may be the most common form of sampling used by auditors, there are a number of other sampling methods which could be more appropriate in certain circumstances. Discussion of these other sampling methods has not been included in this Audit Manual.

Selection of Confidence Factors

When designing a substantive test, the auditor may find it useful to use three levels of risk reduction such as high, moderate, and low. The difference between the levels can be based on the confidence factor used for selecting the sample. The higher the confidence factor, the higher the sample size and the level of risk reduction obtained. This is illustrated in the following exhibit, which provides typical confidence levels to achieve high-, moderate-, and low-risk reductions.

Exhibit 17.3-1

Risk Reduction Required	Confidence Level	Confidence Factor
High	95%	3.0
Moderate	80-90%	1.6 – 2.3
Low	65-75%	1.1 – 1.4

An effective set of audit procedures designed to respond to assessed risks and specific assertions may contain a mixture of tests of controls and substantive procedures.

The following table gives a partial list of confidence factors for various confidence levels. For example, if a 90% confidence level is required, the confidence factor to be used would be 2.3.

Exhibit 17.3-2

Confidence Level	Confidence Factor
50%	0.7
55%	0.8
60%	0.9
65%	1.1
70%	1.2
75%	1.4
80%	1.6
85%	1.9
90%	2.3
95%	3.0
98%	3.7
99%	4.6

Selecting the Sample

Exhibit 17.3-3

Monetary Unit	Description
Sample Selection Process	Remove the high-value and key items from the population.
	Computer the sampling interval.
	Select a random starting point for selecting the first item. The random starting point can range from Rs.1 to the sampling interval. Each successive selection is made on the value of the previous selection plus one sampling interval.

Note: Ensure that the sample selection process, including the basis for selecting the random starting point (from a random number generator or using professional judgment), is appropriately documented.

Step 1—Calculate the sampling interval

The formula is as follows.

Sampling Interval = Performance Materiality (Tolerable Misstatement) ÷ Confidence Factor

If the sampling interval was Rs.17,391, the first account to be selected could be randomly chosen as the one containing the Rs.10,000th. The second account selected would be the account containing the cumulative amount of Rs.27,391st (starting point + sampling interval = Rs.10,000 + Rs.17,391). The third account selected would be the account that contained the cumulative amount of Rs. 44,782nd (Rs.27,391 + Rs.17,391). This process would continue to the end of the population.

Step 2—Calculate the sample size

Sample sizes for the monetary-unit sampling of representative items are usually determined by the following formula.

Sample Size = Population to Be Tested ÷ Sampling Interval

The population to be tested should exclude any specific items removed for separate evaluation.

Step 3—Select the sample

Remove any high-value and key items from the population (for separate consideration) and compute the sampling interval (refer to Step 1 above). Then select a random starting point for selecting the first item. The random starting point can range from Rs.1 to the sampling interval. Each successive selection is made on the value of the previous selection plus one sampling interval.

The following three examples illustrate this process.

Example 1—Sampling Accounts Receivable Balances

Exhibit 17.3-4

Question	Response
Purpose of Test	To ensure the existence of accounts receivable by selecting a sample of receivable balances and sending confirmation letters
Risks of Material Misstatement in the Relevant Assertions	Existence = high risk
Population to Be Tested	Accounts receivable balances at period end
Monetary Value of Population	Rs.177,203
Specific Items Subject to Separate Evaluation	Rs.38,340
Risk Reduction Obtained from Testing Controls	None
Risk Reduction from Other Procedures such as Risk Assessment Procedures	Limited
Confidence Factor to Be Used (Reduce for risk reduction gained from other sources)	No other sources of risk reduction so 95% or 3.0 will be used
Performance Materiality	Rs.15,000
Expected Deviations in Sample	None

Sampling Interval = Rs.15,000 / 3.0 = Rs.5,000

Sample Size = (Rs.177,203 – Rs.38,340) / Rs.5,000 = 28

In this example, the sampling interval was Rs.5,000. Therefore, if the first item chosen randomly was Rs.436, the next item would be in the transaction or balance that contained the cumulative amount of Rs.5,436. The third item would be in the transaction or balance that contained the cumulative amount of Rs.10,436, and so on until the 28 items have been selected.

Note: It is likely that the higher value items will be selected for testing (refer to the partial population of accounts receivable balances below).

Exhibit 17.3-5

	Accounts Receivable Balance	Cumulative Total	Sampling Interval	Include in Sample?
Customer A	4,750	4,750	436	Yes
Customer B	3,500	8,250	5,436	Yes
Customer C	1,800	10,050	10,436	No
Customer D	2,700	12,750	10,436	Yes
Customer E	950	13,700	15,436	No
Customer F	2,580	16,280	15,436	Yes

Example 2—Sampling Accounts Receivable Balances

Exhibit 17.3-6

Question	Response
Purpose of Test	To ensure the existence of receivables by selecting a sample of accounts receivable balances and sending confirmation letters
Risks of Material Misstatement in the Relevant Assertions	Existence = moderate risk
Population to Be Tested	Accounts receivable balances at period end
Monetary Value of Population	Rs.177,203
Specific Items Subject to Separate Evaluation	Rs.38,340
Risk Reduction Obtained from Testing Controls	A low level of control risk has been established over related controls
Risk Reduction from Other Procedures (such as risk assessment procedures)	Limited
Confidence Factor to Be Used (reduce for risk reduction gained from other sources)	In light of other sources of evidence, a confidence factor of 70% (1.2) will be used
Performance Materiality	Rs.15,000
Expected Deviations in Sample	None

Sampling interval = Rs.15,000 / 1.2 = Rs.12,500

Sample size = (Rs.177,203 – Rs.38,340) / Rs.12,500 = 12

Example 3—Sampling Purchase Invoices

Exhibit 17.3-7

Question	Response
Purpose of Test	To ensure the existence and accuracy of purchases by selecting a sample of purchase invoices
Risks of Material Misstatement in the Relevant Assertions	Existence = low risk Accuracy = low risk
Population To Be Tested	Purchase invoices for period
Monetary Value of Population	Rs.879,933
Specific Items Subject to Separate Evaluation	Rs.46,876
Risk Reduction Obtained from Testing Controls	None
Risk Reduction from Other Procedures (such as risk assessment procedures)	Moderately effective substantive analytical procedures

Question	Response
Confidence Factor To Be Used (reduce for risk reduction gained from other sources)	In light of the other sources of evidence, a confidence factor of 80% (1.6) will be used
Performance Materiality	Rs.15,000
Expected Deviations in Sample	None

Sampling interval = Rs.15,000 / 1.6 = Rs.9,375

Sample size = (Rs.879,933 – Rs.46,876) /Rs. 9,375 = 89

As illustrated above, the sample sizes for substantive tests can become very large when examining transaction streams. It is often more efficient to test internal controls (where the sample size is smaller) or perform other types of audit procedures to obtain the required evidence.

Projecting Misstatements

The process is set out in the following exhibit.

Exhibit 17.3-8

Steps in Projecting the Extent of Misstatements
1. Calculate the percentage of misstatement in each item. If the amount was found to be Rs.50 but should have been Rs.60, the misstatement is Rs.10 or 17% of the total.
2. Add up the misstatement percentages, netting overstatements and understatements.
3. Calculate the average percentage misstatement per item sampled by dividing the total misstatement percentages by the number of all items sampled (with and without misstatement).
4. Multiply the average percentage misstatement by the total representative population monetary value (excluding high-value and key items). This results in the projected misstatement for the sample. Obviously, this excludes any misstatements found in high-value and key items previously removed from the sample.

For example, a sample of 50 items selected from a population of Rs.250,000 contained the following three misstatements.

Exhibit 17.3-9

Correct Value	Audited Value	Misstatement	Misstatement %
Rs.500	Rs.400	Rs.100	20.00%
350	200	150	42.86%
600	750	(150)	(25.00%)
Total % error (sum of misstatement percentages)			37.86%
Average % misstatement:	37.86% ÷ 50 (sample size) =		0.7572%
Projected misstatement:	0.7572% × Rs.250,000 (population) =		Rs.1,893

The projected misstatement is sometimes called "most likely error" (MLE).

CONSIDER POINT

Anomalies
There may be a temptation to regard some misstatements/deviations (discovered in a sample) to be an anomaly (not representative of the population) and exclude them when projecting misstatements in the population. However, additional audit work is required, regardless of whether the misstatement/deviation is or is not representative of the population:

- If the deviation is representative of the population, the auditor shall investigate the nature and cause, and evaluate their possible effect on the purpose of the audit procedure and on other areas of the audit.
- If the deviation is considered an anomaly, the auditor shall obtain a high degree of certainty that such misstatement or deviation is not representative of the population. This requires performing further audit procedures to obtain sufficient appropriate audit evidence that the misstatement or deviation does not affect the remainder of the population.

Note that SLAuS 530.13 states that anomalies only occur in extremely rare circumstances.

17.4 Extent of Substantive Analytical Procedures

Substantive analytical procedures will either be the primary test of the account balance, or they will be used in combination with other tests of details that have been appropriately reduced in extent.

Volume 1, Chapter 10 outlines the two levels of risk reduction that can be gained from performing substantive analytical procedures. This risk reduction is highly effective (i.e., the primary test) and moderately effective.

Simple analytical procedures (such as a comparison of last year's results to this year) may help to identify an issue that needs to be followed up but provide little further audit evidence. This type of analytical procedure can be used in understanding the entity, performing risk assessment procedures, and reviewing the final financial statements.

When designing substantive analytical procedures, the auditor would:

- Develop the amount of difference from the expectation that can be accepted without further investigation. This should be influenced primarily by materiality and consistency with the desired level of risk reduction;
- Consider the possibility that a combination of misstatements in the specific account balance, class of transactions, or disclosure could aggregate to an unacceptable amount; and
- Increase the desired level of risk reduction as the risks of material misstatement increase.

Exhibit 17.4-1

Example of a Substantive Analytical Procedure

Questions	Response	
Describe the procedure to be performed and the expected outcome.	*Multiply the rent charges per unit with the number of rental units to predict the revenue from apartments, and then compare result with the revenue recorded in the entity's accounting records.*	
What is the value of the recorded amount or ratio?	*Rs.278,000*	
What assertions will be addressed?	*Completeness, existence, and accuracy*	
What performance materiality will be used?	*Rs.10,000*	
What amount of difference (between recorded amounts and expected values) is acceptable?	*1%*	
Remaining risk of material misstatement after procedure performed (i.e., moderate or low).	*Low*	
Describe details of each data element used in calculating the expected outcome (i.e., financial and non-financial).	Describe the procedures performed to evaluate the reliability of each data element used (consider source, comparability, nature, relevance, and controls over preparation).	WP Ref.
1. Rental units	*We reviewed the floor plans and physically inspected the building for major changes.*	
2. Rent per unit	*We reviewed a sample of lease contracts to determine the rent payable.*	
3.		
4.		
Provide details of the calculation, the expected outcome, and results of the comparison to the recorded amount or ratio: *Number of rental units = 26 Rent per unit = Rs.12,000 per year* *Calculation = 26 X 12,000 = Rs.312,000. The difference to the recorded amount is Rs.34,000*		
Where the difference (between recorded amounts and expected values) exceeds the acceptable value, explain what investigation was performed and the results (i.e., inquiries of management, obtaining additional evidence and performing other audit procedures). *We inquired about the difference and verified that, on average, 2 units were vacant (not the same ones) each month during the year, and one unit was not rented and used for meeting purposes and as an occasional accommodation for visitors. This accounts for Rs.36,000 of the difference leaving Rs.2,000 unexplained. This is below the acceptable level described above.*		
Conclusion: *Test was successfully completed.*		

CONSIDER POINT

The use of "non-financial" data in a substantive analytical procedure can often enhance the result. Non- financial data could include information such as head counts, square footage for a retail store, or the number of specific products shipped.

When performing analytical procedures, it is imperative to set expectations (e.g., relationship with related balances, changes from prior period, etc.) and then compare those expectations to the financial statement information. Avoid the opposite approach of starting with the financial information and then attempting to explain variances using knowledge of the client and its environment. Analytical procedures are much stronger when they are created by expectations based on an understanding of the entity and its environment. However, the reliability of any "non-financial data" used needs to be established before its use in a substantive analytical procedure.

17.5 Tests of Controls—Operating Effectiveness

Audit procedures used to test controls consist of one or more of the four types outlined below.

Exhibit 17.5-1

Tests of Internal Control Over Operating Effectiveness	
Types of Procedures	Inquiries of appropriate personnel. (Remember, though, that inquiry alone is not sufficient to test the operating effectiveness of controls.)
	Inspection of relevant documentation.
	Observation of the entity's operations.
	Re-performance of the application of the control.

Pervasive (Entity-Level) Controls

Paragraph#	Relevant Extracts from SLAuSs
315.14	The auditor shall obtain an understanding of the control environment. As part of obtaining this understanding, the auditor shall evaluate whether: (a) Management, with the oversight of those charged with governance, has created and maintained a culture of honesty and ethical behavior; and (b) The strengths in the control environment elements collectively provide an appropriate foundation for the other components of internal control, and whether those other components are not undermined by deficiencies in the control environment. (Ref: Para. A69-A78)

Testing of the pervasive controls that exist at the entity level tends to be more subjective (such as testing the commitment to competence or understanding of entity policies on acceptable behaviors) than testing specific transactional controls. Yet these controls collectively provide the appropriate foundation for the other components of internal control.

The exhibit below sets out some possible methods for testing pervasive (entity-level) controls.

Exhibit 17.5-2

Control Environment	Possible Tests of Controls
Communication and Enforcement of Integrity and Ethical Values	• Read statement on the entity's website and any code of conduct or equivalent. • Review communications to staff. • Conduct interviews with a sample of staff.
Commitment to Competence	• Review hiring and firing policies. • Review job descriptions and documentation contained on selected employee files.
Participation by Those Charged With Governance	• Review any self-assessments made. • Review qualifications of board members and minutes of meetings. • Attend a meeting as an observer.
Management's Philosophy and Operating Style	• Review any relevant, available documentation. • Conduct interviews with a sample of staff.
Organizational Structure	• Review structure in light of best practices for nature of entity.
Assignment of Authority and Responsibility	• Review any documentation such as job descriptions.
Human Resources Policies and Practices	• Review policies and practices and compliance. • Review employee files for staff evaluations, training programs attended, etc.

Similar types of tests of controls could be designed to address other pervasive (entity-level) controls such as:

- Risk assessment;
- Information systems;
- Monitoring;
- The period-end close process; and
- Anti-fraud controls.

The results of performing tests of pervasive controls can also be more difficult to document than internal control at the business process level (such as checking to see if a payment was authorized, which can be documented with a simple yes/no response). As a result, the evaluation of pervasive (entity-level and general IT) controls is often documented with memorandums to the file along with supporting evidence.

For example, to test whether management communicates the need for integrity and ethical values to all personnel, and enforces its policies, a sample of employees could be selected for interviews. The employees could be asked about communications they have received from management, what relevant policies and procedures exist, what values they see demonstrated on a day-to-day basis by management, and whether the policies are indeed enforced. If the common response among the employees is that management has indeed communicated the need for integrity and ethical values and there are instances of where policies were enforced, then the test would be a success. Details of each employee's interview and supporting documentation (such as the entity's policies, communications, and enforcement actions) would then be recorded in a memo to file with the conclusions reached.

CONSIDER POINT

Timing
It is preferable to test the pervasive (entity-level) controls early in the audit process. The results of testing these controls could impact the nature and extent of other planned audit procedures. For example, if it is found that management's attitude towards controls is not as good as expected, further procedures will be required in relation to account balances and classes of transactions.

Planning
Take time to determine the most appropriate way to test the pervasive (entity-level) controls. Consider using an appropriate combination of inquiry, observation, re-performance, and inspection tests.

Ask open-ended questions
Avoid asking yes/no questions. Instead, ask questions that may elicit information that you may not already know. For example, ask, "Have you ever been asked to depart from an established accounting policy or do something that made you feel uncomfortable?" Also remember to listen carefully to the person's response, and watch his or her body language for signs of unease or distress giving answers.

Follow up on outstanding matters
If management or a staff member refuses to supply requested information or you obtain unexpected information, ensure that it is appropriately followed up, and changes made if necessary in the overall audit strategy and planned procedures.

Monitoring controls in larger entities
Some larger entities have developed entity-level monitoring controls that provide evidence of the ongoing operation of entity-level controls. Where this occurs, consider whether reliance can be placed on these controls to reduce the overall extent of other testing required.

Although most pervasive (entity-level) and general IT controls will be tested through the exercise of professional judgment and objectively applied to the circumstances, there are some situations where use of a representative sample may be applicable. An example would be the availability of evidence that monthly financial reports were reviewed and appropriate action taken.

Transactional Controls—Attribute Sampling

Tests of controls provide evidence that a control is operating effectively throughout the period of reliance, which will be a specified period such as a year.

Because transactional controls either operate effectively or not, it is not worth testing the operation of controls that could ultimately prove unreliable. Unreliable controls are those where there is a likelihood that deviation will be found. Sample sizes for tests of controls are often small because they are based on no exceptions being found. Otherwise, the sample sizes required would be much larger.

Some of the factors to consider in assessing the reliability of controls are outlined below.

Exhibit 17.5-3

Test of Controls Design	
Factors to Consider	Is it possible for the established procedures to have been circumvented by management (i.e., management override)?
	Is there a significant manual element involved in the control that could be prone to error?
	Is there a weak control environment?
	Are general IT controls poor?
	Is the ongoing monitoring of internal control poor?
	Have personnel changes occurred during the period that significantly affect the application of the control?
	Does the small number of staff involved in the control operation make meaningful segregation of duties impractical?
	Have changing circumstances necessitated the need for changes in the operation of the control?

Reliance on Indirect Internal Controls

Consider the need to obtain audit evidence supporting the effective operation of significant indirect internal controls. These are controls upon which other controls depend, such as non-financial information produced by a separate process, the treatment of exceptions, and periodic reviews of reports by managers. Where significant, evidence of the operating effectiveness of the indirect internal controls would be required. If any of the above factors are significant, it may be more effective to perform substantive procedures.

In designing tests of controls, the auditor should focus on the evidence that will be obtained with respect to the relevant assertions addressed (the points where misstatements could occur in the financial statements), as opposed to nature of the control itself. Controls are designed to mitigate risks and ensure, for example, the completeness of sales.

There are also a number of practical advantages in designing tests of controls that focus first on the assertion to be addressed. For example:

- The controls tested can be linked directly to the risks of material misstatements in the financial statements;
- Because the test objective is not dependent on specific controls, other controls that address the same risks (or control objectives) can be tested. This enables unpredictability or variation in the testing to be used; and
- It makes it easier to evaluate and test new controls introduced by the entity that address the same assertions.

Tests of controls are often designed to provide either a low or a moderate level of control risk (high or moderate level of risk reduction (confidence)) that the control being tested is operating effectively.

When designing tests of controls, the auditor may find it useful to consider the two levels of confidence to be gained from tests of controls:

- A high level of confidence (low level of risk remaining). This applies where the primary evidence is coming from tests of controls; and
- A moderate level of confidence (moderate level of risk remaining). This applies where the tests of controls will be combined with other substantive procedures to address a particular assertion.

Attribute sampling is often used to test controls. This technique uses the smallest sample size capable of providing a specified chance of detecting a deviation rate that exceeds the tolerable rate of deviation.

Exhibit 17.5-4

	Advantages
Attribute/Discovery Sampling	Ideal for testing the operating effectiveness of internal controls that have already been assessed as highly reliable during the evaluation of control design and implementation.
	If any level of deviation is expected in the performance of a control, it is recommended that alternative approaches to gathering audit evidence be considered.
	If no deviations are found in such a test-of-controls sample, the auditor can assert that the control is operating effectively. If a deviation is found, it is usually more efficient to stop the procedure and perform alternative substantive audit procedures instead. Just one control deviation will likely cause a revision to the assessed level of control risk. To continue with a test after finding a deviation would require a significant extension of the sample size, and possibly no further deviations would be found.

Determining the Sample Size

Sample sizes are determined as illustrated below.

Sample Size = Confidence Factor ÷ Tolerable Deviation Rate

For testing the operating effectiveness of controls with minimal reliance on other work performed, a 90% confidence level (related confidence factor = 2.3) is often used (see Exhibit 17.3-2 for the confidence factor table). The maximum tolerable deviation rate could be 10%. The smallest sample size in this case would be 23, calculated as follows.

