### TOPIC 1 AUDIT PLANNING AND RISK ASSESSMENT

**3.1 The audit process**

ISA 200 *Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing* requires an external audit to be performedin four main phases as shown below.

1. **Engagement**

**b) Audit Planning**

Understand the entity including documentation /confirmation of the accounting system and internal control

Assess the risk of material misstatement

Select appropriate audit procedures to respond to the risk of material misstatement

**c) Performance**

Auditor expects ineffective internal control

Auditor expects effective internal control controls

Tests show that controls are ineffective

Perform tests of control approach

Perform tests of controls (TOCs)

Report to those charged with governance

Tests show that controls are effective

Perform extensive substantive procedures to obtain evidence

Perform reduced substantive procedures to obtain evidence

**d) Completion and Reporting**

Final audit review

Issue auditor’s report

1. **Engagement phase**

The auditor performs **engagement acceptance** procedures to ensure high risk clients are avoided and there is staff to undertake the audit and compliance with ethical requirements.

1. **Planning phase**

The auditor obtains understanding ofthe entity and its environment, assesses the risk of material misstatement, establishes an overall audit strategy and develops an audit plan.

1. **Performance phase (Fieldwork phase)**

In response to the assessed risks of material misstatement, the auditor collects sufficient and appropriate audit evidence by performing audit procedures.

1. **Completion and reporting phase**

Theauditor carries out analytical review, subsequent events review, going concern review, management representations review, overall review of evidence and forms an opinion in an audit report.

**Risk-based approach to audit**

ISAs require auditors to adopt a risk-based approach to auditing.

A **risk-based audit** is where auditors:

* Analyse the risks in the client's business, transactions and systems which could lead to misstatements in the financial statements.
* Direct their testing to risky areas.

**3.2 Audit risk**

In order to obtain reasonable assurance that financial statements are free from material misstatements, ISA 200 requires an auditor to obtain sufficient appropriate evidence to reduce audit risk to an acceptably low level so as to draw reasonable conclusions on which to base the audit opinion.

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when financial statements are materially misstated.

Audit risk has two major components:

* Risks of material misstatement in the financial statements arising from **inherent risk** and **control risk** and is dependent on the entity.
* Detection risk that is the risk that the auditor will not detect material misstatements in the financial statements and is dependent on the auditor.

In an audit risk model, Audit risk = Inherent risk x Control risk x Detection risk.

**Inherent risk** is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement which could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

Inherent risk is affected by the nature of the entity e.g.

1. The industry in which the audit client operates e.g. one with rapid technological developments.
2. Any regulations it is subject to
3. Whether the financial statements:
4. Include complex calculations
5. Are subject to complex accounting standards like financial instruments
6. Include amounts derived from accounting estimates like provisions rather than factual data.

**Control risk** is 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. Some control risk will always exist due to the inherent limitations on internal control like collision.

**Detection risk** is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements. Detection risk is divided into sampling risk and non-sampling risk.

* **Sampling risk** is 'the risk that the auditor's conclusion based on a sample may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure'.
* **Non-sampling risk** is 'the risk that the auditor does not detect material misstatement due to factors other than the sample tested e.g. misinterpretation of audit evidence.

Factors which increase non-sampling risk include:

1. Auditor’s lack of experience
2. Time pressure
3. Financial constraints
4. Poor planning
5. New client
6. Lack of industry knowledge

**Business risk**

**Business risk** is the 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. Audit risk relates to misstatements in financial statements and is different from business risk that relates to entity objectives.

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| **3.3** **Materiality in planning and performing an audit**  **Definition**   |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  |  | | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | --- | | Materiality is the significance of the misstatements including omissions that could reasonably be expected to influence the economic decisions of users taken based on information in the financial statements.  ISA 320 *Materiality in planning and performing an audit* requires an auditor to apply the concept of materiality appropriately throughout the audit in planning and performing an audit.  If the financial statements include a material misstatement, then they will not present fairly (give a true and fair view) the financial position, performance and cash flows of the entity.  A misstatement may be considered material due to its:   * Size (Quantitative materiality) * Nature (Qualitative materiality), or both   The materiality level set by the auditor is always a matter of judgement and depends on the level of audit risk. The higher the anticipated level of audit risk, the lower the materiality value.  A Low IR, Low CR Low AR, Higher Materiality 10m  B High IR, High CR High AR, Lower Materiality 4m  The materiality level set influences:   1. The nature, timing and extent of audit procedures performed. The higher the risk of misstatement, the lower the materiality and the higher the level of planned audit procedures so as to increase the auditor’s likelihood of detecting lower misstatements if they exist. 2. Whether to use sampling techniques 3. Evaluation of the effect of misstatements in terms of:  * Evaluating the effect of uncorrected misstatements, if any, on the financial statements. * Forming the opinion in the auditor’s report.   **Calculation of materiality**  When planning an audit, the auditor establishes materiality for the financial statements as a whole.  Factors that may affect the identification of an appropriate benchmark include the following:   1. Elements of financial statements e.g. assets, liabilities, revenue, expenses and equity 2. Whether they are items on which users tend to focus 3. Nature of the entity, industry and economic environment 4. Entity’s ownership structure and financing 5. Relative volatility of the bench mark   The following benchmarks and percentages may be used for financial statements as a whole.   |  |  |  | | --- | --- | --- | | Benchmark | Range % | Where commonly used | | Profit before tax (PBT)\* | 5 – 10 | * Profit-oriented entities with a relatively low total asset base. * Focus is on financial performance. | | Revenue | 0.5 – 1 | * Profit-oriented entities where PBT from operations is volatile. * Focus is on financial performance. | | Total assets | 1 – 2 | * Entities with high total assets but low profits. * Focus is on return on investment and ability to repay debt. | | Gross profit | 0.5 – 1 | * Profit-oriented entities where PBT from operations is volatile. | | Total expenses | 0.5 – 2 | * Public sector and not-for-profit entities. * Focus is to evaluate the entity’s spending with its objectives. | | Net assets | 2 – 5 | * Focus is on return on investment and ability to repay debt. |   **Performance materiality**  Performance materiality means the amount 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.  It is used in testing individual transactions, account balances and disclosures. The lower figure enables the auditor to perform more audit procedures to detect smaller misstatements in particular areas. It reduces the risk that the total of all the errors in transactions, account balances and disclosures exceeds overall materiality.  Determining performance materiality is a matter of the auditor’s judgement. It is affected by:   * The nature and extent of misstatements identified in prior audits * The auditor’s understanding of the entity * Results of risk assessment   **Qualitative factors determining materiality include:**   * Non-compliance with laws, regulations, IFRSs and contracts. * Measurement or disclosure of transactions with related parties * Personal use of assets by management and those charged with governance. * The existence of fraud by management. * Key industry disclosures e.g. research and development costs for a pharmaceutical company).  |  | | --- | | * Significant events and changes in operations like newly acquired businesses or discontinued operations. |  * Significant events like unusual events (e.g. destruction of assets), lawsuits. * A transaction that affects the going concern assumption of the entity. | | | Materiality may be revised as the audit progresses due to events that occur during audit, new information or a change in the auditor’s understanding of the entity.  **Example**  Below are figures extracted from the financial statements of Bitabuse Ltd, a small company owner-managed by Bitabuse who owns 80% of the shares. The company has a bank loan of Shs 40m.  2024 2023 2022  Shs 000 Shs 000 Shs 000  Revenue 250,000 260,000 210,000  Gross profit 115,000 140,000 110,000  Operating expenses 104,700 97,000 74,000  Profit before tax 10,300 23,000 26,000  Total assets 158,000 113,000 73,000  What are the materiality and performance materiality levels when planning the audit of Bitabuse Ltd in 2024.   |  | | --- | | Solution  The main users of the financial statements are the banks and owners. Considering user needs and this being a small company, materiality is assessed at 1% of revenue as this is a more stable benchmark than  profits before tax. Therefore, materiality for 2024 is Shs 2.5m (250m x 1%). Using professional  judgment, which is largely based on errors in previous periods, performance materiality is set at  Shs 2m which is about 80% of materiality*.* | | |

**3.4 Risk assessment and understanding the entity and its environment**

**Objective of the auditor**

ISA 315 *Identifying and Assessing the Risks of Material Misstatement* requires an auditor to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

* The auditor first identifies the risks and then assesses their effects on the financial statements.
* The auditor then designs responses to the risks.
* In order to perform proper risk assessment, the auditor must understand the entity.
* Risks at the financial statement level affect the financial statements as a whole and may affect many assertions e.g. poor management attitude to internal controls affect any area of financial statements.
* Risks at the assertion level are more specific e.g. keeping inventories in several locations may lead to some items not being counted during the inventory count.