Confidence Factor (2.3) ÷ Tolerable Deviation Rate (0.1) = Sample Size of 23

Where other evidence (such as evidence from substantive audit procedures) has been obtained for a particular assertion, the confidence factor could be reduced so that only a moderate level of risk reduction is obtained through testing the operational effectiveness of a control. In such a case, a confidence level of 80% (related confidence factor = 1.61) could be used, resulting in the smallest sample size of 8. Some firms use slightly higher confidence factors, resulting in the smallest sample size of 10 items for a moderate level of risk reduction and 30 for a higher level of risk reduction.

Selecting the Sample

Sample selection is set out below.

Exhibit 17.5-5

	Steps to Take
Selecting the Sample	Determine the purpose of the procedure and the evidence it will provide in relation to the assertions underlying the control attributes to be tested.
	Select the appropriate population of items to achieve the test objective. This may differ based on the underlying assertion being addressed. For example, invoices might be selected for testing sales existence, but these documents would not provide evidence on sales completeness. In this instance, the better choice might be tracing order entry or shipping documents to an invoice, and then into the accounts receivable.
	Determine the smallest sample size necessary to provide the required level of risk reduction. This could be either moderate or high levels of risk reduction.
	Use a random number generator or other appropriate method to select the individual items to be checked. Every item in the population should have an equal chance of being selected.

Control Procedures that Operate Less than Daily

For selecting samples where the control does not operate daily, the following guidelines may be of assistance. However, the actual sample sizes used should always be based on professional judgment.

Exhibit 17.5-6

Control Operates	Suggested Minimum Sample	Coverage Percentage of Test
Weekly	10	19%
Monthly	2-4	25%
Quarterly	2	50%
Yearly	1	100%

CONSIDER POINT

When statistical sampling is used for testing the operating effectiveness of internal control, the sample size required does not increase as the size of the population grows. A random sample of as little as 30 items with no deviation found can provide a high level of confidence that the control is operating effectively.

When designing tests of controls, spend time to define exactly what constitutes an error or exception to the test. This will save time during the performance of the test or the evaluation of the results, and avoid doubts in determining what a control deviation is.

If any level of deviation is expected in the operating effectiveness of a control, it is recommended that alternative approaches to gathering audit evidence be considered.

A simple plan that can be used for attribute sampling is as follows:

Based on a 95% confidence rate (a 5% deviation rate), it is suggested that:

- A sample of 10 items with no deviations will provide a moderate level of risk reduction. If a deviation is found, no risk reduction can be gained;
- A sample of 30 items with no deviations will provide a high level of risk reduction. If a single deviation is found, only a moderate level of risk reduction can be gained. If more than one deviation is found, no risk reduction can be gained; and
- A sample of 60 items and up to one deviation will provide a high level of risk reduction. If two deviations are found, only a moderate level of risk reduction can be gained. If more than two deviations are found, no risk reduction can be gained from testing of controls.

17.6 Evaluating Deviations

The process for evaluating deviations as set out below.

Exhibit 17.6-1

	Steps to Take
Evaluating Deviations	Identify deviations. Place each sample item into one of two classifications: “deviation” or “no deviation.”
	The nature and cause of each deviation should be carefully considered. For example, is there an indication of management override or possible fraud, or was the problem simply a result of the person responsible being on vacation?
	Consider sampling risk. If deviations have been found, consider if reliance on control effectiveness should be reduced, the sample size extended (see below), or alternative procedures performed.

CONSIDER POINT

As stated above, there is little point in testing controls if deviations are likely to be found. This is because the only way to gain the required assurance is to expand the sample size. Then, if another deviation is found, the sample would have to be expanded again, and so on. It would be much better to perform alternative procedures rather than expand sample size.

One possible exception would be where a reason for a particular type of deviation can be clearly identified and taken into account in the test design. For example, deviations during a specific period, such as when the person who normally performs the control is on holiday, may be addressed instead by performing some substantive procedures.

The results of the sample can be evaluated by comparing the maximum tolerable deviation rate to what is called the upper deviation limit. The upper deviation limit is approximated by the formula below.

Upper Deviation Limit = Adjusted Confidence Factor ÷ Sample Size

An adjusted confidence factor could be based on the number of deviations found, as illustrated in the exhibit below.

Exhibit 17.6-2

Adjusted Confidence Factor for Number of Deviations Found					
Confidence Level Required	**1**	**2**	**3**	**4**	**5**
95%	4.7	6.3	7.8	9.2	10.5
90%	3.9	5.3	6.7	8.0	9.3
80%	3.0	4.3	5.5	6.7	7.9
70%	2.4	3.6	4.7	5.8	7.0

For example, let's assume a sampling of 30 items (using a 90% confidence level and 10% maximum tolerable deviation rate) and two deviations were found. The upper deviation limit would be calculated as follows.

Adjusted Confidence Factor (5.3) ÷ Sample Size (30) = Upper Deviation Limit of 17%

The result at 17% is much higher than the maximum tolerable deviation rate of 10%, which would mean that reliance on control effectiveness would have to be reduced. If, however, it was decided to increase the sample size, it would have to be extended to 60 items and no further deviations found. This would reduce the upper deviation limit (as calculated below) to an acceptable level (i.e., close to the original limit of 10%).

Adjusted Confidence Factor (5.3) ÷ Sample Size (60) = Upper Deviation Limit of 9%

However, if a further deviation was found, it would require yet another extension in the sample to try for the desired results. This would probably not be an effective use of audit time, as yet another deviation could well be found.

Adjusted Confidence Factor (6.7) ÷ Sample Size (75) = Upper Deviation Limit of 9%

17.7 Case Studies—Extent of Testing

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

Case Study A—Dephta Furniture, Inc.

Determining the Extent of Testing

Designing Further Procedures—Accounts Receivable

The following is an outline of an audit program for accounts receivable. This program includes a statistical sample of accounts receivable.

Dephta Furniture, Inc.
Accounts Receivable—Audit Procedures

Client: *Dephta Furniture, Inc.*

	Assertions Addressed	Work Completed by: (initials)	WP Ref.	Comments
PROCEDURES				
1. Analytical procedures Develop expectations for the period-end accounts receivable balances, based on information obtained from understanding the entity. Investigate significant changes or trends in the: • Accounts receivable balance. • Aging of accounts receivable by customer. • Day's sales in accounts receivable. • Credit balances in accounts receivable. • Other unexpected variations. Explain. • Other (non-trade receivables). Document findings.	*CEA*	*MAG*	*C.120*	*Accounts receivables have increased by 60% from the prior period.* *Debtor's days in accounts receivable have also increased from 39 days to 45 days.*
2. Listing Obtain a detailed (and aged) listing of receivables at the period end: a) Check arithmetic accuracy and agree to general ledger.	*E*	*MAG*	*C.110*	

	Assertions Addressed	Work Completed by: (initials)	WP Ref.	Comments
b) Check names and amounts to subsidiary ledger. c) Ask staff dealing with receivables about any instances where: • A customer has been given preferential treatment, • The terms of sale have been modified, • Transactions have occurred with related parties, or • Where internal credit limits have been significantly overridden.	*E A*	*MAG* *MAG*		*Per discussion with Arjan and Karla, the sales terms do vary between customers but are approved by Arjan.*
3. Allowance for doubtful accounts Ensure that the allowance for doubtful accounts relates to specific accounts and is adequate: a) Review the aged accounts receivable trial balance and compare it to preceding periods.	*Cv*	*MAG*	*C.120*	*Accounts receivable over 60 days have increased as a percentage of sales from the prior period.* *Review listing of overdue accounts with Arjan and obtain details of allowance.*
b) Review payments received subsequent to period end (if possible, obtain an aged trial balance as at the period-end date with subsequent collections posted on it).	*Av*	*MAG*		
4. Cut off Perform and document cutoff procedures	*A*	*MAG*	*C.115*	*Obtain listing of sales returns since as part of cutoff testing. There were several large returns last year.* *Conditions for returns on contract sales reviewed as part of sales testing. See WP 503.1.* *All journal entries around period end reviewed on WP 626.*
SUBSTANTIVE PROCEDURES—SAMPLING				
S1. Extended confirmation Select 15 confirmations of accounts as outlined in accounts receivable confirmation checklist. Summarize the results and investigate differences by examining supporting documentation and inquiry.	EA	*MAG*	*C.200*	

	Assertions Addressed	Work Completed by: (initials)	WP Ref.	Comments
TESTS OF CONTROLS				*None*
EXTENDED PROCEDURES—for specific fraud risks identified				
E1. Accounts receivable confirmations – (fraud risk) a) Verify a sample of names, addresses, and fax/telephone numbers of customers selected to telephone or business directories to ensure that they are valid businesses. b) Consider reviewing websites or other online information about customers, in addition to sending a confirmation to verify account details and sales terms/conditions. Ask about any side deals or special terms. c) Consider accepting only original (signed) copies of confirmations.	*EA*	*MAG*	*C.200*	*verified 5 names, addresses, fax numbers from the confirmation selected. No exceptions noted.* *Called 2 customers to verify and confirm details and the contract terms for contract sales. No exceptions noted.*
E2. Allowance for doubtful accounts a) Test a sample of 10 subsequent payments to bank deposits. b) Review all credit memos issued after period end. Consider reviewing customer files or supporting documentation as appropriate. c) Review all write-offs of accounts receivable after period end to ensure that these were not doubtful in the prior period.	*v*	*MAG*	*C.121*	*No exceptions noted.* *There were 2 credit memos issued after period end but these were not material. The customers returned the items since they were damaged upon arrival. It is not clear whether they were damaged in transport or already damaged when leaving the factory.*

WP ref. = Working Paper Reference

Substantive Procedures—Sampling

The following illustrates the test design of a statistical sample for determining the existence and accuracy of the receivable balances. Invoices have been chosen as the source document for the customers chosen for confirmation, as certain retailers have indicated they will not confirm actual period-end balances.

A statistical sample (using monetary-unit sampling) will be performed to determine the existence and accuracy of receivables.

Question	Response
Purpose of test	*To ensure the existence and accuracy of receivables by selecting a sample of receivable balances and sending confirmation letters*

Question	Response
RMM in the relevant assertions	*Existence = Moderate risk* *Accuracy = Low risk*
Population to be tested	*Accounts receivable balances at period end*
Monetary value of population	*Rs.177,203*
Specific items subject to separate evaluation	*Rs.38,340*
Risk reduction obtained from testing the operational effectiveness of internal control	*Moderate*
Risk reduction from other procedures such as risk assessment procedures	*Limited*
Confidence factor to be used (reduced for risk reduction gained from other sources)	*Test of controls planned for revenue/receivables/receipts; therefore, a confidence interval of 75%, or 1.4, will be used*
Materiality	*Rs.15,000*
Expected deviations in sample	*None*

Estimating the Sample Size

Specific items will be tested separately. There are two related party receivables of Rs.28,340 and Rs.10,000 from Kalyani Dephta and Vinjay Sharma respectively that should be confirmed separately.

The remaining trade receivables balance of Rs.138,863 (Rs.177,203 – Rs.38,340) will need to be tested for existence and accuracy using accounts receivable confirmations. Since some customers cannot confirm balances after the fact, accounts receivable confirmations will be based on confirming invoices and:

- Sampling interval:
  Precision (materiality) ÷ confidence factor
  Rs.15,000 ÷ 1.4 (75%) = Rs.10,714
- Sample size:
  Population to be tested ÷ sampling interval
  Exclude specific items removed for separate evaluation
  Rs.138,340 ÷ Rs.10,714= 13

Since the sampling units in this population are invoices, the sample consists of 13 invoices to be selected for confirmation, plus the two related party transaction balances identified above.

Selecting Invoices To Be Tested

To select the invoices and customers for confirmation, the invoices will be chosen using monetary-unit sampling. For the remaining trade receivables balance of Rs.138,340, a starting point of Rs. 913 was chosen. Using the sampling interval of Rs.10,714, the 13 invoices were selected.

Case Study B—Kumar & Co.

Determining the Extent of Testing

Designing Further Procedures—Accounts Receivable

Audit procedures program for Kumar:

Balance—Accounts Receivable (AR)

Basic procedures:

Procedure	Assertions	Work Completed by and WP Ref.	Comments
Analytical procedures Perform analytical procedures on the AR balance, aging, and key ratios, and compare trends and result to prior period.	*CEA*	*C.110* *LP*	*Day's sales in AR have increased to 106 days from 58 days two years ago. Majority of increase seems to be due to increases in Dephta AR.*
Listing Obtain aged listing of AR and check arithmetic accuracy, agree to general ledger, and review the listing with Ruby for related party balances. Check the accuracy of the aging by reviewing 5 invoices, chosen judgmentally, and ensure the aging report is accurate.	*A*	*C.105* *LP* *C.105* *LP*	*Listing agrees to general ledger and no errors found on the aging and arithmetic checks.* *No evidence noted.*
Allowance Obtain details for allowance with Raj and review the aging. Discuss the collectability of accounts over 90 days. Obtain a listing of subsequent payments to the end of our subsequent events testing.	*v*	*C.120* *LP*	*Reviewed listing with Raj. Only two accounts are over 90 days. Invoices over 90 days from Dephta totaled Rs.10,590. Per Raj, these are all collectible and will be paid soon. Some of the invoices were paid subsequent to period end.*
Cut Off Review a sample of 10 invoices before and after period end and document other cutoff procedures to ensure transactions were recorded in the correct period. Examine evidence that the goods were shipped prior to period end for transactions selected.	*A*	*C.122* *LP*	*No errors noted here and revenue testing regarding cut off.* *All journal entries around period end reviewed on WP 626.*

Procedure	Assertions	Work Completed by and WP Ref.	Comments
Confirmations Confirm all related party accounts. Judgmentally select accounts receivable balances (excluding related party balances above) for 60% coverage. Check a sample of names and addresses before sending confirmation to ensure that company information is accurate. Follow-up confirmations faxed back to us with a phone call to verify the confirmation details. Perform alternative procedures for confirmations not returned.	*EA*	*C.130* *LP*	*Confirmed Dephta receivable and also agreed balance to Dephta working paper file.* *Accounts-receivable confirmations only had a 45% response rate, so alternative procedures were performed.*

Substantive Procedures—Sampling

The sample of confirmations was extended for moderate level of risk. Reliance was placed on substantive procedures.

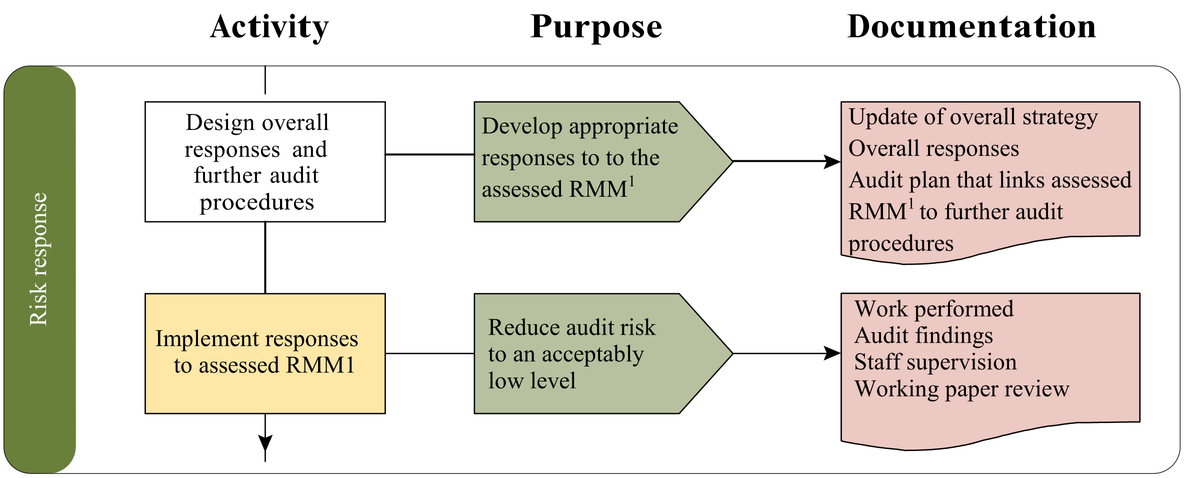
Extended/Other Substantive Procedures

Given the risk of management override, names and addresses were checked for a sample of confirmations sent. For any confirmation returned by fax, the confirmation details were confirmed with a telephone call to ensure their accuracy.

18. Documenting Work Performed

Chapter Content	Relevant SLAuSs
Guidance on proper and adequate documentation of the auditor's risk response in the audit working paper file.	230

Exhibit 18.0-1



Notes:
1. RMM = Risks of material misstatement.

Paragraph #	Relevant Extracts from SLAuSs
230.7	The auditor shall prepare audit documentation on a timely basis. (Ref: Para. A1)
230.8	The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: (Ref: Para. A2-A5, A16-A17) (a) The nature, timing and extent of the audit procedures performed to comply with the SLAuSs and applicable legal and regulatory requirements; (Ref: Para. A6-A7) (b) The results of the audit procedures performed, and the audit evidence obtained; and (c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions. (Ref: Para. A8-A11)

Paragraph #	Relevant Extracts from SLAuSs
230.9	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; (Ref: Para. A12) (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. (Ref: Para. A13)
230.10	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. (Ref: Para. A14)

18.1 Overview

File documentation plays a critical role in the planning and performance of the audit. It provides the record that work was in fact performed, and it forms the basis for the auditor's report. It will also be used for quality control reviews, monitoring of compliance with SLAuSs and applicable legal and regulatory requirements, and possibly inspections by third parties.

The specific requirements and nature of audit documentation have been extensively addressed in Volume 1, Chapter 16 and are not repeated here. The following exhibit provides a checklist of some of the matters that would be addressed in completing the file.

Exhibit 18.1-1

Documentation Considerations	Yes/No
Has compliance with the firm's documentation requirements, as set out in the firm's quality control manual, been documented?	
Is the audit documentation well organized and complete, including clear links to where significant matters were addressed?	
Does file documentation indicate: • Who performed the audit work and the date such work was completed? • Who reviewed the audit work performed and the date and extent of such review? • Results of 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?	
Could an experienced auditor, who has had no previous connection with the audit, understand: • The nature, timing, and extent of the audit procedures performed to comply with the applicable legal, regulatory, and professional requirements? • The results of the audit procedures and the audit evidence obtained? • The nature of significant matters arising, the conclusions reached, and significant professional judgments made in reaching those conclusions?	
Does the file contain documentation that addresses: • The presence of the audit preconditions and the decision to accept or continue with the engagement? • The overall audit strategy? • Discussion among the engagement team? • Key elements of the understanding of the entity obtained, and of each of the five internal control components, including the sources of the information obtained? • Results of performing risk assessment procedures? • Identified and assessed risks of material misstatement at the financial statement level and at the assertion level? • The detailed audit plan that responds to the assessed risks? • Results of performing audit procedures, including the relevance and reliability of evidence obtained and the treatment of exceptions found, including any changes required in assessed risks? • Information and procedures performed to address any indicators of fraud identified during the audit? • Changes in materiality as a result of new information obtained? • Enough information to re-perform each procedure if that was ever necessary? • Significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes? • Details of significant matters and their resolution, such as material uncertainties, concerns with management estimates, subsequent events, and other matters that could result in a modified audit opinion?	

Documentation Considerations	Yes/No
Have consultations within the firm and with experts hired by the auditor and management been documented? Where an expert was used, has the appropriateness of the expert's work as audit evidence been documented?	
Has compliance with the requirements of SLAuS 600 with regard to communications with component auditors been documented?	
Have all the documentation requirements of each relevant SLAuS been addressed? (See Volume 1, Chapter 16 for a list of SLAuSs with specific documentation requirements.)	

File Ownership

Unless otherwise specified by legislation or regulation, audit documentation is the property of the audit firm.

Copies of Entity's Records

Abstracts or copies of the entity's records (e.g., significant and specific contracts and agreements) may be included as part of audit documentation if considered appropriate. However, copies of the entity's accounting records are not a substitute for appropriate audit documentation.

CONSIDER POINT

Timeliness of preparation
Preparing audit documentation on a timely basis helps to enhance the quality of the audit, and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalized. Documentation prepared after the audit work has been performed is likely to be less accurate than documentation prepared at the time such work is performed.

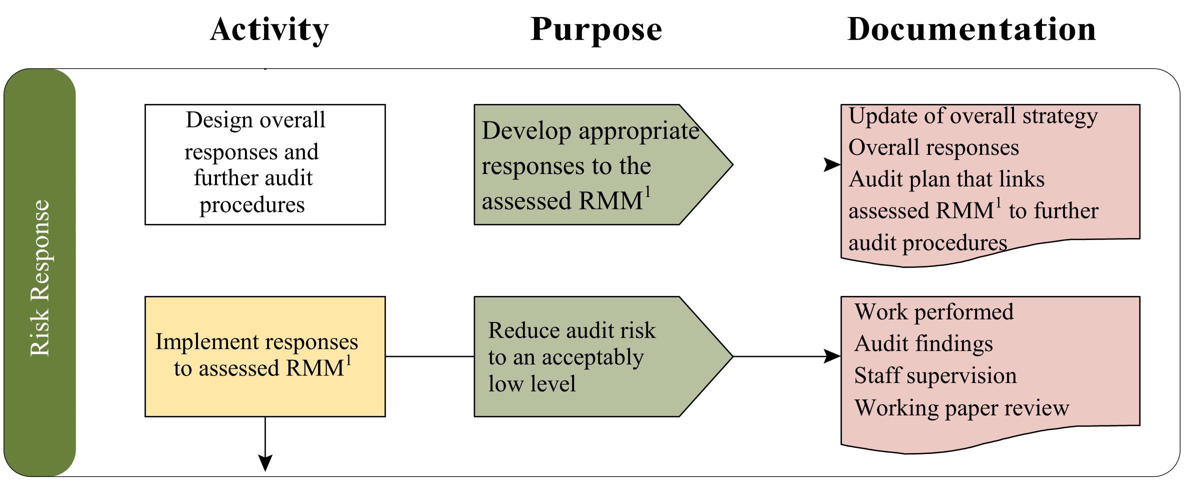
Can the audit file stand by itself?
Where possible, audit documentation should be clear and understandable without the need for additional oral explanations. Oral explanations on their own do not represent adequate support for the work performed or conclusions reached. They may be used, though, to explain or clarify information contained in the audit documentation.

Inconsistencies
If audit evidence is obtained that is inconsistent with the final conclusion regarding a significant matter, ensure that documentation is added to the file that explains how the auditor addressed the inconsistency. This does not imply that the auditor needs to retain documentation that is incorrect or superseded.

19. Written Representations

Chapter Content	Relevant SLAuS
Guidance on obtaining written confirmation of management representations.	580

Exhibit 19.0-1



Notes:
1. RMM = Risks of material misstatement.

Paragraph #	SLAuS Objective(s)
580.6	The objectives of the auditor are: (a) To obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor; (b) To support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations if determined necessary by the auditor or required by other SLAuSs; and (c) To respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.

Paragraph #	Relevant Extracts from SLAuSs
580.9	The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned. (Ref: Para. A2-A6)
580.10	The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement. (Ref: Para. A7-A9, A14, A22)
580.11	The auditor shall request management to provide a written representation that: (a) It has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement, and (b) All transactions have been recorded and are reflected in the financial statements. (Ref: Para. A7-A9, A14, A22)
580.12	Management’s responsibilities shall be described in the written representations required by paragraphs 10 and 11 in the manner in which these responsibilities are described in the terms of the audit engagement.
580.13	Other SLAuSs require the auditor to request written representations. If, in addition to such required representations, the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations. (Ref: Para. A10-A13, A14, A22)
580.14	The date of the written representations shall be as near as practicable to, but not after, the date of the auditor’s report on the financial statements. The written representations shall be for all financial statements and period(s) referred to in the auditor’s report. (Ref: Para. A15-A18)
580.15	The written representations shall be in the form of a representation letter addressed to the auditor. If law or regulation requires management to make written public statements about its responsibilities, and the auditor determines that such statements provide some or all of the representations required by paragraphs 10 or 11, the relevant matters covered by such statements need not be included in the representation letter. (Ref: Para. A19-A21)
580.16	If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general. (Ref: Para. A24-A25)
580.19	If management does not provide one or more of the requested written representations, the auditor shall: (a) Discuss the matter with management; (b) Reevaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and (c) Take appropriate actions, including determining the possible effect on the opinion in the auditor’s report in accordance with SLAuS 705, having regard to the requirement in paragraph 20 of this SLAuS.
580.20	The auditor shall disclaim an opinion on the financial statements in accordance with SLAuS 705 if: (a) The auditor concludes that there is sufficient doubt about the integrity of management such that the written representations required by paragraphs 10 and 11 are not reliable; or (b) Management does not provide the written representations required by paragraphs 10 and 11. (Ref: Para. A26-A27)

19.1 Overview

Written representations are requested by the auditor from those responsible (usually management but, depending on the entity and any relevant law or regulation, may extend to those charged with governance) for the preparation of the financial statements. One of the responsibilities of management when they sign the engagement letter (see Volume 2, Chapter 4) is to confirm the auditor's expectation of receiving written confirmation concerning the representations made in connection with the audit.

During the course of the audit, management will make a number of verbal representations to the auditor, which can be used as audit evidence to complement other audit procedures. At the end of the engagement, these verbal representations are to be included in a written representation letter obtained from management and, where appropriate, those charged with governance.

Note: A number of SLAuSs contain specific requirements for the auditor to request written representations.

The written representation letter would include specific representations required, and management's belief that:

- It has fulfilled its responsibilities for the preparation of the financial statements; and
- The information provided to the auditor was complete.

The written representation letter would be obtained as near as practicable to, but not after, the date of the auditor's report on the financial statements. Written representations would cover all financial statements and period(s) referred to in the auditor's report.

Written management representations are not to be used as:

- A substitute for performing other audit procedures; or
- As the sole source of evidence on significant audit matters.

CONSIDER POINT

Who signs the letter?
For engagements deemed to be high risk, consider obtaining more than one signature on the representation letter. For example, the representation letter could be signed by the owner-manager and other key members of the management team.

Representations as evidence
Written representations do not provide sufficient appropriate audit evidence on their own about any of the matters with which they deal. Nor does the fact that management has provided reliable written representation affect the nature or extent of other audit evidence that the auditor obtains about the fulfillment of management's responsibilities, or about specific assertions.

19.2 Subject Matter

Management representations may be:

- **Verbal, whether solicited or unsolicited**
  Such representations are typically obtained during the audit engagement.
- **Written**
  At the end of the engagement, the auditor is required to request a written statement from management confirming certain matters such as:
  – The verbal representations referred to above,
  – Management has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework,
  – All transactions have been recorded and are reflected in the financial statements, and
  – Other representations as necessary to support the audit evidence obtained.

Exhibit 19.2-1

Forms of Management Representations	Matters communicated in discussions.
	Matters communicated electronically, such as emails, recorded telephone messages, or text messages.
	Schedules, analyses, and reports prepared by the entity, and management's notations and comments therein.
	Internal and external memoranda or correspondence.
	Minutes of meetings of those charged with governance and compensation committees.
	Signed copy of the financial statements.
	Representation letter from management.

19.3 Considerations in Performing the Audit

The following matters should be considered when evaluating management representations.

Exhibit 19.3-1

Evaluating Management Representations	
Matters to Consider	Can the person making the representation be expected to be objective and knowledgeable on the subject matter?
	Is the representation reasonable in light of: • The auditor's understanding of the entity and its environment? • Other evidence obtained, including other representations obtained from management? • Other evidence obtained through the performance of audit procedures to achieve other audit objectives?
	What further audit procedures are required to corroborate the representations? For corroborating management intent, consider sources of evidence such as board minutes, minutes of investment committees, legal documents, or internal correspondence and emails. For example, as part of the auditor's consideration of going concern, "substantiating" evidence would include inspection of board minutes, legal documents, and availability of funding information, etc. Where corroborating evidence is not available, is there a scope limitation?
	Where management representations have been contradicted by other audit evidence obtained: • Is there reason to doubt management's honesty and integrity? If yes, the auditor would discuss the matter with those charged with governance, and consider the impact on the risk assessment and the need for further audit procedures. • Is continued reliance on any other of management's representations appropriate and justified?
	Consider the most appropriate means of documenting the representation. For example: • A memorandum created by the auditor; • A written memorandum created by the entity's management; and • Inclusion in the management representation letter.

19.4 Written Representations

Written representations are an important source of audit evidence, for reasons such as the following:

- If management modifies or does not provide the requested written representations, it may alert the auditor to the possibility that one or more significant issues may exist; and
- A request for written (rather than oral) representations may prompt management to consider such matters more rigorously, thereby enhancing the quality of the representations.

Written representations are requested from those responsible for the preparation and presentation of the financial statements and knowledge of the matters concerned. Often, this will be the entity's chief executive officer and the chief financial officer, or other equivalent persons such as the owner-manager.

The auditor is required to request management to provide a written representation that:

- It has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework;
- It has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement; and
- All transactions have been recorded and are reflected in the financial statements.

If management does not provide these required representations, or if the auditor concludes there is sufficient doubt about the integrity of management such that these representations are not reliable, then the auditor must disclaim an opinion on the financial statements.

Written representations also support other evidence relevant to the financial statements (such as required by other SLAuSs) or one or more specific assertions in the financial statements.

Other particular SLAuSs that require written representations are outlined below.

Exhibit 19.4-1

ISA	Title	Paragraph
240	*The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*	39
250	*Consideration of Laws and Regulations in an Audit of Financial Statements*	16
450	*Evaluation of Misstatements Identified during the Audit*	14
501	*Audit Evidence—Specific Considerations for Selected Items*	12
540	*Auditing Accounting Estimates, Including Fair value Accounting Estimates, and Related Disclosures*	22
550	*Related Parties*	26
560	*Subsequent Events*	9
570	*Going Concern*	16(e)
710	*Comparative Information—Corresponding Figures and Comparative Financial Statements*	9

Written representations address matters such as those set out below.

Exhibit 19.4-2

	Management has:
Management's Responsibilities	• Fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework (including, where relevant, its fair presentation, as set out in the terms of the audit engagement), and for the completeness of the information provided to the auditor; and • In some cases (such as where the terms of engagement were agreed by other parties), management may also be asked to reconfirm its acknowledgement and understanding of those responsibilities in written representations.
	Provided the auditor with all relevant information and access as agreed in the terms of the audit engagement.
	Recorded all transactions in the accounting records, and reflected those transactions in the financial statements.

Exhibit 19.4-3

	Management represents that:
Specific Representations	The selection and application of accounting policies are appropriate and are in accordance with the applicable financial reporting framework.
	The following matters, where relevant under the applicable financial reporting framework, have been recognized, measured, presented, or disclosed in accordance with that framework: • Plans or intentions that may affect the carrying value or classification of assets and liabilities; • Liabilities, both actual and contingent; • Title to, or control over, the assets; • Liens or encumbrances on assets and assets pledged as collateral; and • Aspects of laws, regulations, and contractual agreements that may affect the financial statements, including non-compliance.
	It has communicated all known deficiencies in internal control of which management is aware.
	All of the entity's reasons for choosing a particular course of action have been communicated.
	Its intentions in relation to [specify matter] are as follows: [describe the entity's plans or intentions].

Other Considerations

Exhibit 19.4-4

	Comments:
Qualifying Language	In some cases, management may include qualifying language to the effect that representations are made to the best of its knowledge and belief. Such wording can be accepted if the auditor is satisfied that the representations are being made by those with appropriate responsibilities and knowledge of the matters included in the representations.
Trivial Misstatements	When obtaining representations about misstatements, a threshold amount could be established below which individual misstatements may be regarded as trivial.
Date of Letter	The auditor's report would not be dated before the date of the written representations, as the representations are part of the audit evidence.
Address Letter to Auditor	The required written representations would be included in a letter addressed to the auditor.
Report to Those Charged With Governance	SLAuS 260 requires the auditor to communicate with those charged with governance the written representations which the auditor has requested from management.
Management Inquiries of Others	If management does not have sufficient knowledge on which to base the written representations, it may decide to make inquiries of others who participated in preparing/presenting the financial statements and assertions therein. This would include individuals who have specialized knowledge.

Doubts about Representations Provided or Not Provided

If there are doubts as to the reliability of written representations, or requested written representations have not been provided, the auditor would consider the nature of the concern and act accordingly.

Exhibit 19.4-5

Doubts	Auditor's Required Response
Requested Representations Not Provided	• Discuss the matter with management; • Re-evaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and • Take appropriate actions, including determining the possible effect on the opinion in the auditor's report.
Inconsistencies Identified	• Perform additional audit procedures to attempt to resolve the matter. • If the matter remains unresolved, reconsider the assessment of the competence, integrity, ethical values, or diligence of management (see point below), or of its commitment to or enforcement of these, and determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general.

Doubts	Auditor's Required Response
Management Incompetence; Lack of Integrity or Ethical Values	Determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general. The auditor would disclaim an opinion on the financial statements where: • The auditor concludes that there is sufficient doubt about the integrity of management such that the required written representations are not reliable; or • Management does not provide the written representations required.

Supplementary/Additional Representations

In addition to the required written representations, the auditor may consider it necessary to request:

Supplementary representations about the financial statements

Such written representations may supplement, but do not form part of, the written representation required by SLAuS 580.10. Examples could include:

- Whether the selection and application of accounting policies are appropriate; and
- Whether matters such as the following have been recognized, measured, presented, or disclosed in accordance with that framework:
  - Plans or intentions that may affect the carrying value or classification of assets and liabilities,
  - Liabilities, both actual and contingent,
  - Title to, or control over, assets, the liens or encumbrances on assets, and assets pledged as collateral, and
  - Aspects of laws, regulations, and contractual agreements that may affect the financial statements, including non-compliance.

Additional written representations

In addition to the written representation required by SLAuS 580.11, the auditor may consider it necessary to request written representations such as:

- Confirmation that management has communicated all deficiencies in internal control of which management is aware; and
- Specific assertions.
  In some cases, it may not be possible to obtain sufficient appropriate audit evidence without a written representation from management confirming the reasons, judgements, or intentions with respect to specific assertions in the financial statements. Matters to consider include:
  - The entity's past history in carrying out its stated intentions,
  - The entity's reasons for choosing a particular course of action,
  - The entity's ability to pursue a specific course of action, and
  - The existence or lack of any other information that might have been obtained during the course of the audit that may be inconsistent with management's judgment or intent.

CONSIDER POINT

Take some time to meet with management to explain the nature of requested representations, and to ensure management is fully aware of what it is agreeing to sign.

19.5 Example of Written Representations

The example of a management-representation letter contained in the case-study materials follows the format contained in SLAuS 580.

19.6 Case Study—Management Representations

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

Case Study A—Dephta Furniture, Inc.

Management Representations

The following are examples of management representations by Suraj, and some further audit procedures that could apply.

Management Representation	Evaluation
There is no impairment in the tools that have been superseded by new machinery. This is because the machines break down; therefore, the older ones will be required on occasion while the other machine is repaired.	*Make inquiries of the production manager and others to determine whether the tools and equipment, new or old, are currently in use and still operable. This could be established by physical examination and review of maintenance records.*
There is no additional provision required for the slightly damaged goods identified during the inventory count.	*Check whether the damaged goods were in fact sold after period end. Inquire with the production manager whether damaged goods are sold as-is or repaired (if so, at what cost) or sold for a discounted price.*

At the conclusion of the audit, important representations would be documented in a management representation letter that would be signed by Suraj Dephta and Jawad Kassab.

Such representations might be included in a letter as follows.

Dephta Furniture, Inc. Letterhead

March 15, 20X3

To: Jamel, Woodwind & Wing, LLP
55 Kingston St.
Cabetown, United Territories
123-50004

Dear Mr. Lee:

This representation letter is provided in connection with your audit of the financial statements of Dephta Furniture, Inc. for the year ended December 31, 20X2, for the purpose of expressing an opinion as to whether the financial statements are presented fairly, in all material respects, in accordance with Sri Lanka Accounting Standards.

We confirm that:

Financial Statements

- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated October 15, 20X2, for the preparation of the financial statements in accordance with Sri Lanka Accounting Standards; in particular the financial statements are fairly presented in accordance therewith.
- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable.
- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of Sri Lanka Accounting Standards.
- All events subsequent to the date of the financial statements and for which Sri Lanka Accounting Standards require adjustment or disclosure have been adjusted or disclosed.
- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter.
- The Company has complied with all aspects of contractual agreements that could have a material effect on the financial statements in the event of non-compliance.
- There has been no non-compliance with requirements of regulatory authorities that could have a material effect on the financial statements in the event of non-compliance.
- The Company has satisfactory title to all assets, and there are no liens or encumbrances on the company’s assets, except for those that are disclosed in Note X to the financial statements.
- We have no plans to abandon lines of product or other plans or intentions that will result in any excess or obsolete inventory, and no inventory is stated at an amount in excess of net realizable value.

- There has been no impairment in the net realizable value of fixed assets (tools) whose functionality has now been superseded by new machinery.

Information Provided

- We have provided you with:
  - Access to all information of which we are aware that is relevant to the preparation of the financial statements such as records, documentation, and other matters;
  - 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 necessary to obtain audit evidence.
- All transactions have been recorded in the accounting records and are reflected in the financial statements.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.
- We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:
  - Management;
  - Employees who have significant roles in internal control; or
  - Others where the fraud could have a material effect on the financial statements.
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators, or others.
- We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements.
- We have disclosed to you the identity of the entity's related parties, and all the related party relationships and transactions of which we are aware.

Yours truly,

____

Suraj Dephta

____

Jawad Kassab

Case Study B—Kumar & Co.

Management Representations

The following are examples of management representations by Raj, and some further audit procedures that could apply.