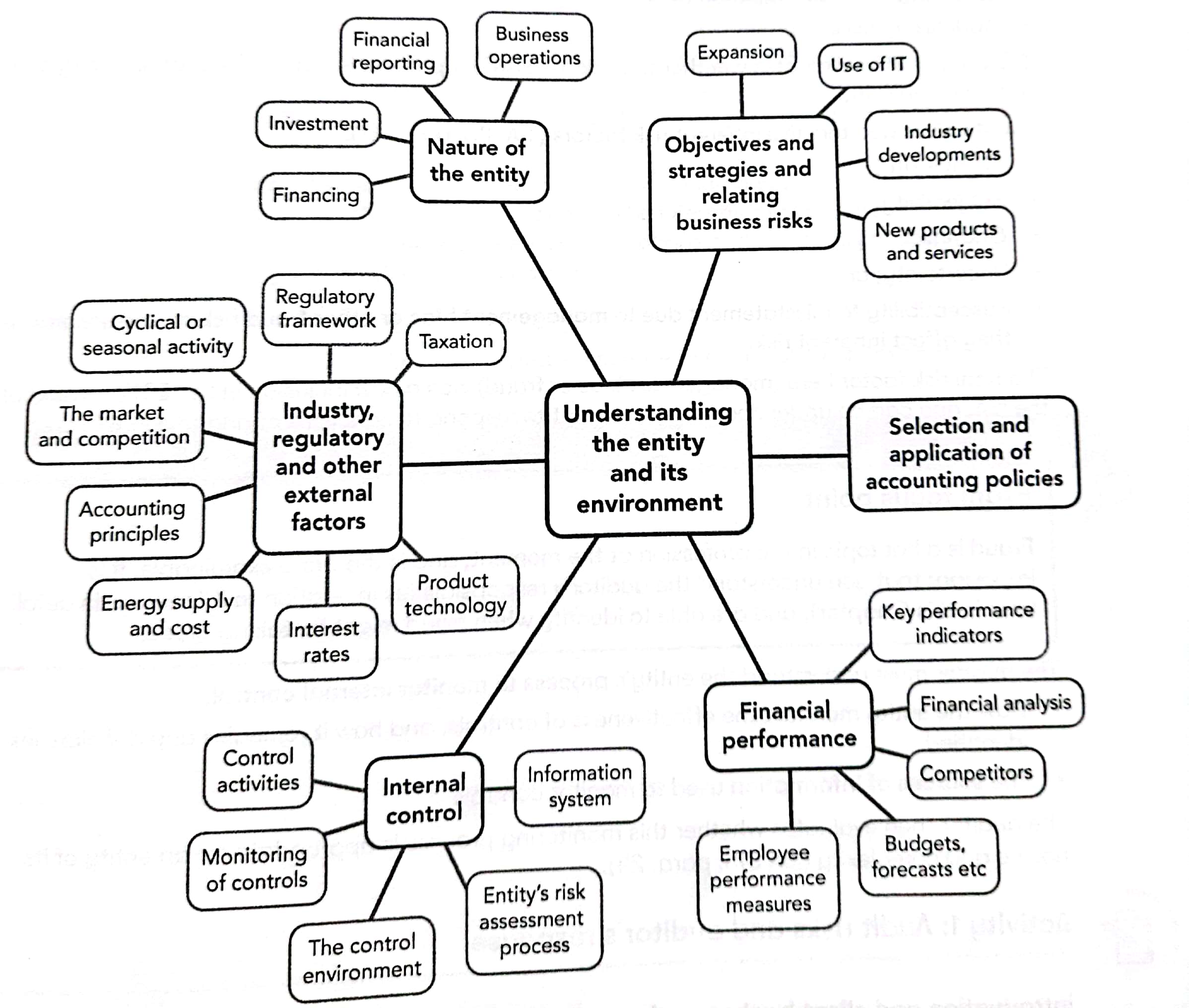
**Risk assessment procedures**

1. **Inquiries** of management and of others individuals including those in internal audit function (if it exists) e.g. about processing accounting transactions, compliance with laws and regulations and sales trends.
2. **Observation** of the entity operations e.g. observe how goods are received from suppliers by the entity.
3. **Inspection** of accounting records and entity’s premises and plant facilities etc.
4. **Analytical procedures** mean the analysis of relationships to identify inconsistencies and unexpected relationships involving the use of ratios and other comparisons (covered later).

In order to assess entity risks, the auditor must obtain understanding of three things:

* The entity and its environment
* The applicable financial reporting framework
* The entity’s system of internal control

**The entity and its environment**



1. **Nature of the entity**
2. **Organizational structure**

A single entity or a complex structure with subsidiaries in multiple locations.

Complex structures may increase susceptibility to risks of material misstatement. Goodwill, joint ventures and other investments may not be accounted for appropriately and there may be inadequate disclosure in financial statements.

1. **Ownership** and relationships between owners and related parties.
2. Related party transactions may not have been appropriately identified, accounted for and adequately disclosed in the financial statements
3. There may be no distinction between the owners, those charged with governance and management .
4. **Governance**

Whether those charged with governance may not provide appropriate oversight of its system of internal control and financial reporting.

1. **Structure and complexity of the entity’s IT environment**

Multiple legacy IT systems in diverse businesses that are not well integrated resulting in a complex IT environment or IT systems may be outsourced.

1. **Objectives, strategies and related business risks**

Business risks are broader than the risks of material misstatement of the financial statements although business risks include the latter. However, not all business risks give rise to risks of material misstatement.

Business risks that may result in a risk of material misstatement of the financial statements include:

1. **Industry developments**, such as the lack of personnel or expertise to deal with the changes in the industry that may lead to going concern uncertainty.