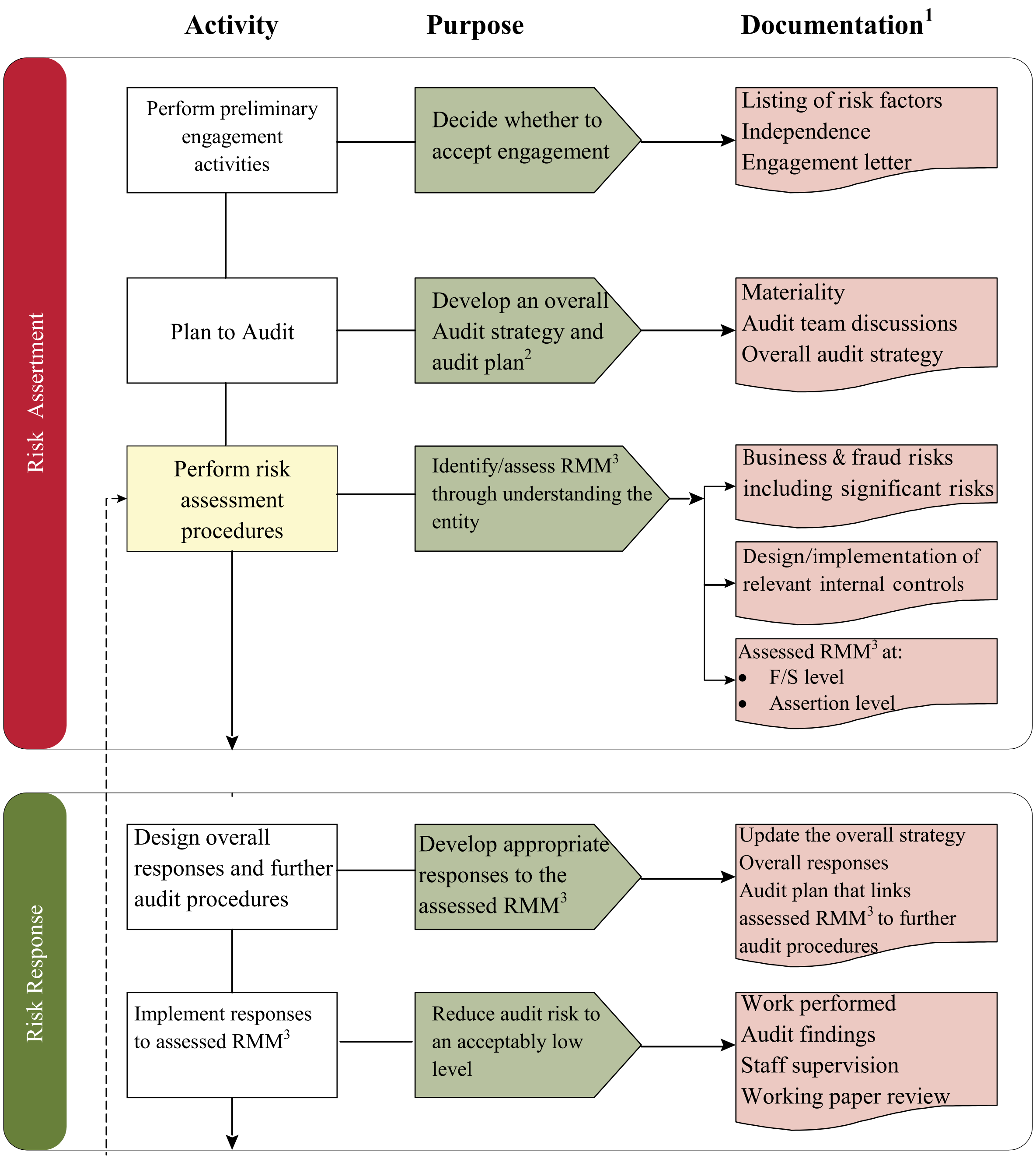
Management Representation	Evaluation
No additional allowance for doubtful accounts is necessary. The Dephta account is fully collectible and other AR is not significant enough to estimate an allowance for.	*Send AR confirmation to Dephta.* *Make inquiries of Raj and Ruby to understand the various AR customer accounts and their history of payments, and look for any trends. Validate that the proportion of non-Dephta AR is not significant, as the client is suggesting.* *Review subsequent payments to support collectability of account.* *Consider any relevant information from the audit of Dephta.*
Dephta continues to be satisfied with the quality of the goods we sell them.	*Review the history of sales returns and look for any trends.* *Review the results of the AR confirmations to Dephta for any commentary on quality of goods or the collectability of amounts.* *Conduct inventory observation and look for obsolete items and non-moving inventory.* *Make inquiries to Ruby as to the quality of the goods and any communications she may have received from Dephta regarding quality of the goods they have purchased to date.*

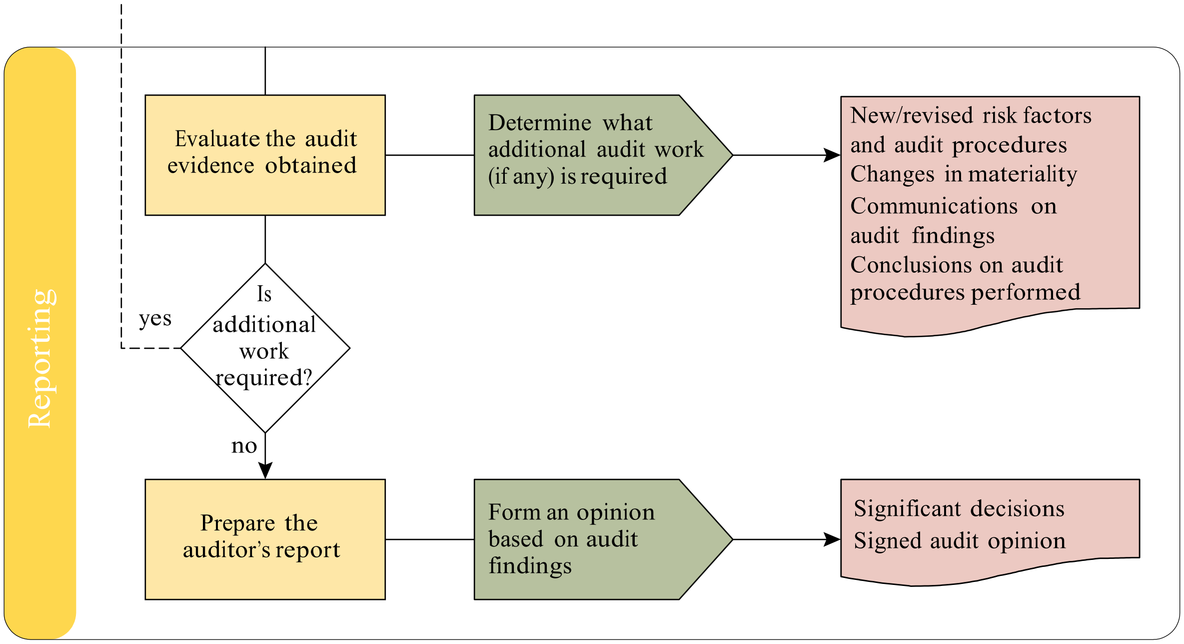
At the conclusion of the audit, important representations would be documented in a management representation letter that would be signed by Raj Kumar.

Such representations might be included in a letter as previously illustrated in Case Study A—Dephta Furniture, Inc.

20. Reporting – Overview

Exhibit 20.0-1





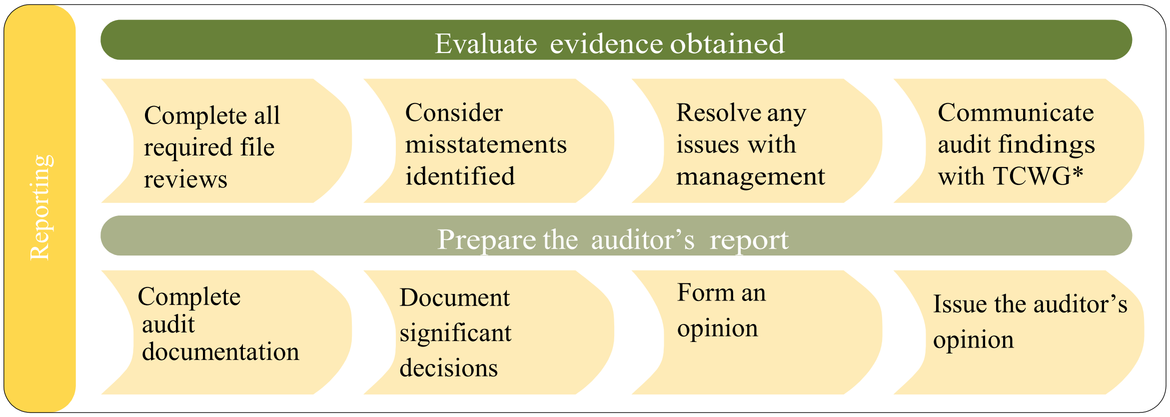
Notes:

1. Refer to SLAuS 230 for a more complete list of documentation required.
2. Planning (SLAuS 300) is a continual and iterative process throughout the audit.
3. RMM = Risks of material misstatement.

Paragraph #	Relevant Extracts from SLAuSs
200.11	In conducting an audit of financial statements, the overall objectives of the auditor are: (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and (b) To report on the financial statements, and communicate as required by the SLAuSs, in accordance with the auditor's findings.
200.12	In all cases when reasonable assurance cannot be obtained and a qualified opinion in the auditor's report is insufficient in the circumstances for purposes of reporting to the intended users of the financial statements, the SLAuSs require that the auditor disclaim an opinion or withdraw (or resign) from the engagement, where withdrawal is possible under applicable law or regulation.

The final phase of the audit involves the following.

Exhibit 20.0-2



*TCWG = those charged with governance

Basic concepts addressed in the reporting phase are as follows.

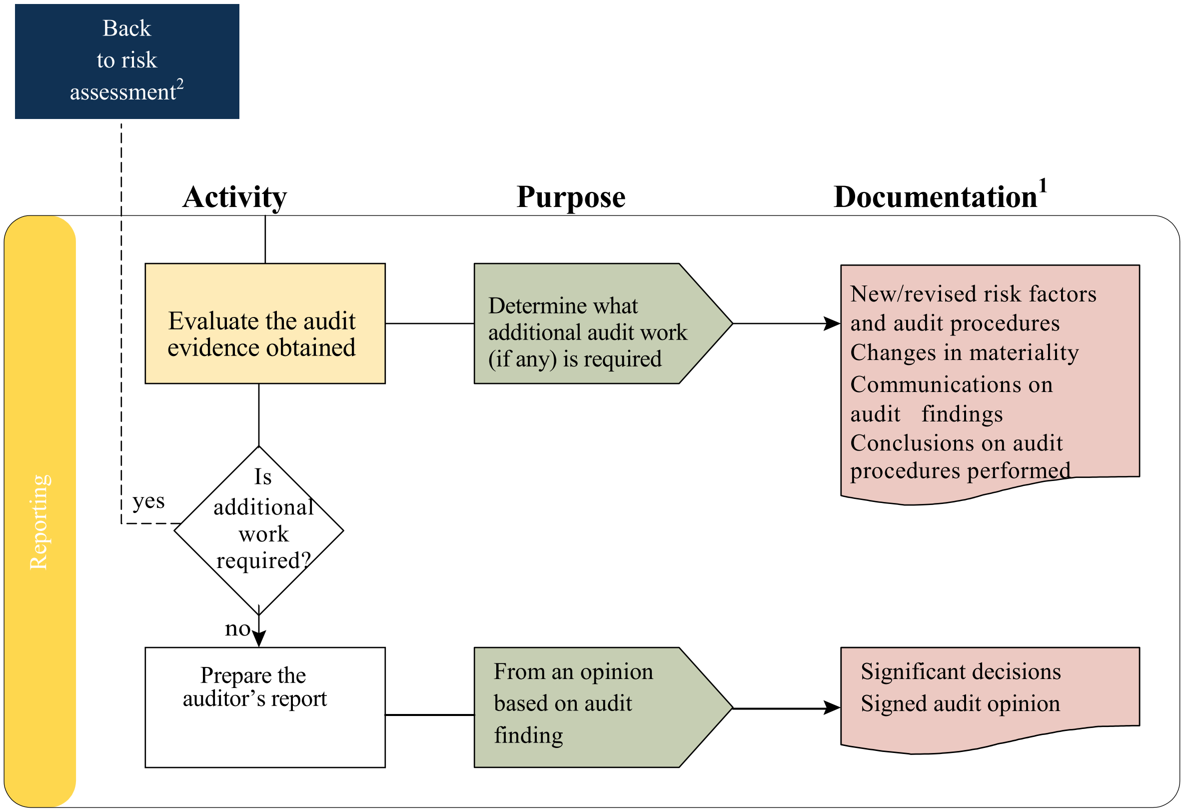
Exhibit 20.0-3

	Volume and Chapters
Subsequent Events	V1 – 13
Going Concern	V1 – 14
Audit Documentation	V1 – 16
Communicating Audit Findings	V2 – 22
The Auditor's Report	V1 – 17

21. Evaluating Audit Evidence

Chapter Content	Relevant SLAuSs
Guidance on evaluating the sufficiency and appropriateness of audit evidence so that reasonable conclusions can be made on which to base the audit opinion.	220, 330, 450, 520, 540

Exhibit 21.0-1



Notes:

1. Refer to SLAuS 230 for a more complete list of documentation required.
2. Planning (SLAuS 300) is a continual and iterative process throughout the audit.

Paragraph #	Relevant Extracts from SLAuSs
220.15	The engagement partner shall take responsibility for: (a) The direction, supervision and performance of the audit engagement in compliance with professional standards and applicable legal and regulatory requirements; and (Ref: Para. A13-A15, A20) (b) The auditor's report being appropriate in the circumstances.
220.16	The engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures. (Ref: Para. A16-A17, A20)
220.17	On or before the date of the auditor's report, the engagement partner shall, through a review of the audit documentation and discussion with the engagement team, be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached and for the auditor's report to be issued. (Ref: Para. A18-A20)
220.18	The engagement partner shall: (a) Take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters; (b) Be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm; (c) Be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and (d) Determine that conclusions resulting from such consultations have been implemented. (Ref: Para. A21-A22)
220.19	For audits of financial statements of listed entities, and those other audit engagements, if any, for which the firm has determined that an engagement quality control review is required, the engagement partner shall: (a) Determine that an engagement quality control reviewer has been appointed; (b) Discuss significant matters arising during the audit engagement, including those identified during the engagement quality control review, with the engagement quality control reviewer; and (c) Not date the auditor's report until the completion of the engagement quality control review. (Ref: Para. A23-A25)
220.20	The engagement quality control reviewer shall perform an objective evaluation of the significant judgments made by the engagement team, and the conclusions reached in formulating the auditor's report. This evaluation shall involve: (a) Discussion of significant matters with the engagement partner; (b) Review of the financial statements and the proposed auditor's report; (c) Review of selected audit documentation relating to the significant judgments the engagement team made and the conclusions it reached; and (d) Evaluation of the conclusions reached in formulating the auditor's report and consideration of whether the proposed auditor's report is appropriate. (Ref: Para. A26-A27, A29-A31)

21.1 Overview

After the planned audit procedures have been performed, an evaluation of the results will take place. This would include a review of the audit documentation and discussions with the engagement team, and any changes to the audit plans as a result of the procedures performed. Some of the key considerations are set out below.

Exhibit 21.1-1

Quality Control	It is the responsibility of the engagement partner to ensure that the file reviews are being performed in accordance with the firm's review policies and procedures, and that the auditor's opinion is appropriate.
Consultation	The engagement partner is responsible to ensure that: • The engagement team sought appropriate consultation (both internally within the firm and externally with third parties) on difficult or contentious matters; and • Conclusions resulting from such consultations have been documented and implemented.
Engagement Quality Control Review (EQCR)	When firm policy requires an EQCR, the engagement partner shall: • Ensure that an appropriately qualified EQC reviewer has been appointed; • Discuss significant audit issues with the EQC reviewer; and • Not date the auditor's report until completion of the EQCR.

The goal for the auditor is to be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached, and for an appropriately worded auditor's report to be issued.

The evaluation of the audit evidence obtained would address the matters set out below.

Exhibit 21.1-2

Materiality	Are the amounts established for overall and performance materiality still appropriate in the context of the entity's actual financial results? If a lower overall materiality (for the financial statements as a whole) than that initially determined is appropriate, the auditor is required to determine: • Whether it is necessary to revise performance materiality; and • Whether the nature timing and extent of the further audit procedures remain appropriate.
Risk	In light of the audit findings, are assessments of risks of material misstatement at the assertion level still appropriate? If not, the risk assessments would be revised and further planned audit procedures modified.

Misstatements	Has the effect on the audit of identified misstatements and uncorrected misstatements been considered? Has the reason for misstatements/deviations been considered? They may indicate an unidentified risk or a significant deficiency in internal control. Does the overall audit strategy and audit plan need to be revised? This would apply when: • The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material; or • The aggregate of misstatements accumulated during the audit approaches materiality. Have additional audit procedures been performed to determine whether misstatements remain (in classes of transactions, account balance, or disclosures) where management was asked to correct misstatements?
Fraud	Does information obtained from performing other risk assessment procedures and related activities indicate that one or more fraud risk factors are present? Did the analytical procedures performed near the end of the audit indicate a previously unrecognized risk of material misstatement due to fraud? Have identified misstatements been evaluated to determine whether such a misstatement is indicative of fraud? If so, evaluate the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations. An instance of fraud is unlikely to be an isolated occurrence. Is there any reason to believe that management could be involved in the identified misstatements whether material or not, as a result of fraud? If so, re-evaluate the assessment of the risks of material misstatement due to fraud and its resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks. Also consider whether circumstances or conditions indicate possible collusion involving employees, management, or third parties when reconsidering the reliability of evidence previously obtained. If fraud risks have been identified, it is possible to confirm that the financial statements are not materially misstated as a result of fraud. If not possible, determine the implications for the audit, including whether it brings into question the ability to continue performing the audit.
Evidence	Has sufficient appropriate evidence been obtained to reduce the risks of material misstatement in the financial statements to an acceptably low level? Consider the need for further procedures to be performed.
Analytical Procedures	Did the analytical procedures performed at the final review stage of the audit: • Corroborate the audit findings; or • Identify previously unrecognized risks of material misstatement?

21.2 Reassess Materiality

Paragraph #	Relevant Extracts from SLAuSs
450.10	Prior to evaluating the effect of uncorrected misstatements, the auditor shall reassess materiality determined in accordance with SLAuS 320 to confirm whether it remains appropriate in the context of the entity's actual financial results. (Ref: Para. A11-A12)

Before the auditor evaluates the results of performing procedures and any misstatements arising therefrom, the first step is to reassess the amounts established for overall and performance materiality. This is necessary because the initial determination of materiality will often be based on estimates of the entity's financial results, and the actual results may be different. Factors that would lead to a change include:

- Initial determination of materiality is no longer appropriate in the context of the entity's actual financial results;
- New information becomes available (such as user expectations) that would have caused the auditor to determine a different amount (or amounts) initially; and
- Unexpected misstatements that may cause the materiality amount for that particular class of transactions, account balance, or disclosure to be exceeded.

Whenever a revision is necessary, the auditor is required to consider and document the impact on the assessed risks and the nature, timing, and extent of further audit procedures required.

If a lower materiality is required for the financial statements as a whole, also determine if it is necessary to revise performance materiality. If so, determine whether the nature, timing, and extent of the further audit procedures remain appropriate.

CONSIDER POINT

If materiality has to be revised, do not wait until the end of the audit to make the change. If materiality is lowered, it may well require changes in risk assessments and the performance of additional or further audit procedures.

21.3 Changes in Risk Assessments

Paragraph #	Relevant Extracts from SLAuSs
330.25	Based on the audit procedures performed and the audit evidence obtained, the auditor shall evaluate before the conclusion of the audit whether the assessments of the risks of material misstatement at the assertion level remain appropriate. (Ref: Para. A60-A61)

The assessment of risk at the assertion level will often be based on audit evidence available before performing further audit procedures. During the time these procedures are being performed, new information may be obtained that will require the original risk assessment to be modified.

For example, in the audit of inventories, the assessed level of risk for the completeness assertion may be low, based on an expectation that internal control is operating effectively. If a test of controls finds that internal control is not effective, the risk assessment would need to change and further audit procedures performed to reduce the risk to an acceptably low level. The same is true for any audit procedures performed where the results do not match the expectations.

Some points to consider in determining whether the original assessment of risk has changed or not are outlined in the exhibit below.

Exhibit 21.3-1

Internal Control	**Tests of controls** • Do the results of performing tests of controls support the planned level of risk reduction based on their operating effectiveness? **Management override** • Is there any evidence of management override of existing internal control? **Control deficiencies** • Does a potential misstatement(s) result from a deficiency in internal control that should be immediately brought to management's attention?
Nature of Audit Evidence Obtained	**New risk factors** • Does the evidence identify any new business risks, fraud risk factors, or management override? **Contradictory evidence** • Does the evidence obtained contradict other sources of information available? **Conflicting evidence** • Does the evidence obtained conflict with the current understanding of the entity? **Accounting policies** • Is there evidence that the entity's accounting policies are not always consistently applied? **Unpredictable relationships** • Does the evidence substantiate the relationships among financial and non- financial data? **Fraud** • Is there evidence of any patterns, oddities, exceptions, or deviations found in performing tests that could be indicative of possible fraud (including management override) occurring? **Reliability of representations** • Is there evidence that questions the reliability of representations made by management or those charged with governance?
Nature of Misstatements	**Bias in estimates** • Could misstatements found in accounting estimates and fair value measurements indicate a possible pattern of bias by management? **Misstatements** • Do misstatements, either individually or combined with all other uncorrected misstatements, constitute a material misstatement in the financial statements taken as a whole?

Where the original assessment of risk has changed, the details should be documented and a revised assessment of risk determined. There should also be details of how the detailed audit plan has been changed to address the revised risk assessment. This may be a modification to the nature, timing, or extent of other planned audit procedures or performance of further audit procedures.

CONSIDER POINT

Allocate time in the audit budget for the audit engagement team to discuss their findings (as a group) immediately after the work is completed. The matters outlined in the above exhibit could form the agenda. Remember that the detection of fraud often comes from piecing together information about small and seemingly insignificant matters.

21.4 Evaluating the Effect of Misstatements

Paragraph #	SLAuS Objective(s)
450.3	The objective of the auditor is to evaluate: (a) The effect of identified misstatements on the audit; and (b) The effect of uncorrected misstatements, if any, on the financial statements.