2. **New products and services** that may lead to increased product liability that may be understated.
3. **Expansion** of the entity’s business and demand has not been accurately estimated that may lead to obsolete inventory.
4. **Use of a new IT system** may lead to more errors.
5. **Industry, regulatory and other external factors**
6. The market and competition, including demand, capacity and price competition.
7. Cyclical or seasonal activity – changing demand for goods as in the case of fashionable goods may lead to inventory obsolescence and overstatement of closing inventories and profits for the period.
8. Product technology relating to the entity’s products – make products like mobile phones obsolete and more susceptible to overstatement.
9. Energy supply and cost e.g. in the construction industry, long-term contracts may involve significant estimates of revenues and expenses that give rise to risks of material misstatement.
10. Regulatory framework including related disclosures.
11. Legislation significantly affecting the entity’s operations e.g. labor laws.
12. Taxation – an increase in the tax rate may lead to non-compliance and fines that may be underestimated or completely omitted.
13. Government policies including foreign exchange controls and trade restriction policies.
14. Environmental requirements affecting the industry and the entity’s business.
15. General economic conditions like a recession make receivables difficult to collect and may lead to understatement of bad debts and overstatement of receivables.
16. Interest rates and availability of financing
17. Inflation or currency revaluation.
18. **Financial performance** **measures used by management**
19. **Key performance indicators** create pressures on the entity to achieve performance targets that management may misstate financial statements intentionally to improve business performance.
20. Period-on-period financial **performance analyses**.
21. **Budgets**, forecasts etc.
22. **Employee performance measures** and incentive performance bonuses – bonus related pay may lead management to overstate profits in order to earn higher bonus.
23. **Comparisons** of an entity’s performance with that of competitors – unusually rapid growth or profitability when compared to that of other entities in the same industry may indicate the likelihood of risks of material misstatement of related financial statement information.

1. **Applicable financial reporting framework** **and the entity’s accounting policies**
2. Industry-specific practices e.g. loans and investments for banks
3. Revenue recognition
4. The entity’s selection and application of accounting policies e.g. after a business combination.
5. New financial reporting standards and laws may lead to non-compliance with them or improper implementation and errors before staff become conversant with them.
6. **The entity’s system of internal control (***covered in Topic 2***)**
7. **Control environment**.
8. **The entity’s risk assessment process i.e.**
9. Identifying business risks relevant to financial reporting
10. Assessing the significance of risks
11. Addressing risks
12. **The information system and communication**.
13. **Control activities**.
14. **The entity’s process to monitor internal control**:
15. How the entity monitors the effectiveness of controls and how it remedies the deficiencies identified
16. The sources of information used to monitor controls

**Analytical procedures**

The auditor must apply analytical procedures during:

* Audit planning as risk assessment procedures to obtain an understanding of the entity and its environment.
* Audit completion in the overall review of financial statements at the end of the audit.

Analytical procedures may also be used as substantive procedures to collect audit evidence during audit field work.

Analytical procedures include the following types of comparisons:

* Prior periods
* Budgets and forecasts
* Industry information
* Predictive estimates i.e. expectations
* Relationships between financial information i.e. ratio analysis
* Relationships between financial and non-financial information e.g. payroll costs to number of employees.

Common ratios used in analytical procedures include:

**Profitability ratios**

1. Gross profit margin = Gross profit x 100

Revenue

* A change in revenue is discussed with the client.
* A drop in revenue in 2024 may indicate:
* That the entity has had a bad year in 2024, with potential impact on the assessment of going concern
* That the entity had a particularly good year in 2023 and 2024 is more representative of what the company expected
* A major customer has been lost
* There have been errors in recording sales
* Lack of completeness in the recording of sales
* Misclassification of sales
* Wrong application of cut-off
* Errors in the accounting records
* Possible fraud
* Auditors should carry out further analysis to assess any explanations given to them by the client. Further work would be planned to include a more detailed substantive analytical review on the sales figure, by obtaining detailed analysis of sales by month and by product to see if this reveals any more answers about why the sales figure has dropped in 2024.

1. Net profit margin = Profit before interest & tax x 100

Revenue

* Profit before interest and tax figure decreasing when the revenue figure has dropped by a significant amount compared to last year may indicate:
* That the company has implemented cost saving measures and has made substantial savings in administrative expenses
* That there have been errors in recording expenses
* That the amount of interest payable by the company has reduced
* That management has tried to inflate profit figures by not recording all expenses for the year
* Auditors should discuss this with the client to find out if any cost saving measures have been implemented or if there any other factors which could have resulted in a reduction in expenses.
* Auditors may also plan to perform detailed testing of expenses at the year-end in order to make sure they have been captured in the correct period and not incorrectly recorded in the following year.

1. Return on capital employed = Profit before interest and tax x 100

Share capital + Reserves + Non-current liabilities

* A change may be due to:
* Misstatements in operating expenses and related balance sheet accounts.
* Wrong capitalization of repair expenses or fraudulent payments.
* New loans/non-current assets
* ROCE may be below the borrowing rate that may lead to loan default and possible going concern uncertainty.

1. Asset turnover= Revenue

Share capital + Reserves + Non-current liabilities

**Liquidity ratios**

1. Current ratio =Current assets

Current liabilities

1. Quick ratio (Acid test) = Current assets – Inventory

Current liabilities

**Efficiency ratios**

1. Inventory holding period = Inventory × 365 days

Cost of sales

* A rise in inventory turnover period could be due to:
* A reduction in the total number of products sold
* Incorrect valuation of inventories at the year-end
* An error in the cost of sales or inventories figures
* Auditors should discuss this with the client and could perform further analysis based on the results of the detailed revenue testing.
* Auditors would also plan to perform additional procedures around the valuation of inventories, as well as carefully reviewing the results of the inventory count testing performed at the year end to check that inventory was counted accurately.

1. Receivables collection period =Trade receivables × 365 days

Credit sales

* An increase in the receivables collection period in 2024 compared to 2023 could indicate:
* More sales in the last few months of this year compared to last year, so there are more outstanding receivables at the year end.
* Customers are paying more slowly than they did in the previous year, so there are more outstanding receivables at the year end.
* There have been errors in recording sales and receivables.
* Poor credit control.
* Auditors should discuss this with the client and plan to perform further analysis based on the results of the detailed month by month revenue testing.
* Auditors would also plan to perform a more detailed analysis on the age of outstanding receivables compared to last year in order to see if this reveals any more information about why receivables have increased.