Paragraph #	Relevant Extracts from SLAuSs
450.5	The auditor shall accumulate misstatements identified during the audit, other than those that are clearly trivial. (Ref: Para. A2-A3)
450.6	The auditor shall determine whether the overall audit strategy and audit plan need to be revised if: (a) The nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material; or (Ref: Para. A4) (b) The aggregate of misstatements accumulated during the audit approaches materiality determined in accordance with SLAuS 320. (Ref: Para. A5)

Paragraph #	Relevant Extracts from SLAuSs
450.7	If, at the auditor's request, management has examined a class of transactions, account balance or disclosure and corrected misstatements that were detected, the auditor shall perform additional audit procedures to determine whether misstatements remain. (Ref: Para. A6)
450.8	The auditor shall communicate on a timely basis all misstatements accumulated during the audit with the appropriate level of management, unless prohibited by law or regulation. The auditor shall request management to correct those misstatements. (Ref: Para. A7-A9)
450.9	If management refuses to correct some or all of the misstatements communicated by the auditor, the auditor shall obtain an understanding of management's reasons for not making the corrections and shall take that understanding into account when evaluating whether the financial statements as a whole are free from material misstatement. (Ref: Para. A10)
450.11	The auditor shall determine whether uncorrected misstatements are material, individually or in aggregate. In making this determination, the auditor shall consider: (a) The size and nature of the misstatements, both in relation to particular classes of transactions, account balances or disclosures and the financial statements as a whole, and the particular circumstances of their occurrence; and (Ref: Para. A13-A17, A19-A20) (b) The effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole. (Ref: Para. A18)
450.12	The auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected. (Ref: Para. A21-A23)
450.13	The auditor shall also communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.
450.14	The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation. (Ref: Para. A24)
540.18	The auditor shall evaluate, based on the audit evidence, whether the accounting estimates in the financial statements are either reasonable in the context of the applicable financial reporting framework, or are misstated. (Ref: Para. A116-A119)

The objective of evaluating misstatements is to determine the effect on the audit and whether there is a need to perform additional audit procedures.

Revisions to the audit strategy and detailed audit plans may be required when:

- The nature or circumstances of identified misstatements indicate that other misstatement(s) may exist that, when aggregated with known misstatements, could exceed performance materiality; or
- The aggregate of identified and uncorrected misstatements comes close to or exceeds performance materiality.

CONSIDER POINT

Remember that there will always be a risk of undetected misstatements in the financial statements. This is because of the inherent limitations of an audit outlined in Volume 1, Chapter 4.1 of this Audit Manual.

Misstatements can arise in areas set out in the exhibit below.

Exhibit 21.4-1

Source	Description
Inaccuracies or Fraud	Mistakes may be made by the entity's personnel in gathering or processing data upon which the financial statements are prepared. This would also include errors made in cut off at the period end. In addition to identifying specific misstatements, the auditor may also: • Quantify the mistakes in a particular population (such as sales) through monetary sampling. A likely aggregate of misstatements can be projected when a representative sample is used; and • Consider the nature of identified misstatements. If there are numerous misstatements affecting a particular balance or business location, it may be indicative of a risk of material misstatement due to fraud.
Omissions or Fraud	Some transactions may not be recorded, either by mistake or deliberately, the latter of which would constitute fraud.
Significant Transactions	A lack of business rationale for significant transactions (unusual or outside the normal course of business) could be intended to manipulate the financial statements or to conceal misappropriation of assets.
Journal Entries	Inappropriate or unauthorized journal entries may have occurred throughout the period or at period end. These could be used to manipulate amounts reported in the financial statements.
Errors in Estimates	Management estimates may calculate incorrectly, overlook or misinterpret certain facts, use faulty assumptions, or contain some element of bias if the entity's estimate falls outside an acceptable range. Estimates could also be deliberately misstated to manipulate financial statement results.
Errors in Fair Values	There may be disagreements with management's judgments with respect to the fair value of certain assets, liabilities, and components of equity required to be measured or disclosed at fair values in accordance with the financial framework.
Selection and Application of Accounting Policies	There may be disagreements with management with regard to the selection and use of certain accounting policies.
Uncorrected Misstatements in Opening Equity	Uncorrected misstatements from prior periods would be reflected in opening equity. If not adjusted, they may also cause a misstatement in the current period financial statements.
Revenue Recognition	Overstatement or understatement of revenues (e.g., premature revenue recognition, recording fictitious revenues, or improperly shifting revenues to a later period).

Source	Description
Internal Control Weaknesses	Misstatements could result from unexpected deficiencies in internal control. These would be discussed or reported to management, and consideration would be given to performing additional work to identify other misstatements that may exist.
Financial Statement Presentation or Disclosures	Certain financial statement disclosures required by the accounting framework may be omitted, incomplete, or inaccurate.

Aggregating Identified Misstatements

Misstatements identified during the audit, other than those that are clearly trivial, should be aggregated. They can also be distinguished between factual misstatements, judgmental misstatements, and projected misstatements.

CONSIDER POINT

Most quantitative misstatements can be aggregated so that the overall impact on the financial statements can be evaluated. However, some misstatements (such as incomplete or inaccurate financial statement disclosures) and qualitative findings (such as the possible existence of fraud) cannot be aggregated. These misstatements should be documented and evaluated on an individual basis.

To enable the aggregate effect of uncorrected misstatements to be evaluated, they can be documented on a centrally maintained working paper. This will provide a summary of all non-trivial uncorrected misstatements that have been identified.

There are a number of stages in the aggregation process where the impact of aggregated misstatements can be considered, as follows.

Exhibit 21.4-2

	Impact of Aggregated Misstatements
Consider Impact of Uncorrected Misstatements on:	Each particular account balance or class of transactions
	Total current assets and current liabilities
	Total assets and liabilities
	Total revenues and expenses (pre-tax income)
	Net income

A possible approach to the aggregation of misstatements is illustrated in the following exhibit.

Note: For this example, misstatements of up to Rs.100 have been deemed trivial and will therefore not be accumulated.

Exhibit 21.4-3

Summary of Identified Misstatements

			Amount of Over (Under) Statement				
Description	Circumstances of Occurrence	WP Ref.	Assets	Liabilities	Pre-tax Income	Equity	Corrected?
Failure to accrue for rent liability	Factual—Resulting from oversight			(5,500)	5,500	4,125	Yes
Unrecorded sales	Projection from representative		(12,500)		(12,500)	(9,375)	Yes
Receivables netted with payables	Factual—Classification error		(5,500)	(5,500)			Yes
Capital equipment expensed	Judgment—Error in applying accounting policy		(13,500)		(13,500)	(10,125)	Yes
Total of identified misstatements during the audit			(31,500)	(11,000)	(20,500)	(15,375)	
Misstatements corrected by management			31,500	11,000	20,500	15,375	
Total uncorrected misstatements			0	0	0	0	

Identified misstatements are to be discussed with management on a timely basis along with the request to correct them. Corrections could affect financial statement balances or rectify inadequate financial statement disclosures. The steps involved in addressing identified misstatements are set out below.

Exhibit 21.4-4

Addressing Identified Misstatements	
Re-evaluate Materiality	Consider whether it may be necessary to revise the overall materiality prior to evaluating the effect of uncorrected misstatements, based on the actual financial results.
Consider the Reasons and Impact on Audit Plan	Consider the reasons for the misstatements identified during the audit. This includes: • Potential indicators of fraud; • Possible existence of other misstatements; • Existence of an unidentified risk; or • A significant deficiency in internal control. In light of the findings above, determine whether the overall audit strategy and audit plan need to be revised. This would be necessary when: • Other misstatements may exist that, when aggregated with misstatements accumulated during the audit, could be material; or • The aggregate of misstatements accumulated during the audit approaches materiality.

Addressing Identified Misstatements	
Request Management to Make Corrections	Ask management to correct **all** identified misstatements, other than those that are clearly trivial.
Ask Management to Perform Additional Procedures	If the precise amount of misstatement in a population is not known (such as in a projection of misstatements identified in an audit sample), ask management to perform procedures to determine the amount of the actual misstatement, and then to make appropriate adjustments to the financial statements. Where this occurs, some additional audit procedures will be necessary by the auditor to determine whether any misstatements remain.
Management Refuses to Correct Some or All Misstatements	If management refuses to correct some or all of the misstatements: Obtain an understanding of management's reasons for not making the corrections, and take this understanding into account when evaluating whether the financial statements are materially misstated; • Communicate uncorrected misstatements with those charged with governance, including their effect on the opinion in the auditor's report (unless prohibited by law or regulation); and • Request that those charged with governance correct the misstatements that remain uncorrected by management.

In forming a conclusion as to whether the uncorrected misstatements (individually or in aggregate) would cause the financial statements as a whole to be materially misstated, the auditor would consider the factors listed in the exhibit below.

Exhibit 21.4-5

	Consider
Is There a Material Misstatement?	The size and nature of misstatements, in relation to: • The financial statements as a whole; • Particular classes of transactions, account balances, and disclosures; and • The particular circumstances of their occurrence.
	The limitations inherent in judgmental or statistical testing. There is always the possibility that some misstatements may not be found.
	How close is the likely level of aggregate uncorrected misstatement to materiality level(s)? The risks of material misstatement increase as the likely aggregate misstatement approaches the materiality threshold.
	Quantitative considerations or the possibility of fraud where misstatements of a relatively small amount could have a material effect on the financial statements.
	The effect of uncorrected misstatements related to prior periods.

It is management's responsibility to adjust the financial statements to correct material misstatements (including inadequate disclosures) and to implement any other actions required.

Qualitative Considerations

Some misstatements may be evaluated as material (individually or when considered together with other misstatements accumulated during the audit), even if they are lower than overall materiality. Examples of such matters are set out below.

Exhibit 21.4-6

Misstatements that:	Description
Affect Compliance	Non-compliance with regulatory requirements, debt covenants, or other contractual requirements.
Mask Changes	For example, change in earnings or other trends, especially in the context of general economic and industry conditions.
Increase Management Compensation	Misstatement that would ensure that the requirements for bonuses or other compensation incentives is satisfied.
Impact Other Parties	For example, external and related parties.
Affect Users' Understanding	Omission of information (not specifically required) but in the judgment of the auditor is important to the users' understanding of the financial position, financial performance, or cash flows of the entity.
Are Immaterial Now But Significant in Future	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.
Bank Covenants	A relatively small amount could be highly material to the entity if it resulted in the breach of a banking or loan covenant.
Affects Performance Ratios	Affects ratios used to evaluate the entity's financial position, results of operations, or cash flows.

Written Representations

Management's responsibility is to be evidenced by obtaining a written representation from management. This representation will state that any uncorrected misstatements (attach or include a list) are, in management's opinion, immaterial both individually and in the aggregate. If management disagrees with the assessment of misstatements, it may add to its written representation words such as:

"We do not agree that items...and...constitute misstatements because [description of reasons]."

Note: When the auditor communicates findings with those charged with governance, there is a requirement to identify material uncorrected misstatements individually.

Where uncorrected misstatements by management are reported to those charged with governance and corrections are still not made, the auditor is required to obtain a similar representation. This would state that those charged with governance also believe that the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items is also to be included in or attached to the written representation.

21.5 Sufficient Appropriate Audit Evidence

Paragraph #	Relevant Extracts from SLAuSs
330.26	The auditor shall conclude whether sufficient appropriate audit evidence has been obtained. In forming an opinion, the auditor shall consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the assertions in the financial statements. (Ref: Para. A62)
330.27	If the auditor has not obtained sufficient appropriate audit evidence as to a material financial statement assertion, the auditor shall attempt to obtain further audit evidence. If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall express a qualified opinion or disclaim an opinion on the financial statements.

The overall objective is to obtain sufficient appropriate evidence to reduce the risks of material misstatement in the financial statements to an acceptably low level.

What constitutes sufficient appropriate audit evidence is ultimately a matter of professional judgment. It will be primarily based on the satisfactory performance of further audit procedures designed to address the assessed risks of material misstatement. This includes any additional or modified procedures that were performed to address changes identified in the original assessment of risk. Some of the factors to consider in evaluating the sufficiency and appropriateness of audit evidence include the factors outlined in the exhibit below.

Exhibit 21.5-1

Evaluating the Sufficiency and Appropriateness of Audit Evidence	
Factors to Consider	**Materiality of misstatements** • How significant is a misstatement in the assertion being addressed, and what is the likelihood of it having a material effect (individually or aggregated with other potential misstatements) on the financial statements? **Management responses** • How responsive is management to audit findings, and how effective is the internal control in addressing risk factors? **Previous experience** • What has been the previous experience in performing similar procedures, and were any misstatements identified? **Results of performed audit procedures** • Do the results of performed audit procedures support the objectives, and is there any indication of fraud or error? **Quality of information** • Are the source and reliability of the available information appropriate for supporting the audit conclusions? **Persuasiveness** • How persuasive (convincing) is the audit evidence? **Understanding the entity** • Does the evidence obtained support or contradict the results of the risk assessment procedures (which were performed to obtain an understanding of the entity and its environment, including internal control)?

If it is not possible to obtain sufficient appropriate audit evidence, the auditor would express a qualified opinion or a disclaimer of opinion.

21.6 Final Analytical Procedures

Paragraph #	Relevant Extracts from SLAuSs
520.6	The auditor shall design and perform analytical procedures near the end of the audit that assist the auditor when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity. (Ref: Para. A17-A19)

In addition to performing analytical procedures for the purposes of risk assessment and then later as a substantive procedure, the auditor is required to apply analytical procedures at, or near the end of, the audit when forming an overall conclusion (SLAuS 520).

The objectives for carrying out these final analytical procedures are to:

- Identify a previously unrecognized risk of material misstatement;
- Ensure that the conclusions formed during the audit on individual components or elements of the financial statements can be corroborated; and
- Assist in arriving at the overall conclusion as to the reasonableness of the financial statements.

If new risks or unexpected relationships between data are identified, the auditor may need to re-evaluate the audit procedures planned or performed.

21.7 Significant Findings and Issues

The final step in the evaluation process is to record all the significant findings or issues in an engagement completion document. This document may include:

- All information necessary to understand the significant findings or issues; or
- Cross-references, as appropriate, to other available supporting audit documentation.

This document would also include conclusions about information the auditor has identified relating to significant matters that are inconsistent with or contradict the auditor's final conclusions. However, this requirement does not extend to retention of documentation that is incorrect or superseded, such as drafts of financial statements that may have been incomplete.

21.8 Case Studies—Evaluating Audit Evidence

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

As a result of performing the planned audit procedures, the following unadjusted misstatements and matters were noted.

Case Study A—Dephta Furniture, Inc.

February 18, 20x3

Extract from the Summary of Possible Adjustments – Dephta

Description	Circumstances of Occurrence	WP Ref	Amount of Over (Under) Statement: Assets	Liabilities	Pre-tax Income	Equity	Corrected?
Errors in inventory valuation calculation.	*New clerk made some mistakes.*	*D.300*	*(19,000)*		*(19,000)*	*(15,200)*	*Yes*
Personal expenses paid through Dephta and not added to shareholder account.	*Found during expense testing. This prompted some additional work to find similar items.*	*550.8*		*(4,800)*	*(4,800)*	*(3840)*	*Yes*
Customer account over 90 days and no subsequent payments received.	*Review of aging and subsequent payments.*	*C.305*	*12,000*		*12,000*	*9,600*	*Yes*
Total of identified misstatements during the audit			*(7,000)*	*(4,800)*	*(11,800)*	*(9.440)*	
Misstatements corrected by management			*(7,000)*	*(4,800)*	*(11,800)*	*(9,440)*	
Total uncorrected misstatements			*0*	*0*	*0*	*0*	

A cross-reference would also be provided in the listing above to where additional work has been performed to ensure other similar misstatements do not exist or that the misstatement is not indicative of a more serious issue such as management override.

Extract from the Memo to File Regarding Evaluation of Audit Evidence

Audit Finding	Planned Response
A number of clerical errors in the inventory valuation resulted in an understatement of Rs.19,000 worth of inventory.	*The nature of the errors should be reviewed to identify any area of weakness in internal control.* *Additional work should be performed to ensure that all significant errors have now been discovered.* *Include comment in management letter.*
During expense testing, it was discovered that Rs4,800 of equipment maintenance expenses were related to the service costs of Suraj's personal Mercedes-Benz SUv.	*Additional work should be performed to identify any other unidentified transactions that relate to personal use. If others are found, consider whether this is a lapse in management's integrity and an indicator of possible fraud.*
During the accounts receivable testing, we noted that some accounts were greater than 90 days and no payments had been received on these accounts during our accounts receivable testing. Although Suraj assured us these accounts are collectable (since the customer has confirmed the balance), collection seems unlikely. Recorded as an unadjusted error.	*Continue to monitor cash receipts to the date of the subsequent events' work. Review the collection history of the clients in the past and try to obtain more information about the companies.*
Some of the tools and equipment in the accounting records do not seem to be used anymore. Machines have been purchased that do the same work in a fraction of the time. Management still feels the assets have value, as they would still be used in the event of a machine breakdown.	*Inquire whether the tools and equipment were in fact used in the past period.* *Determine the capital cost of the tools and equipment and whether a write-down is required.*

Case Study B — Kumar & Co.

Extract from Memo on Summary of Possible Adjustments

Inventory

Inventory listing from our inventory count did not tie into the final listing—understated inventory by Rs. 1,800 and income by Rs.1,800; see WP D.108.

Audit Response

Error was caused by Ruby not using the final inventory listing. Our substantive procedures will be expanded to ensure that all adjustments discussed at the count have been reflected in the final listing.

Accounts Payable Cutoff Error

Ruby did not accrue for a major repair and service to the lathe. Caught during subsequent payments testing. See WP CC.110. Affects liabilities and pre-tax income by Rs.900.

Audit Response

Should expand scope of our cutoff testing, since it appears Ruby was too busy this period to keep a listing of all expenses paid subsequent to period end that related to fiscal year 20X2. Threshold for testing lowered to Rs.400

Management has agreed to correct these misstatements.

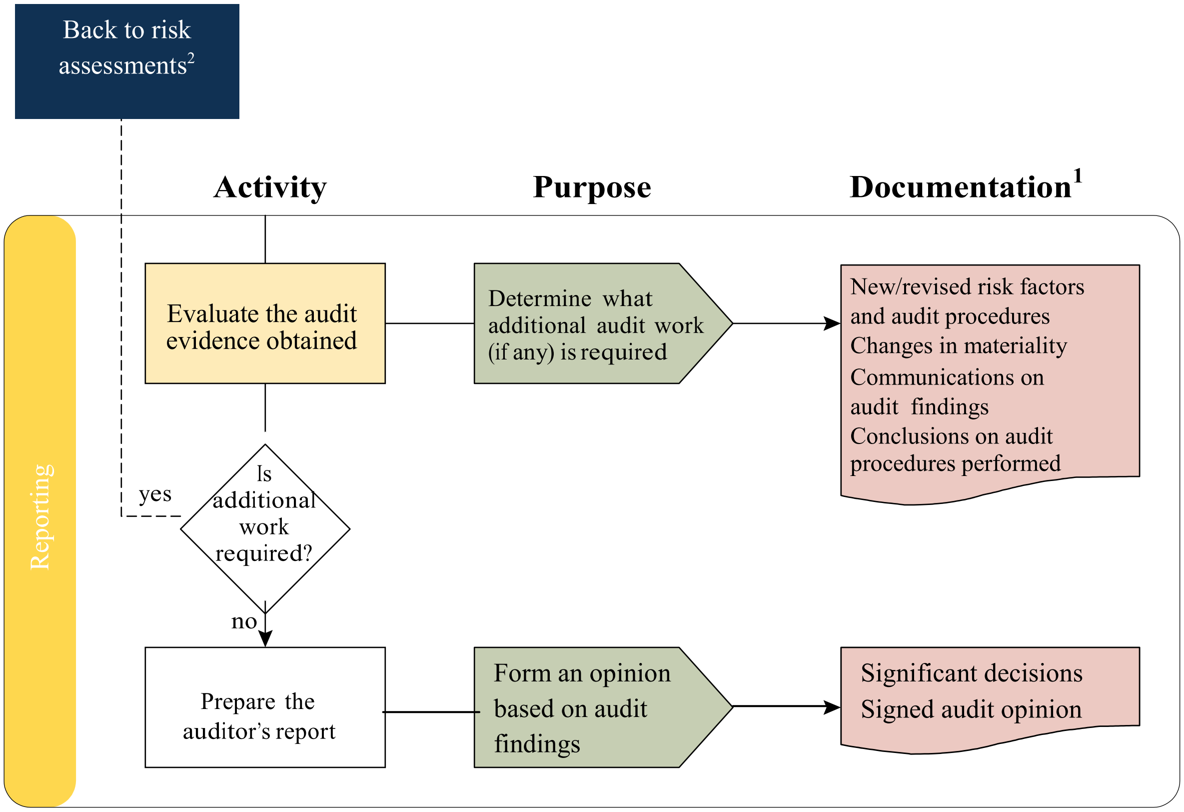
Prepared by: FJ **Date:** February 24, 20X3

Reviewed by: LF **Date:** March 5, 20X3

22. Communicating With Those Charged With Governance

Chapter Content	Relevant SLAuSs
Guidance on how to promote an effective two-way communication between the auditor and those charged with governance, and what audit findings and other matters are to be communicated.	260, 265, 450

Exhibit 22.0-1



Notes:

1. Refer to SLAuS 230 for a more complete list of documentation required.
2. Planning (SLAuS 300) is a continual and iterative process throughout the audit.