1. Payables payment period = Trade payables × 365 days

Credit purchases

A high or increasing level of payables payment period may be due to:

* An increase in purchases or trading activity.
* Difficulty in paying debts as they fall due. As creditors may sue the entity, this may lead to understatement of provisions for legal expenses or may indicate a going concern problem.

**Gearing ratios**

1. Debt /Equity ratio = Interest bearing debt

Share capital & Reserves

1. Interest cover = Profit before interest and tax

Finance costs

* High gearing may indicate:
* Non-compliance with loan covenants, receivership or bankruptcy.
* Going concern uncertainty may not be properly disclosed.
* Loan default penalties may not be disclosed in financial statements.
* Discuss with management how the high gearing is to be reduced
* Read correspondence with banks and default clauses in loan agreements
* Do a detailed going concern review

**3.5 Assessing the risks of material misstatement**

After understanding the entity and its environment, the auditor assesses the risks of material misstatement in the financial statements to identify significant risks.

**Significant risk** is an identified risk of material misstatement arising from high inherent risk that is considered most severe and requires special audit attention. Inherent risk factors are characteristics of events or conditions that affect susceptibility to misstatement, whether due to fraud or error of an assertion before consideration of controls. ISA 315 gives the following examples of inherent risk factors.

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| **Risk factor** | |
| **Complexity** | * Regulatory – much complex regulation * Business model – complex alliances and joint ventures * Financial reporting framework – complex accounting measurements * Transactions – complex arrangements e.g. off-balance sheet finance |
| **Subjectivity** | Financial reporting framework:   * Wide range of possible accounting estimates e.g. depreciation * Management choice of valuation technique |
| **Change** | Changes in:   * Economic conditions e.g. currency devaluation * Markets – exposure to volatility e.g. futures trading * Customer loss – going concern, liquidation risk * Industry model – changes in the industry in which the entity operates * Business model – changes in supply chain, new lines of business * Geography – expanding into new locations * Entity structure e.g. reorganizations, sale of subsidiaries * IT environmental change and new IT systems for financial reporting |
| **Uncertainty** | * Financial reporting – estimation uncertainty * Pending litigation and contingent liabilities |
| **Management bias or fraud risk** | * Opportunities for fraudulent financial reporting * Transactions with related parties * Non-routine or non-systematic transactions * Transactions based on management intentions |

**Assessment of audit risk**

* Inherent risk, control risk and detection risk may be assessed as low, moderate or high.
* Inherent risk is usually assessed as high and may be reduced by the entity’s internal control.
* Control risk may be assessed as low if the entity’s internal control prevents, detects and corrects misstatements.
* The auditor assesses the risk of material misstatement in order to design and perform audit procedures to reduce detection risk and audit risk to an acceptably low level.

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| Auditor’s objective: Determine whether the entity’s financial statements  are free from material misstatement | | | |
|  | Low risk | Moderate risk | High risk |
| Inherent risk  Control risk | Audit risk reduced to an acceptably low level  Entity’s internal control may prevent, detect and  correct material misstatement  Audit procedures designed to respond to risks  of misstatement identified  Assessed risks of misstatement  Entity’s business/fraud risks would lead to material misstatements |  |  |
| Risks of material misstatement |

LOW Risk exposure to fraud and error HIGH

Note: In assessing the risk the auditor is guided by materiality.

**Response to assessed risks**

The auditor should obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.

Below are some examples of assessed risks together with response to each risk.