Paragraph #	SLAuS Objective(s)
260.9	The objectives of the auditor are: (a) To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit; (b) To obtain from those charged with governance information relevant to the audit; (c) 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 (d) To promote effective two-way communication between the auditor and those charged with governance.

Paragraph #	Relevant Extracts from SLAuSs
260.10	For purposes of the SLAuSs, the following terms have the meanings attributed below: (a) Those charged with governance—The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. For some entities in some jurisdictions, those charged with governance may include management personnel, for example, executive members of a governance board of a private or public sector entity, or an owner-manager. For discussion of the diversity of governance structures, see paragraphs A1-A8. (b) Management—The person(s) with executive responsibility for the conduct of the entity's operations. For some entities in some jurisdictions, management includes some or all of those charged with governance, for example, executive members of a governance board, or an owner-manager.
260.11	The auditor shall determine the appropriate person(s) within the entity's governance structure with whom to communicate. (Ref: Para. A1-A4)
260.12	If the auditor communicates with a subgroup of those charged with governance, for example, an audit committee, or an individual, the auditor shall determine whether the auditor also needs to communicate with the governing body. (Ref: Para. A5-A7)
260.13	In some cases, all of those charged with governance are involved in managing the entity, for example, a small business where a single owner manages the entity and no one else has a governance role. In these cases, if matters required by this SLAuS are communicated with person(s) with management responsibilities, and those person(s) also have governance responsibilities, the matters need not be communicated again with those same person(s) in their governance role. These matters are noted in paragraph 16(c). The auditor shall nonetheless be satisfied that communication with person(s) with management responsibilities adequately informs all of those with whom the auditor would otherwise communicate in their governance capacity. (Ref: Para. A8)
260.14	The auditor shall communicate with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, including that: (a) The auditor is responsible for forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance; and (b) The audit of the financial statements does not relieve management or those charged with governance of their responsibilities. (Ref: Para. A9-A10)

Paragraph #	Relevant Extracts from SLAuSs
260.15	The auditor shall communicate with those charged with governance an overview of the planned scope and timing of the audit. (Ref: Para. A11-A15)
260.16	The auditor shall communicate with those charged with governance: (Ref: Para. A16) (a) The auditor's views about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures. When applicable, the auditor shall explain to those charged with governance why the auditor considers a significant accounting practice, that is acceptable under the applicable financial reporting framework, not to be most appropriate to the particular circumstances of the entity; (Ref: Para. A17) (b) Significant difficulties, if any, encountered during the audit; (Ref: Para. A18) (c) Unless all of those charged with governance are involved in managing the entity: (i) Significant matters, if any, arising from the audit that were discussed, or subject to correspondence with management; and (Ref: Para. A19) (ii) Written representations the auditor is requesting; and (d) Other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process. (Ref: Para. A20)
260.18	The auditor shall communicate with those charged with governance the form, timing and expected general content of communications. (Ref: Para. A28-A36)
260.19	The auditor shall communicate in writing with those charged with governance regarding significant findings from the audit if, in the auditor's professional judgment, oral communication would not be adequate. Written communications need not include all matters that arose during the course of the audit. (Ref: Para. A37-A39)
260.21	The auditor shall communicate with those charged with governance on a timely basis. (Ref: Para. A40 -A41)
260.22	The auditor shall evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purpose of the audit. If it has not, the auditor shall evaluate the effect, if any, on the auditor's assessment of the risks of material misstatement and ability to obtain sufficient appropriate audit evidence, and shall take appropriate action. (Ref: Para. A42-A44)
260.23	Where matters required by this SLAuS to be communicated are communicated orally, the auditor shall include them in the audit documentation, and when and to whom they were communicated. Where matters have been communicated in writing, the auditor shall retain a copy of the communication as part of the audit documentation. (Ref: Para. A45)
265.09	The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. (Ref: Para. A12-A18, A27)
450.12	The auditor shall communicate with those charged with governance uncorrected misstatements and the effect that they, individually or in aggregate, may have on the opinion in the auditor's report, unless prohibited by law or regulation. The auditor's communication shall identify material uncorrected misstatements individually. The auditor shall request that uncorrected misstatements be corrected. (Ref: Para. A21-A23)
450.13	The auditor shall also communicate with those charged with governance the effect of uncorrected misstatements related to prior periods on the relevant classes of transactions, account balances or disclosures, and the financial statements as a whole.

22.1 Overview

Effective two-way communication between the auditor and those charged with governance is an important element of every audit. This enables:

- The auditor to communicate required and other matters; and
- Those charged with governance to provide the auditor with information that might not otherwise have been available. This information could be helpful to the auditor in planning and evaluating the results.

22.2 Governance

Governance structures vary by jurisdiction and by entity, reflecting influences such as different cultural and legal backgrounds, and size and ownership characteristics. In most entities, governance is the collective responsibility of a governing body, such as a board of directors, a supervisory board, partners, proprietors, a committee of management, a council of governors, trustees, or equivalent persons.

In smaller entities, one person may be charged with governance—for example, the owner-manager where there are no other owners, or a sole trustee. In these cases, if matters are required to be communicated with management, they need not be communicated again with those same person(s) in their governance role. However, where there is more than one person charged with governance of the entity (such as other family members), the auditor would take steps to ensure that every person is adequately informed.

In other entities, where governance is a collective responsibility, the auditor's communications may be directed to a subgroup of those charged with governance, such as an audit committee. In these cases, the auditor would determine whether there is also a need to communicate with the entire governing body. This determination would be based on:

- The respective responsibilities of the subgroup and the governing body;
- The nature of the matter to be communicated;
- Relevant legal or regulatory requirements; and
- Whether the subgroup has the authority to take action in relation to the information communicated, and can provide further information and explanations the auditor may need.

Where the appropriate person(s) with whom to communicate may not be clearly identifiable from the applicable legal framework or other engagement circumstances, the auditor may need to discuss and agree with the engaging party the relevant person(s) with whom to communicate. In deciding with whom to communicate, the auditor's understanding of an entity's governance structure and processes would be relevant. The appropriate person(s) with whom to communicate may also vary depending on the matter to be communicated.

When the entity is a component of a group, the appropriate person(s) with whom the component auditor communicates depends on the engagement circumstances and the matter to be communicated. In some cases, a number of components may be conducting the same businesses within the same system of internal control and using the same accounting practices. Where those charged with governance of those components are the same (e.g., common board of directors), duplication may be avoided by dealing with these components concurrently for the purpose of communication.

22.3 Matters to be Communicated

Audit matters of governance interest include:

- Auditor's responsibilities in relation to the financial statement audit;
- Planned scope and timing of the audit; and
- Significant findings arising from the audit.

The auditor is not required to design audit procedures for the specific purpose of identifying matters of governance interest, unless specifically requested or required by country-specific auditing standards or by legislation.

In some cases, local requirements, laws, or regulations may impose obligations of confidentiality that restrict the auditor's communications. Reference would be made to such requirement before communicating with those charged with governance.

CONSIDER POINT

Take the time to develop constructive working relationships with those charged with governance. This will help to improve the effectiveness of communications between the parties.

Auditor's Responsibilities

Those charged with governance are to be informed about significant matters relevant to their role of overseeing the financial reporting process. This includes communicating that:

- The audit of the financial statements does not relieve management or those charged with governance of their responsibilities; and
- The auditor's responsibilities include:
  - Forming and expressing an opinion on the financial statements that have been prepared by management with the oversight of those charged with governance, and
  - Communicating significant matters arising from the audit of the financial statements.

This requirement can often be met by providing those charged with governance with a copy of the audit engagement letter. This will inform those charged with governance about the matters set out below.

Exhibit 22.3-1

	Nature of Communication
Provide a Copy of Audit Engagement Letter	The auditor's responsibility for performing the audit in accordance with SLAuSs.
	The SLAuS requirements that significant matters arising from the audit, relevant to those charged with governance in overseeing the financial reporting, will be communicated.
	SLAuSs do not require the auditor to design procedures for the purpose of identifying supplementary matters to communicate with those charged with governance.
	The auditor's responsibility (where applicable) for communicating particular matters required by law or regulation, by agreement with the entity, or by additional requirements applicable to the engagement (e.g., the standards of a national professional accountancy body).

Planned Scope and Timing of the Audit

The purpose of discussing audit planning is to promote two-way communication between the auditor and those charged with governance. However, care must be taken not to provide detailed information (such as the nature and timing of specific audit procedures) that could compromise the effectiveness of the audit. This is of particular concern where some or all of those charged with governance are involved in managing the entity.

Matters to be discussed would include those set out below.

Exhibit 22.3-2

	Description
The Audit Plan	General details of the audit plan, scope, and timing.
	The application of the concept of materiality in the audit.
	How significant risks of material misstatement, whether due to fraud or error, will be addressed.
	Approach to internal control relevant to the audit.
	Significant changes in accounting standards and the likely impact.
Obtain Input from Those Charged With Governance (That May Impact Audit Plans)	Discussion about the entity’s objectives and strategies, any significant communications with regulators, and the related business risks that may result in material misstatements.
	Description of the oversight exercised over: • Adequacy of internal control, including the risks of fraud; • Competency and integrity of management; and • Responses to previous communications with the auditor.
	Matters that warrant particular attention during the audit.
	Requests for the auditor to undertake additional procedures.
	Other matters that may influence the audit of the financial statements.

Significant Findings from the Audit

Except where a matter relates to management’s competence or integrity, the auditor would initially discuss audit matters of governance interest with management. These initial discussions serve to clarify the facts and issues, and give management an opportunity to provide further information.

Appendix 1 to SLAuS 260 (reproduced below) provides a list of specific matters requiring communication with those charged with governance. These requirements have been addressed in other parts of the Audit Manual.

Exhibit 22.3-3

SLAuS #	Specific Communication Requirements	Paragraph
SLSQC 1	*Quality Controls for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*	30(a)
SLAuS 240	*The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*	21, 38(c)(i), 40-42
SLAuS 250	*Consideration of Laws and Regulations in an Audit of Financial Statements*	14, 19, 22-24
SLAuS 265	*Communicating Deficiencies in Internal Control to Those Charged With Governance and Management*	9
SLAuS 450	*Evaluation of Misstatements Identified during the Audit*	12-13
SLAuS 505	*External Confirmations*	9
SLAuS 510	*Initial Audit Engagements—Opening Balances*	7
SLAuS 550	*Related Parties*	27
SLAuS 560	*Subsequent Events*	7(b)-(c), 9, 10(a), 13(b), 14(a), 17
SLAuS 570	*Going Concern*	23
SLAuS 600	*Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*	49
SLAuS 705	*Modifications to the Opinion in the Independent Auditor's Report*	12, 14, 19(a), 28
SLAuS 706	*Emphasis of Matter and Other Matter Paragraphs in the Independent Auditor's*	9
SLAuS 710	*Comparative Information—Corresponding Figures and Comparative Financial*	18
SLAuS 720	*The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*	10, 13, 16

Some of the more common matters of governance interest that may be communicated (preferably in writing) are outlined in the following exhibit.

Exhibit 22.3-4

Audit Matters	Communication Considerations
Accounting Policies	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.
Prior Period Communications	Matters of governance interest previously communicated that could have an effect on the current period's financial statements.
Risks of Material Misstatement	The potential effect on the financial statements of any material risks (such as pending litigation) that require disclosure in the financial statements.
Material Uncertainties	Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern.
Concerns	Business conditions affecting the entity and its business plans and strategies that may affect the risks of material misstatement. Concerns about management's consultations with other accountants on accounting or auditing matters.
Significant Difficulties Encountered	This could include: • Resolution of difficult accounting or audit issues; • Unavailable documents required for the audit; • Personnel unable to answer questions; • Scope limitations and how they were resolved; and • Disagreements with management about matters that, individually or in aggregate, could be significant to the entity's financial statements or the auditor's report.
Comments on Entity Management	Questions regarding management's competence: • Significant deficiencies in internal control; • Questions regarding management's integrity; • Significant transactions with related parties; • Illegal acts; and • Fraud involving management.
Audit Adjustments	Uncorrected audit adjustments that have or could have a material effect on the entity's financial statements.
Uncorrected Misstatements	Uncorrected misstatements that were determined by management to be immaterial (other than trivial amounts), both individually and in the aggregate, to the financial statements taken as a whole.
The Auditor's Report	Outline the reasons for any expected modifications to the auditor's report.
Agreed-Upon Matters	Any other matters agreed upon in the terms of the audit engagement.
Other Matters	Other matters, if any, arising from the audit that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process.

CONSIDER POINT

Communicate significant matters in writing where possible. A letter or report provides a document shared by both parties that outlines the matters to be communicated. If the required matters are communicated verbally, take minutes of the meeting that can be shared with the entity to form an appropriate record that the communication took place.

Documentation

Where matters required to be communicated by an SLAuS are communicated orally, prepare notes for the file describing when and to whom these matters were communicated. Where matters have been communicated in writing, retain a copy of the communication as part of the audit documentation.

Timeliness

Ensure that audit matters of interest are communicated on a timely basis so that those charged with governance can take appropriate action.

22.4 Case Studies—Communicating with Those Charged With Governance

For details of the case studies, refer to Volume 2, Chapter 2—Introduction to the Case Studies.

Case Study A—Dephta Furniture, Inc.

Audit Matters of Governance Interest

The following is an extract from the letter sent to management and those charged with governance.

Jamel, Woodwind & Wing LLP
55 Kingston St., Cabetown, United Territories 123-53004

March 15, 20X3

Mr. Suraj Dephta, Managing Director
Dephta Furniture
2255 West Street
North Cabetown
United Territories
123-50214

Dear Mr. Dephta,

The matters raised in this report arise from our financial statement audit and relate to matters that we believe need to be brought to your attention.

We have substantially completed our audit of Dephta Furniture's financial statements in accordance with professional standards. We expect to release our audit report dated March 20, 20X3 as soon as we obtain the signed letter of representation.

Our audit is performed to obtain reasonable assurance whether the financial statements are free of material misstatements. Absolute assurance is not possible due to the inherent limitations of an audit and of internal control, resulting in the unavoidable risk that some material misstatements may not be detected.

In planning our audit, we consider internal control over financial reporting to determine the nature, extent, and timing of audit procedures. However, a financial statement audit does not provide assurance on the effective operation of internal control at Dephta Furniture. However, if in the course of our audit, certain deficiencies in internal control come to our attention, these will be reported to you. Please refer to Appendix A to this letter (not included).

Because fraud is deliberate, there are always risks that material misstatements, fraud, and other illegal acts may exist and not be detected by our audit of the financial statements.

The following is a summary of findings resulting from the performance of the audit.

1. We did not identify any material matters (other than the identified misstatements already discussed with you and have now been corrected) that need to brought to your attention.
2. We received good cooperation from management and employees during our audit. To the best of our knowledge, we also had complete access to the accounting records and other documents that we needed in order to carry out our audit. We did not have any disagreements with management, and we have resolved all auditing, accounting, and disclosure issues to our satisfaction.

We would also like to draw the following matters to your attention:

- Changes during the period in professional pronouncements. See Appendix B. (not included)
- Other matters identified that may be of interest to management. See Appendix C. (not included)

Please note that Sri Lanka Auditing Standards do not require us to design procedures for the purpose of identifying supplementary matters to communicate with those charged with governance. Accordingly, an audit would not usually identify all such matters.

This communication is prepared solely for the information of management and is not intended for any other purpose. We accept no responsibility to a third party who uses this communication.

Yours truly,

____

Sang Jun Lee
Jamel, Woodwind & Wing LLP

Case Study B—Kumar & Co.

MEMO TO FILE: Communication to those Charged with Governance

Audit Adjustments and Findings

We discussed the adjustments to the inventory balance and the accounts payable accruals with Raj. He indicated that because of his family issues, he had not spent as much time supervising Ruby and approving transactions this period, so he was not surprised that things were missed. He did promise to ensure that Ruby tracks accounts paid subsequent to the period end for accrual purposes better next period.

We indicated that except for the adjustments found, we had not found any other material issues during our audit and that Ruby had been very helpful.

Other Recommendations

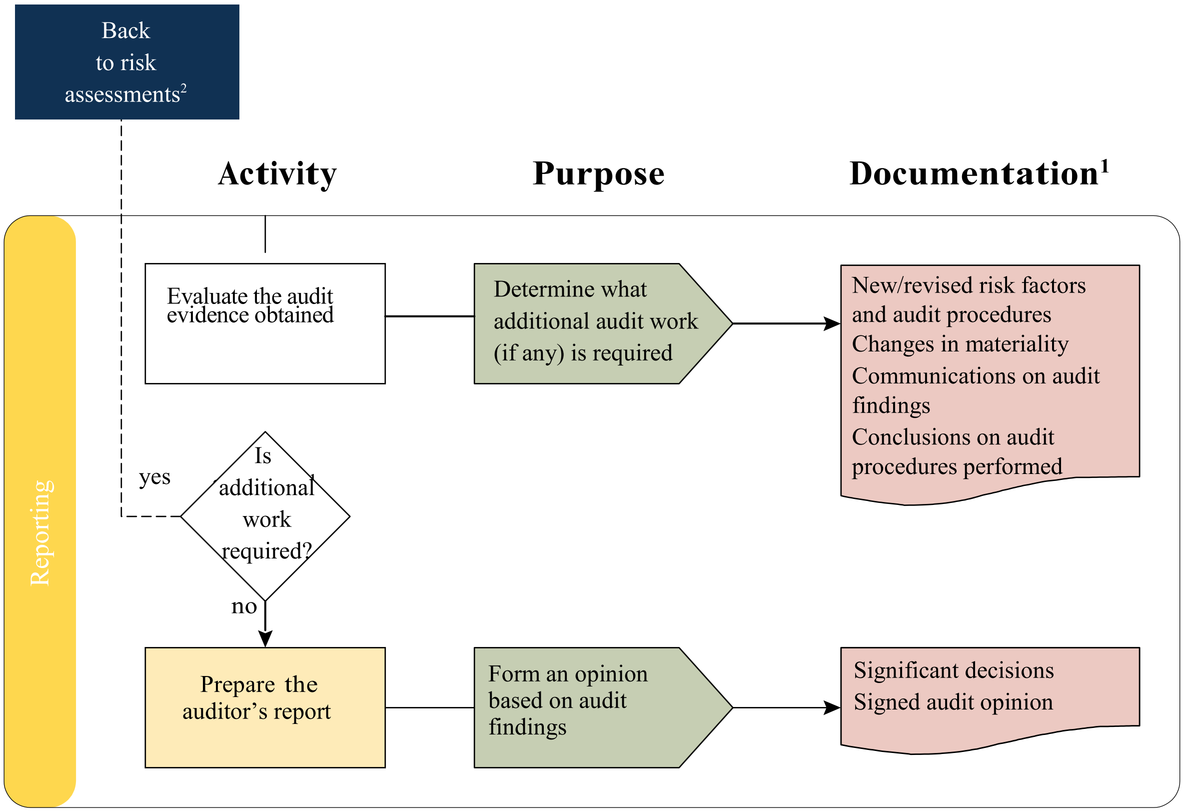
During our IT control discussion, we had become aware that Ruby has never tested the back-up for the accounting package and recommended that Raj test the back-up to make sure that the accounting records could be backed up. In the event of a crash, a loss of accounting records would have a significant impact on our ability to perform an audit.