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| **Risks** | **Possible responses** |
| Inventory has a lower net realisable value than cost and is therefore overstated (e.g. NRV falls due to the client being in an industry where tastes/fashions change quickly). | * Examine the instructions to identify slow moving inventory lines when attending the inventory count. * Increase the emphasis on reviewing the year end aged inventory analysis for evidence of slow-moving inventory. * Ascertain sales values for items sold post year end that were in inventory at the year end to ensure their NRV was higher than the cost recorded as part of the inventory value in the financial statements. |
| Assets more susceptible to theft and items in the SOFP may be non-existent. | * Focus on testing physical internal controls to prevent theft of assets. * Increased sample sizes for inspection of recorded assets, especially material ones. |
| Revenue expenditure being wrongly classified as capital (or vice versa), leading to misstatement of assets/expenses (e.g. refurbishment of non-current assets where judgement is needed on classifying work as enhancement or repair). | * Obtain a breakdown of related costs and review accounting entries against invoices/details of work done to ensure expenditure is correctly treated as capital/revenue. * Perform a detailed review of repairs accounts for any items which should be included in non-current assets. * Review the asset register to ensure only capital items have been included. |
| Increased risk of incomplete or unrecorded income due to fraud or theft (e.g. large amounts of cash collected and held prior to banking). | * Perform analytical procedures focusing on comparing revenue with expected seasonal/monthly patterns. * If a retail client, perform/reperform a reconciliation of a sample of till records to actual bankings. |
| Receipts/invoicing significantly in advance /arrears of providing services or goods, therefore leading to an increased risk of revenue being in the wrong period (e.g. deposits received in advance, reservation fees, contracts spanning the year end). | * For a sample of revenue entries recorded prior to the year end, agree the transactions as relating to pre-year-end sales by inspecting the contract / other supporting documentation. * Trace post year end transactions back to supporting documentation to test that revenue was recorded in the proper period. * For a sample of contracts or GDNs, verify the revenue was recognised according to the provision of services/goods. * Perform analytical procedures where monthly revenue is compared to expectations and budgeted revenue. Unexpected deviations should be investigated. |
| Invoices received (or payments made) in advance/arrears of goods or services delivery date leading to overstatement or understatement of costs and/or liabilities. | * Review post year end bank statements/cash book payments for evidence of amounts relating to the financial year but not included in liabilities. * For a sample of documents pre and post year end indicating date of delivery of goods/services (e.g. GRNs), verify the cost and liability were recorded in the appropriate period. |
| There is an increased risk of irrecoverable debts (e.g. due to the nature of the client's industry or customers), resulting in assets being potentially overstated. | * Identify year end receivable balances still outstanding at the date of the audit by reviewing post year end receipts from customers. For amounts still outstanding establish whether these are provided for. * Review aged receivables analysis and customer correspondence files for evidence of disputes with receivables and consider the adequacy of any related receivables allowance. |
| Significant client borrowing and/or overdraft with cash flow problems which may indicate going concern problems. | * Review correspondence with the bank/lender for any evidence of withdrawal or extension of facilities. * Review compliance with bank covenants linked to performance on which facilities depend, and increase testing on areas where management could manipulate performance indicators (such as provisions). * Review post year end results and cash flow forecasts (if prepared) for evidence that the company can continue as a going concern. |
| New client system/ controls/ staff increasing the risk of errors and controls not operating effectively. | * Undertake additional visits (e.g. interim audit) to assess the effectiveness of controls in areas affected. * Review and document the new system/controls, perform tests of controls where appropriate. * Increase sample sizes for substantive procedures over financial statement areas. |
| Management has an incentive to manipulate performance, increasing the risk of profits being overstated (e.g. remuneration or bank funding is reliant on performance). | * Increased testing on judgement areas in financial statements e.g. revenue recognition accounting policies and provisions. |

**Example 1**

You are the audit senior of Real & Co and you are planning the audit of Kings Construction Co (KCC) for the year ended 30 June 2024. KCC specialises in building houses and provides a five-year building warranty to its customers. Your audit manager has held a planning meeting with the finance director. He has provided you with the following notes of his meeting and financial statement extracts:

KCC has had a difficult year; house prices have fallen and, as a result, revenue has dropped. In order to address this, management has offered significantly extended credit terms to their customers. However, demand has fallen such that there are still some completed houses in inventory where the selling price may be below cost. During the year, whilst calculating depreciation, the directors extended the useful lives of plant and machinery from three years to five years. This reduced the annual depreciation charge.