Prepared by: SL Date: March 16, 20X3

23. Modifications to the Auditor's Report

Chapter Content	Relevant SLAuS
Guidance on how to express an appropriately modified opinion on financial statements when necessary.	705

Exhibit 23.0-1



Notes:

1. Refer to SLAuS 230 for a more complete list of documentation required.
2. Planning (SLAuS 300) is a continual and iterative process throughout the audit.

Paragraph #	SLAuS Objective(s)
705.4	The objective of the auditor is to express clearly an appropriately modified opinion on the financial statements that is necessary when: (a) The auditor concludes, based on the audit evidence obtained, that the financial statements as a whole are not free from material misstatement; or (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Paragraph #	Relevant Extracts from SLAuSs
705.5	For purposes of the SLAuSs, the following terms have the meanings attributed below: (a) Pervasive—A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's judgment: (i) Are not confined to specific elements, accounts or items of the financial statements; (ii) If so confined, represent or could represent a substantial proportion of the financial statements; or (iii) In relation to disclosures, are fundamental to users' understanding of the financial statements. (b) Modified opinion—A qualified opinion, an adverse opinion or a disclaimer of opinion.
705.6	The auditor shall modify the opinion in the auditor's report when: (a) The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or (Ref: Para. A2-A7) (b) The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement. (Ref: Para. A8-A12)
705.7	The auditor shall express a qualified opinion when: (a) The auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or (b) The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.
705.8	The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.
705.9	The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.
705.10	The auditor shall disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, notwithstanding having obtained sufficient appropriate audit evidence regarding each of the individual uncertainties, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

Paragraph #	Relevant Extracts from SLAuSs
705.11	If, after accepting the engagement, the auditor becomes aware that management has imposed a limitation on the scope of the audit that the auditor considers likely to result in the need to express a qualified opinion or to disclaim an opinion on the financial statements, the auditor shall request that management remove the limitation.
705.12	If management refuses to remove the limitation referred to in paragraph 11, the auditor shall communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity, and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence.
705.13	If the auditor is unable to obtain sufficient appropriate audit evidence, the auditor shall determine the implications as follows: (a) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive, the auditor shall qualify the opinion; or (b) If the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive so that a qualification of the opinion would be inadequate to communicate the gravity of the situation, the auditor shall: (i) Withdraw from the audit, where practicable and possible under applicable law or regulation; or (Ref: Para. A13-A14) (ii) If withdrawal from the audit before issuing the auditor's report is not practicable or possible, disclaim an opinion on the financial statements.
705.14	If the auditor withdraws as contemplated by paragraph 13(b)(i), before withdrawing, the auditor shall communicate to those charged with governance any matters regarding misstatements identified during the audit that would have given rise to a modification of the opinion. (Ref: Para. A15)
705.15	When the auditor considers it necessary to express an adverse opinion or disclaim an opinion on the financial statements as a whole, the auditor's report shall not also include an unmodified opinion with respect to the same financial reporting framework on a single financial statement or one or more specific elements, accounts or items of a financial statement. To include such an unmodified opinion in the same report in these circumstances would contradict the auditor's adverse opinion or disclaimer of opinion on the financial statements as a whole. (Ref: Para. A16)
705.16	When the auditor modifies the opinion on the financial statements, the auditor shall, in addition to the specific elements required by SLAuS 700, include a paragraph in the auditor's report that provides a description of the matter giving rise to the modification. The auditor shall place this paragraph immediately before the opinion paragraph in the auditor's report and use the heading "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion," as appropriate. (Ref: Para. A17)
705.17	If there is a material misstatement of the financial statements that relates to specific amounts in the financial statements (including quantitative disclosures), the auditor shall include in the basis for modification paragraph a description and quantification of the financial effects of the misstatement, unless impracticable. If it is not practicable to quantify the financial effects, the auditor shall so state in the basis for modification paragraph. (Ref: Para. A18)
705.18	If there is a material misstatement of the financial statements that relates to narrative disclosures, the auditor shall include in the basis for modification paragraph an explanation of how the disclosures are misstated.

Paragraph #	Relevant Extracts from SLAuSs
705.19	If there is a material misstatement of the financial statements that relates to the non-disclosure of information required to be disclosed, the auditor shall: (a) Discuss the non-disclosure with those charged with governance; (b) Describe in the basis for modification paragraph the nature of the omitted information; and (c) Unless prohibited by law or regulation, include the omitted disclosures, provided it is practicable to do so and the auditor has obtained sufficient appropriate audit evidence about the omitted information. (Ref: Para. A19)
705.20	If the modification results from an inability to obtain sufficient appropriate audit evidence, the auditor shall include in the basis for modification paragraph the reasons for that inability.
705.21	Even if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor shall describe in the basis for modification paragraph the reasons for any other matters of which the auditor is aware that would have required a modification to the opinion, and the effects thereof. (Ref: Para. A20)

23.1 Overview

The auditor is required to clearly express an appropriately modified opinion on financial statements in situations such as those set out below.

Exhibit 23.1-1

	Situations
Modified Report Necessary *(Qualified, Adverse, or Disclaimer of Opinion)*	**Financial Statements Are Materially Misstated** Based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement. This would include uncorrected misstatements that are material, the appropriateness or application of accounting principles, and the failure to disclose information that results in a material misstatement.
	Inability To Obtain Sufficient Appropriate Audit Evidence Unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement. This could include: • Circumstances beyond the control of the entity, such as a fire that damaged accounting records; • Circumstances relating to the nature or timing of the auditor's work, such as an inability to attend an inventory count; or • Limitations imposed by management, such as management not allowing the auditor to obtain an external confirmation of certain receivables.

23.2 Modifications to the Audit Opinion

A modified audit opinion is required where the auditor concludes that:

- Based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or

- It is not possible to obtain sufficient appropriate audit evidence that the financial statements as a whole are free from material misstatement.

There are three types of modified opinions. These are qualified, adverse, and a disclaimer of opinion.

The exhibit below (reproduced from SLAuS 705.A1) illustrates how the type of opinion to be expressed is affected by the auditor's judgment about:

- The nature of the matter giving rise to the modification; and
- The pervasiveness of its effects or possible effects on the financial statements.

Exhibit 23.2-1

Nature of Matter Giving Rise to the Modification	Auditor's Judgment 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

The appropriate use of the three types of modifications is described in the exhibit below.

Exhibit 23.2-2

Type	Applicability
Qualified Opinion	When the effect is not material and pervasive enough to require an adverse or disclaimer of opinion. This applies where: • Sufficient appropriate audit evidence was obtained, but the auditor concludes that misstatements exist, individually or in the aggregate, that are material but not pervasive to the financial statements; or • The auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion. The auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.
Worded as:	"Except for the effects (or the possible effects) of the matter described in the Basis for Qualified Opinion paragraph…"
Adverse Opinion	When the effects of misstatements are both material and pervasive. This applies where sufficient appropriate audit evidence was obtained, but the auditor concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.
Worded as:	"In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph...the financial statements do not present fairly…"

Type	Applicability
Disclaimer of Opinion	When the possible effect of undetected misstatements, if any, could be both material and pervasive. This applies where the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and concludes that the possible effects of undetected misstatements, if any, could be both material and pervasive. This also applies to extremely rare circumstances where it is not possible to form an opinion due to the potential interaction of multiple uncertainties and their possible cumulative effect on the financial statements. This applies even where the auditor has obtained sufficient audit evidence regarding each of the individual uncertainties.
Worded as:	"Because of the significance of the matter described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements."

The only alternative to issuing an adverse or disclaimer of opinion would be withdrawing from the audit altogether (where permissible) and not issuing an opinion.

When a modification is required, the details would be provided in a "basis for modification" as paragraph described below.

Exhibit 23.2-3

Basis for Modification Paragraph	**Purpose** Sets out details of the modification in a separate paragraph (uniformly worded to the extent possible) preceding the opinion or disclaimer of opinion on the financial statements. The paragraph would be headed "Basis for Qualified Opinion," "Basis for Adverse Opinion," or "Basis for Disclaimer of Opinion." **Wording** The paragraph would include: • The substantive reasons for qualification; • Unless impracticable, quantification of the possible effect(s) on the financial statements of modifications involving specific amounts in the financial statements (including quantitative disclosures). This would include quantification of the effects on the account balances, classes of transactions and disclosures affected, plus the effect on income before taxes, net income, and equity; • When applicable, a statement that it is not practical to quantify the financial effects; • Where the material misstatement relates to narrative disclosures, an explanation of how the disclosures are misstated; • Nature of omitted information unless disclosures are not readily available, not prepared by management, or would be unduly voluminous in the report; and • A description of all identified matters that would have required a modification of the auditor's opinion. An adverse or disclaimer of opinion relating to one specific matter does not justify the omission of other matters that would have required a modified auditor's report.

Notes to the Financial Statements	The auditor's report may make reference to a more extensive discussion in a note to the financial statements.

23.3 Financial Statements Are Materially Misstated

Paragraph #	Relevant Extracts from SLAuSs
450.4	For purposes of the SLAuSs, the following terms have the meanings attributed below: (a) Misstatement—A difference between the amount, classification, presentation, or disclosure of a reported 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. (Ref: Para. A1) When the auditor expresses an opinion on whether the financial statements are presented fairly, in all material respects, or give a true and fair view, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to be presented fairly in all material respects, or to give a true and fair view. (b) Uncorrected misstatements—Misstatements that the auditor has accumulated during the audit and that have not been corrected.

This applies where sufficient appropriate audit evidence has been obtained, but the auditor concludes that misstatements, individually or in the aggregate, are material (requiring a qualified opinion) or material and pervasive (requiring an adverse opinion) to the financial statements.

This could result from:

- The auditor's evaluation of uncorrected misstatements;
- The appropriateness of the selected accounting policies;
- The application of the selected accounting policies; or
- The appropriateness or adequacy of disclosures in the financial statements.

Examples of material misstatements are set out below.

Exhibit 23.3-1

Inappropriate Selection of Accounting Policies

Evaluation = Material but not pervasive

Response = Qualified opinion

Framework = Sri Lanka Accounting Standards

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

We have audited...

Management's Responsibility for the Financial Statements

Management is responsible for …

Auditor's Responsibility

Our responsibility is to …

Basis for Qualified Opinion

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements, which practice, in our opinion, is not in accordance with Sri Lanka Accounting Standards. The provision for the period ended December 31, 20X1, should be xxx, based on the straight- line method of depreciation, using annual rates of 5% for the building and 20% for the equipment. Accordingly, the property, plant, and equipment should be reduced by accumulated depreciation of xxx, and the loss for the period and accumulated deficit should be increased by xxx and xxx, respectively.

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements present fairly, in all material respects (or "give a true and fair view of"), the financial position of ABC Company as at December 31, 20X1, and (of) its financial performance and its cash flows for the period then ended, in accordance with Sri Lanka Accounting Standards.

Exhibit 23.3-2

Inadequate Disclosure of a Financial Instrument

Evaluation = Material but not pervasive

Response = Qualified opinion

Framework = Sri Lanka Accounting Standards

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

We have audited...

Management's Responsibility for the Financial Statements

Management is responsible for…

Auditor's Responsibility

Our responsibility is to…

Basis for Qualified Opinion

On January 15, 20XX, the Company issued debentures in the amount of xxx for the purpose of financing plant expansion. The debenture agreement restricts the payment of future cash dividends to earnings after December 31, 20XX. In our opinion, disclosure of this information is required by...

Qualified Opinion

In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements present fairly, in all material respects (or "give a true and fair view of") the financial position of ABC Company as at…

Exhibit 23.3-3

Non-Consolidation of a Subsidiary

Evaluation = Material and pervasive

Response = Adverse opinion

Framework = Sri Lanka Accounting Standards

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

We have audited...

Management's Responsibility for the Financial Statements

Management is responsible for…

Auditor's Responsibility

Our responsibility is to…

Basis for Adverse Opinion

As explained in Note X, the company has not consolidated the financial statements of subsidiary XYZ Company it acquired during 20X1, because it has not yet been able to ascertain 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 Sri Lanka Accounting Standards, the subsidiary should have been consolidated, because it is controlled by the company. Had XYZ been consolidated, many elements in the accompanying financial statements would have been materially affected. The effects on the financial statements of the failure to consolidate have not been determined.

Adverse Opinion

In our opinion, because of the significance of the matter discussed in the Basis for Adverse Opinion paragraph, the consolidated financial statements do not present fairly (or "do not give a true and fair view of") the financial position of ABC Company and its subsidiaries as at December 31, 20X1, and (of) their financial performance and cash flows for the period then ended in accordance with Sri Lanka Accounting Standards.

Exhibit 23.3-4

Inadequate Disclosure of Material Uncertainty

Evaluation = Material and pervasive

Response = Adverse opinion

Framework = Sri Lanka Accounting Standards

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

We have audited...

Management's Responsibility for the Financial Statements

Management is responsible for…

Auditor's Responsibility

Our responsibility is to…

Basis for Adverse Opinion

The Company's financing arrangements expired and the amount outstanding was payable on December 31, 20X1. The Company has been unable to renegotiate or obtain replacement financing and is considering filing for bankruptcy. These events indicate a material uncertainty that may cast significant doubt on the Company's ability to continue as a going concern, and therefore it may be unable to realize its assets and discharge its liabilities in the normal course of business. The financial statements (and notes thereto) do not disclose this fact.

Adverse Opinion

In our opinion, because of the omission of the information mentioned in the Basis for Adverse Opinion paragraph, the financial statements do not present fairly (or "give a true and fair view of") the financial position of the Company as at December 31, 20X1, and of its financial performance and its cash flows for the period then ended in accordance with…

23.4 Inability To Obtain Sufficient Appropriate Audit Evidence

This applies 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 of undetected misstatements, if any, could be material (qualified opinion) or material and pervasive (disclaimer of opinion).

The auditor's inability to obtain sufficient appropriate audit evidence (also referred to as a limitation on the scope of the audit) may arise from:

- Circumstances beyond the control of the entity, such as when the entity's accounting records have been destroyed (such as through fire, water, theft, or computer-data loss) or seized by a government authority;
- Circumstances relating to the nature or timing of the auditor's work. This could occur where the auditor's

appointment is such that the auditor is unable to observe the counting of the physical inventories, the accounting records are not complete at the time of the audit, or where the auditor determines that performing substantive procedures alone is not sufficient but the entity's controls are not effective; or

- Limitations imposed by management, such as not allowing external confirmation of certain receivables or restricting access to key personnel, accounting records, or operating locations. Where this occurs, there may be other audit implications, such as the assessment of fraud risks and whether to continue with the engagement. If the limitation is known before the engagement is accepted, the auditor would ordinarily not accept such a limited engagement.

Before concluding that a modified opinion is required, the auditor would:

- Attempt to obtain sufficient appropriate audit evidence by performing alternative procedures; and
- Discuss the matter with management and those charged with governance to determine if the issue can be resolved. If the matter cannot be resolved, the auditor would then communicate the intention to modify the audit opinion and the proposed wording.

Exhibit 23.4-1

Limitation on Scope, Unable to Observe the Counting of Inventories

Evaluation = Material but not pervasive

Response = Qualified opinion

Framework = Sri Lanka Accounting Standards

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

We have audited...

Management's Responsibility for the Financial Statements

Management is responsible for…

Auditor's Responsibility

Our responsibility is to…

Basis for Qualified Opinion

We did not observe the counting of the physical inventories as of December 31, 20XX, since that date was prior to the time we were initially engaged as auditors for the Company. Owing to the nature of the Company's records, we were unable to satisfy ourselves as to physical inventory quantities by other audit procedures. Accordingly, we were unable to determine whether any adjustments might have been found necessary in inventory, income statement, statement of changes in equity, and cash-flow statement balances.

Qualified Opinion

In our opinion, except for the possible effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements present fairly, in all material respects (or "give a true and fair view of"), the financial position of ABC Company as at…

Exhibit 23.4-2

Limitation on Scope, Management Placed Limitations on Scope of Audit Work

Evaluation = Material and pervasive

Response = Disclaimer of opinion

Framework = Sri Lanka Accounting Standards

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

We have audited...

Management's Responsibility for the Financial Statements

Management is responsible for…

Auditor's Responsibility
Our responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with Sri Lanka Auditing Standards. Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

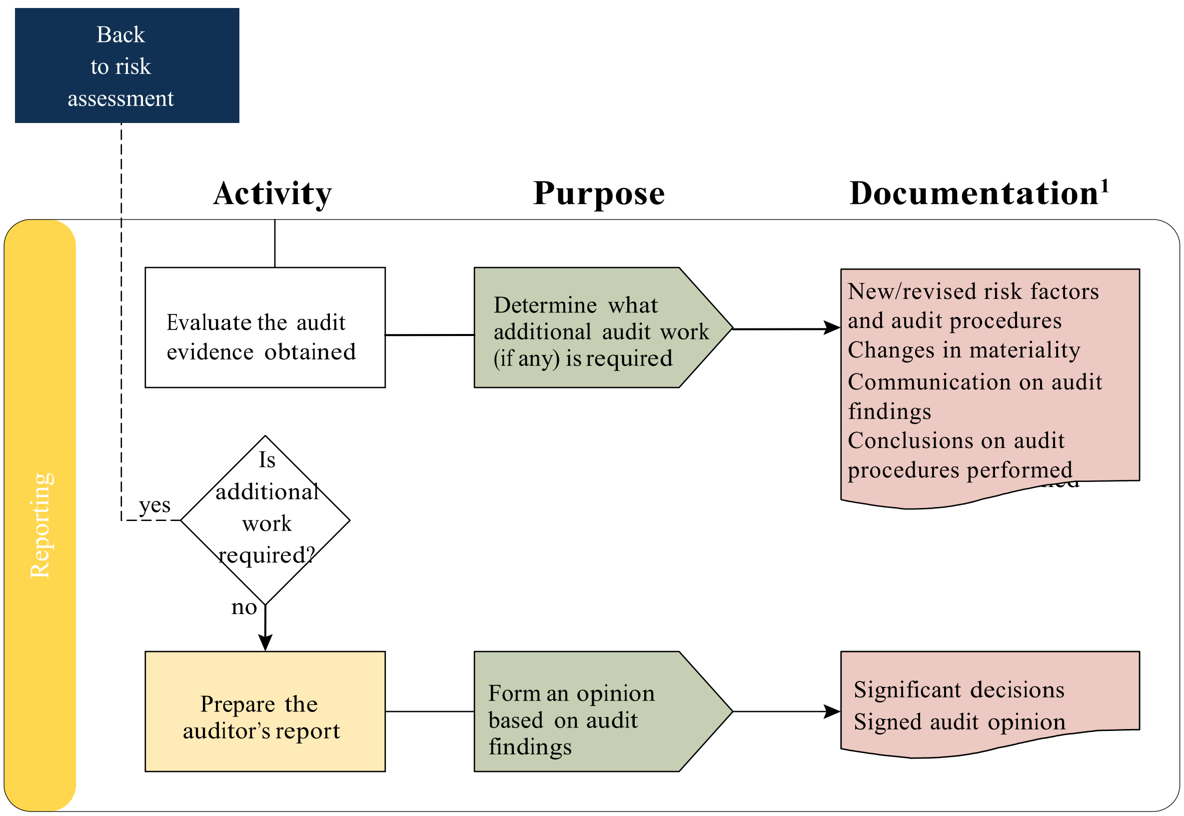
Basis for Disclaimer of Opinion
We were not able to observe all physical inventories and confirm accounts receivable due to limitations placed on the scope of our work by the Company. We were unable to satisfy ourselves by alternative means concerning the inventory quantities and accounts receivable held at December 31, 20XX, which are stated in the balance sheet at xxx and xxx respectively. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the income statement, statement of changes in equity, and cash-flow statement balance.

Disclaimer of Opinion
Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

24. Emphasis of Matter and Other Matter Paragraphs

Chapter Content	Relevant SLAuSs
Guidance on additional communication in the auditor's report to draw financial statement users' attention to certain matters.	706

Exhibit 24.0-1



Notes:
1. Refer to SLAUS 230 for a more complete list of documentation required.
2. Planning (SLAUS 300) is a continual and iterative process throughout the audit.

Paragraph #	SLAuS Objective(s)
706.4	The objective of the auditor, having formed an opinion on the financial statements, is to draw users' attention, when in the auditor's judgment it is necessary to do so, by way of clear additional communication in the auditor's report, to: (a) A matter, although appropriately presented or disclosed in the financial statements, that is of such importance that it is fundamental to users' understanding of the financial statements; or (b) As appropriate, any other matter that is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

Paragraph #	Relevant Extracts from SLAuSs
706.5	For the purposes of the SLAuSs, the following terms have the meanings attributed below: (a) Emphasis of Matter paragraph—A paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements. (b) Other Matter paragraph—A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.
706.6	If the auditor considers it necessary to draw users' attention to a matter presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements, the auditor shall include an Emphasis of Matter paragraph in the auditor's report provided the auditor has obtained sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements. Such a paragraph shall refer only to information presented or discussed in the financial statements. (Ref: Para. A1-A2)
706.7	When the auditor includes an Emphasis of Matter paragraph in the auditor's report, the auditor shall: (a) Include it immediately after the Opinion paragraph in the auditor's report; (b) Use the heading "Emphasis of Matter," or other appropriate heading; (c) Include in the paragraph a clear reference to the matter being emphasized and to where relevant disclosures that fully describe the matter can be found in the financial statements; and (d) Indicate that the auditor's opinion is not modified in respect of the matter emphasized. (Ref: Para. A3-A4)
706.8	If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report and this is not prohibited by law or regulation, the auditor shall do so in a paragraph in the auditor's report, with the heading "Other Matter," or other appropriate heading. The auditor shall include this paragraph immediately after the Opinion paragraph and any Emphasis of Matter paragraph, or elsewhere in the auditor's report if the content of the Other Matter paragraph is relevant to the Other Reporting Responsibilities section. (Ref: Para. A5-A11)
706.9	If the auditor expects to include an Emphasis of Matter or an Other Matter paragraph in the auditor's report, the auditor shall communicate with those charged with governance regarding this expectation and the proposed wording of this paragraph. (Ref: Para. A12)

24.1 Overview

In certain situations, the auditor may want to draw the users' attention to certain matters in the auditor's report that are fundamental to the users' understanding of the financial statements, or of the audit itself and the auditor's responsibilities. This can be achieved by adding an extra paragraph to the auditor's report.

The two types of paragraph that can be added are outlined below.

Exhibit 24.1-1

Paragraph	Applicability
Emphasis of Matter	**Attention is drawn to important matters relating to the financial statements already disclosed in the financial statements.** Matter(s) presented/disclosed in the financial statements that are of such importance that they are fundamental to users' understanding of the financial statements.
Examples	Uncertainty relating to exceptional litigation or regulatory action, subsequent events, a major catastrophe, other significant uncertainties and inconsistencies, and early application (where permitted) of a new accounting standard.
Other Matters	**Matters relevant to users' understanding of the audit function but not disclosed in the financial statements** Any matter(s) (other than those presented or disclosed in the financial statements) that are relevant to the users' understanding of the audit, the auditor's responsibilities, and/or the auditor's report.
Examples	Inability of the auditor to withdraw from the engagement, additional responsibilities of the auditor, and any restrictions on the distribution of the auditor's report.

An "Emphasis of Matter" paragraph is not a substitute for:

- Modifying the audit opinion when required; or
- Management making required disclosures in the financial statements.

When the auditor expects to include an Emphasis of Matter or an Other Matter paragraph, the auditor would communicate with management and those charged with governance on:

- The need for the paragraph; and
- The proposed wording.

24.2 Emphasis of Matter Paragraph

An Emphasis of Matter paragraph is intended to highlight important matters (already disclosed in the financial statements) that will enhance the users' understanding of the financial statements.

The key requirements for using an Emphasis of Matter paragraph are set out below.

Exhibit 24.2-1

Conditions	Comments
Matter is Already Fully Disclosed in the Financial Statements	The Emphasis of Matter paragraph refers to matters already presented or disclosed in the financial statements and is not a substitute for such disclosure. The paragraph would not include more detail than is already presented in the financial statements.
No Material Misstatement Exists	The auditor has to obtain sufficient appropriate audit evidence that the matter is not materially misstated in the financial statements.
Placed Immediately after the Audit Opinion	The paragraph follows the auditor's opinion paragraph, but comes before the section on any other reporting responsibilities. The paragraph is headed "Emphasis of Matter" or other appropriate heading.
Is Not a Modification to Opinion	The paragraph indicates that the auditor's opinion is not modified in respect of the matter emphasized.

The following SLAuSs require the auditor, under specified circumstances, to include an Emphasis of Matter paragraph in the auditor's report.

Exhibit 24.2-2

SLAuS	Title	Paragraph
210	Agreeing the Terms of Audit Engagements	19(b)
560	Subsequent Events	12(b), 16
570	Going Concern	19
800	Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks	14

Sample wording is set out below.

Exhibit 24.2-3

Material Uncertainty—Going Concern

Assuming the adequacy of the note disclosure in the financial statements, the wording of the paragraph could be as follows:

Emphasis of Matter
Without qualifying our opinion, we draw attention to Note X in the financial statements, which indicates that the Company incurred a net loss of ZZZ during the period ended December 31, 20X6 and, as of that date, the Company's current liabilities exceeded its total assets by YYY. These conditions, along with other matters as set forth in Note X, indicate the existence of a material uncertainty, which may cast significant doubt about the Company's ability to continue as a going concern.

Other Significant Uncertainties—A Lawsuit
Assuming the adequacy of the note disclosure in the financial statements, the wording of the paragraph could be as follows:

Emphasis of Matter
Without qualifying our opinion, we draw attention to Note X to the financial statements. The Company is the defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.

24.3 Other Matter Paragraph

An Other Matter paragraph may be necessary to highlight matters not already disclosed in the financial statements that would be relevant to the users' understanding of the audit, the auditor's responsibilities, and/or the auditor's report.

Other Matter paragraphs can be used to highlight matters such as:

- Restriction on distribution of the auditor's report—Since financial statements (using a general purpose framework) are sometimes prepared for a specific purpose, an Other Matter paragraph could state that the auditor's report is intended solely for the intended users and should not be distributed to or used by other parties;

- Highlight additional responsibilities—Specific law, regulation, or generally accepted practice in a jurisdiction may require or permit the auditor to elaborate on the auditor's responsibilities; and

- Inability to withdraw from the engagement—If the auditor is unable to withdraw or resign, an Other Matter paragraph could explain why it is not possible.

The following conditions apply when using an Other Matter paragraph.

Exhibit 24.3-1

Conditions	Comments
Matter is Not Already Disclosed in the Financial Statements	Refers to a matter other than those already presented or disclosed in the financial statements. In addition, an Other Matter paragraph would not include information required to be provided by management.
Disclosure is Not Prohibited	The disclosure would not be prohibited by law, regulation, or other professional standards such as standards relating to confidentiality of information.
Disclosure Relevant to Users	The disclosure is relevant to the financial statement users' understanding of the audit, the auditor's responsibilities, or the auditor's report.
No Contradictions	The information presented would not contradict the opinion or items disclosed or presented in the financial statements. The Other Matter paragraph does not affect the auditor's opinion.
Placed Immediately After the Audit Opinion	The paragraph would immediately follow after the Opinion paragraph and any Emphasis of Matter paragraph, or elsewhere in the auditor's report if the content of the Other Matter paragraph is relevant to the Other Reporting Responsibilities section.
State that Such Disclosure Not Required	The content of an Other Matter paragraph would indicate that the matter is not required to be presented and disclosed in the financial statements.

The following SLAuSs refer to situations where an Other Matter paragraph may be included.

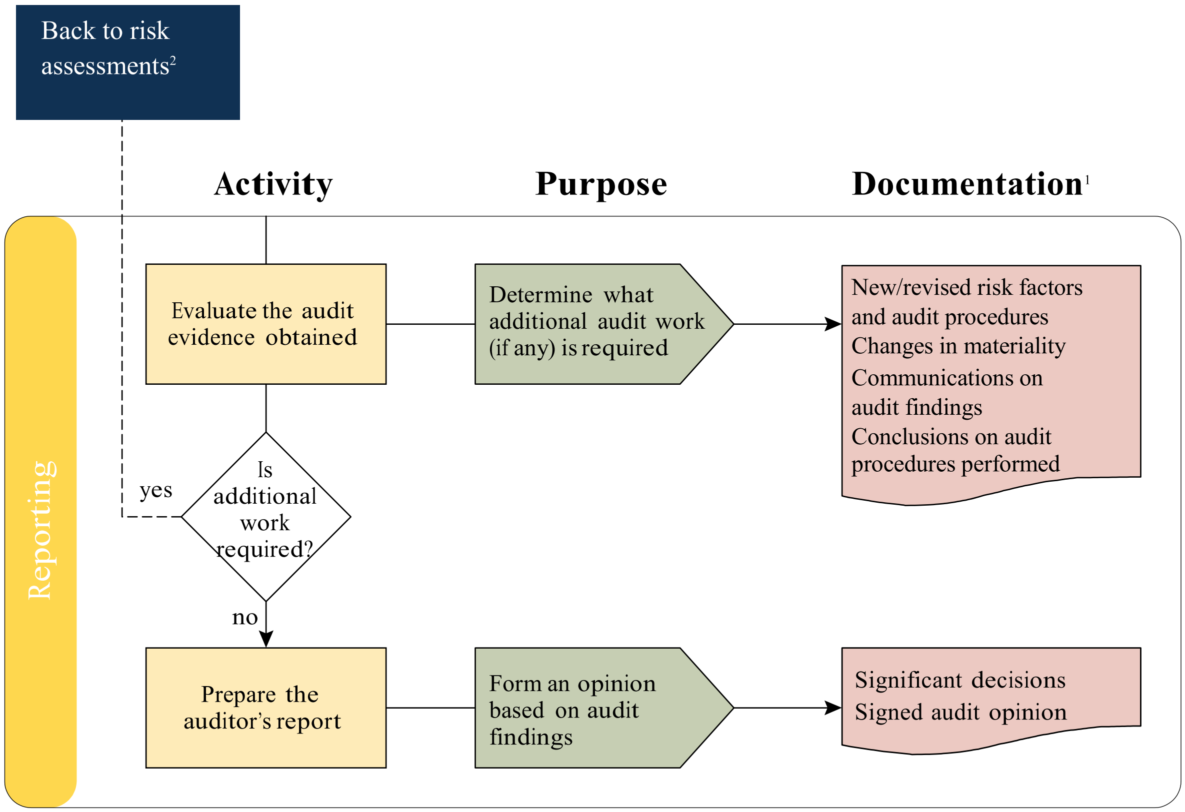
Exhibit 24.3-2

SLAuS	Title	Paragraphs
560	Subsequent Events	12(b), 16
710	Comparative Information—Corresponding Figures and Comparative Financial Statements	13-14, 16-17, 19
720	The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements	10(a)

25. Comparative Information

Chapter Content	Relevant SLAuSs
Guidance on obtaining sufficient appropriate audit evidence on comparative information, and the auditor's reporting responsibilities.	710

Exhibit 25.0-1



Notes:
1. Refer to SLAuS 230 for a more complete list of documentation required.
2. Planning (SLAuS 300) is a continual and iterative process throughout the audit.

Paragraph #	SLAuS Objective(s)
710.5	The objectives of the auditor are: (a) To obtain sufficient appropriate audit evidence about whether the comparative information included in the financial statements has been presented, in all material respects, in accordance with the requirements for comparative information in the applicable financial reporting framework; and (b) To report in accordance with the auditor's reporting responsibilities.

Paragraph #	Relevant Extracts from SLAuSs
710.6	For purposes of the SLAuSs, the following terms have the meanings attributed below: (a) Comparative information—The amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework. (b) Corresponding figures—Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as "current period figures"). The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures. (c) Comparative financial statements—Comparative information where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion. The level of information included in those comparative financial statements is comparable with that of the financial statements of the current period. For purposes of this SLAuS, references to "prior period" should be read as "prior periods" when the comparative information includes amounts and disclosures for more than one period.
710.7	The auditor shall determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether such information is appropriately classified. For this purpose, the auditor shall evaluate whether: (a) The comparative information agrees with the amounts and other disclosures presented in the prior period or, when appropriate, have been restated; and (b) The accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented and disclosed.
710.8	If the auditor becomes aware of a possible material misstatement in the comparative information while performing the current period audit, the auditor shall perform such additional audit procedures as are necessary in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists. If the auditor had audited the prior period's financial statements, the auditor shall also follow the relevant requirements of SLAuS 560. If the prior period financial statements are amended, the auditor shall determine that the comparative information agrees with the amended financial statements.
710.9	As required by SLAuS 580, the auditor shall request written representations for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any restatement made to correct a material misstatement in prior period financial statements that affect the comparative information. (Ref: Para. A1)

Paragraph #	Relevant Extracts from SLAuSs
710.10	When corresponding figures are presented, the auditor's opinion shall not refer to the corresponding figures except in the circumstances described in paragraphs 11, 12, and 14. (Ref: Para. A2)
710.11	If the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either: (a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or (b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures. (Ref: Para. A3-A5)
710.12	If the auditor obtains audit evidence that a material misstatement exists in the prior period financial statements on which an unmodified opinion has been previously issued, and the corresponding figures have not been properly restated or appropriate disclosures have not been made, the auditor shall express a qualified opinion or an adverse opinion in the auditor's report on the current period financial statements, modified with respect to the corresponding figures included therein. (Ref: Para. A6)
710.13	If the financial statements of the prior period were audited by a predecessor auditor and the auditor is not prohibited by law or regulation from referring to the predecessor auditor's report on the corresponding figures and decides to do so, the auditor shall state in an Other Matter paragraph in the auditor's report: (a) That the financial statements of the prior period were audited by the predecessor auditor; (b) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and (c) The date of that report. (Ref: Para. A7)
710.14	If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.
710.15	When comparative financial statements are presented, the auditor's opinion shall refer to each period for which financial statements are presented and on which an audit opinion is expressed. (Ref: Para. A8-A9)
710.16	When reporting on prior period financial statements in connection with the current period's audit, if the auditor's opinion on such prior period financial statements differs from the opinion the auditor previously expressed, the auditor shall disclose the substantive reasons for the different opinion in an Other Matter paragraph in accordance with SLAuS 706. (Ref: Para. A10)

Paragraph #	Relevant Extracts from SLAuSs
710.17	If the financial statements of the prior period were audited by a predecessor auditor, in addition to expressing an opinion on the current period's financial statements, the auditor shall state in an Other Matter paragraph: (a) That the financial statements of the prior period were audited by a predecessor auditor; (b) The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and (c) The date of that report, unless the predecessor auditor's report on the prior period's financial statements is reissued with the financial statements.
710.18	If the auditor concludes that a material misstatement exists that affects the prior period financial statements on which the predecessor auditor had previously reported without modification, the auditor shall communicate the misstatement with the appropriate level of management and, unless all of those charged with governance are involved in managing the entity, those charged with governance and request that the predecessor auditor be informed. If the prior period financial statements are amended, and the predecessor auditor agrees to issue a new auditor's report on the amended financial statements of the prior period, the auditor shall report only on the current period. (Ref: Para. A11)
710.19	If the prior period financial statements were not audited, the auditor shall state in an Other Matter paragraph that the comparative financial statements are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements.

25.1 Overview

The nature of comparative information presented in an entity's financial statements will depend on the requirements of the applicable financial reporting framework. The auditor's reporting responsibilities will be based on the adopted approach to the comparative information presented as established by law, regulation, and by the terms of the engagement.

There are two broad approaches taken with respect to comparative information. These are illustrated below.

Exhibit 25.1-1

Approach	Comments
Corresponding Figures	Amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period. The auditor's opinion would refer to the current period only.

Approach	Comments
Comparative Financial Statements	Amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to separately in the auditor's opinion. The level of information included in the comparative financial statements is comparable with that of the financial statements of the current period. The auditor's opinion would refer to each period for which financial statements are presented.

25.2 Audit Procedures

Exhibit 25.2-1

Task	Procedures
Obtain Necessary Audit Evidence	Obtain sufficient appropriate audit evidence that the comparative information meets the requirements of the applicable financial reporting framework, and whether such information is appropriately classified. This involves evaluating whether: • Accounting policies reflected in the comparative information are consistent with those applied in the current period or, if there have been changes in accounting policies, whether those changes have been properly accounted for and adequately presented; and • Comparative information agrees with the amounts and other disclosures presented in the prior period or, when appropriate, have been restated.
Identify Any Potential Misstatements	If possible, material misstatement in the comparative information is identified while performing the current period audit, and the auditor would: • Perform such additional audit procedures as are necessary in the circumstances to determine whether a material misstatement exists; and • Where the prior period financial statements are amended, determine that the comparative information agrees with the amended financial statements. If the auditor had audited the prior period's financial statements, the auditor would also address the relevant requirements of SLAuS 560 on subsequent events. These are discussed in Volume 1, Chapter 13.
Obtain Written Representations	Request written representations for all periods referred to in the auditor's opinion. This would include specific written representation regarding any restatement made to correct a material misstatement in prior period financial statements.

25.3 Corresponding Figures

The reporting responsibilities are set out below.

Exhibit 25.3-1

	Procedures
No Reference Made to Comparatives in Auditor's Opinion	The auditor's opinion would not refer to the corresponding figures except when the auditor's report on the prior period included an unresolved modification. The auditor would modify the current period's opinion by: • Referring to both the current period's figures and the corresponding figures when the effects or possible effects of the matter on the current period's figures are material; or • Explaining that the current audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.
Any Re-Statements Required?	A qualified or adverse opinion on the current period financial statements is required where a material misstatement exists in the prior period financial statements on which: • An unmodified opinion has been previously issued; and • The corresponding figures have not been properly restated or appropriate disclosures have not been made.
Prior Period Figures Audited by Another Firm	If the auditor is not prohibited by law/regulation from referring to the predecessor auditor's report and decides to make such a reference, the auditor would state in an Other Matter paragraph in the auditor's report: • That the financial statements of the prior period were audited by the predecessor auditor; • The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and • The date of that report.
Prior Period Figures Not Audited	State in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. However, this does not relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain material misstatements that affect the current period's financial statements. If a material misstatement is identified, the corresponding figures would require restating, and appropriate disclosures made. If such a restatement or disclosure is not possible, the audit opinion would be modified in respect of any corresponding figures included.

25.4 Comparative Financial Statements

The reporting responsibilities are set out below.

Exhibit 25.4-1

	Procedures
Make Reference to Each Period Presented	The auditor's opinion would refer to each period for which financial statements are presented and on which an audit opinion is expressed.
Any Changes Required in Previous Opinion Provided	If the auditor's opinion on prior period financial statements differs from the opinion previously expressed, disclose the substantive reasons for the different opinion in an Other Matter paragraph.
Prior Period Figures Audited by Another Firm	In addition to expressing an opinion on the current period's financial statements, state in an Other Matter paragraph (unless the predecessor auditor's report is reissued with the financial statements): • That the financial statements of the prior period were audited by a predecessor auditor; • The type of opinion expressed by the predecessor auditor and, if the opinion was modified, the reasons therefore; and • The date of that report. If a material misstatement exists that affects the prior period's financial statements on which the predecessor auditor had previously reported without modification: • Communicate the misstatement with the appropriate level of management and those charged with governance; and • Request that the predecessor auditor be informed. If the prior period's financial statements are amended and the predecessor auditor agrees to issue a new auditor's report on the amended financial statements of the prior period, the auditor would report only on the current period.
Prior Period Figures Not Audited	State in an Other Matter paragraph in the auditor's report that the corresponding figures are unaudited. However, this does not relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances do not contain material misstatements that affect the current period's financial statements. If a material misstatement is identified, the corresponding figures would require restating and appropriate disclosures made. If such a restatement or disclosure is not possible, the audit opinion would be modified with respect to any corresponding figures included.

THE INSTITUTE OF
CHARTERED ACCOUNTANTS OF SRI LANKA

The Institute of Chartered Accountants of Sri Lanka
30 A, Malalasekera Mawatha, Colombo 07
Tel: 011- 2352000 Fax: 011- 2352060.
Email: technical@casrilanka.com

www.casrilanka.com

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