The directors need to meet a target profit before interest and taxation of Shs 150 million in order to be paid their annual bonus. In addition, to try and improve profits, KCC changed their main material supplier to a cheaper alternative. This has led to some customers claiming on their building warranties for extensive repairs. To improve their operating cash flow, the directors borrowed Shs 300 million from DFCU bank during the year. This is due for repayment at the end of 2024.

Financial statement extracts for year ended 30 June 2024

DRAFT ACTUAL

2024 2023

Shs 000 Shs 000

Revenue 12,500 15,000

Cost of sales (7,000) (8,000)

Gross profit 5,500 7,000

Operating expenses (5,000) (5,100)

Profit before interest and taxation 500 1,900

Inventory 1,900 1,400

Receivables 3,100 2,000

Cash 800 1,900

Trade payables 1,600 1,200

Loan 1000 –

Required:

Using the information above:

1. Calculate **FIVE** ratios for **BOTH** years, which would assist the audit senior in planning the audit of KCC.
2. Using the information provided, identify and describe **FIVE** risks and explain the auditor’s response to each risk in planning the audit of Kings Construction Co.

Solution

Ratios to assist the audit supervisor in planning the audit (working in thousands):

2024 2023

Gross profit margin 5,500/12,500 = 44% 7,000/15,000 = 46·7%

Net profit margin 500/12,500 = 4% 1,900/15,000 = 12·7%

Inventory holding days 1,900/7,000 x 365 = 99 days 1,400/8,000 x 365 = 64 days

Receivable collection period 3,100/12,500 x 365 = 91 days 2,000/15,000 x 365 = 49 days

Payable payment period 1,600/7,000 x 365 = 83 days 1,200/8,000 x 365 = 55 days

Current ratio 5,800/2,600 = 2·2 5,300/1,200 = 4·4

Quick ratio (5,800 – 1,900)/2,600 = 1·5 (5,300 – 1,400)/1,200 = 3.3

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| **Risk** | **Audit response** |
| Receivable days have increased from 49 to 91 days and management has significantly extended the credit terms given to customers. This leads to an increased risk of recoverability of receivables as they may be overvalued. | Extended post year-end cash receipts testing and a review of the aged receivables ledger to be performed to assess valuation. |
| Due to the fall in demand for KCC’s houses, there are some houses where the selling price may be below cost. IAS 2 *Inventories* requires that inventory should be stated at the lower of cost and NRV.  In addition, inventory days have increased from 64 to 99 days and inventory turnover has fallen from 5·7 in 2023 to 3·7 in the current year. There is a risk that inventory is overvalued. | Detailed cost and net realisable value (NVR) testing to be performed and the aged inventory report to be reviewed to assess whether inventory requires writing down. |
| The directors have extended the useful lives of plant and machinery from three to five years, resulting in the depreciation charge reducing. Under IAS 16 *Property, Plant and Equipment*, useful lives are to be reviewed annually, and if asset lives have genuinely increased, then this change is reasonable.  However, there is a risk that this reduction has occurred in order to achieve profit targets. If this is the case, then plant and machinery is overvalued and profit overstated. | Discuss with the directors the rationale for extending the useful lives. Also, the five-year life should be compared to how often these assets are replaced, as this provides evidence of the useful life of assets. |
| The directors need to reach a profit level of Shs 150 million in order to receive their annual bonus. There is a risk that they might feel under pressure to manipulate the results through the judgements taken or through the use of provisions. | Throughout the audit, the team needs to be alert to this risk and maintain professional scepticism. They should carefully review judgemental decisions and compare treatment against prior years. In addition, a written representation should be obtained from management confirming the basis of any significant judgements. |
| Due to a change in material supplier, the quality of products used has deteriorated and this has led to customers claiming on their five-year building warranty. If the overall number of people claiming on the warranty is likely to increase, then the warranty provision should possibly be higher. If the directors have not increased the level of the provision, then there is a risk the provision is understated. | Review the level of the warranty provision in light of the increased level of claims to confirm completeness of the provision. |
| KCC has received a short-term loan Shs 300m from the bank. This loan needs to be repaid in 2025 and so should be disclosed as a current liability. | During the audit, the team should check that the Shs 300m loan finance was received. In addition, the disclosures for this loan should be reviewed in detail to ensure compliance with relevant accounting standards and legislation. |
| In addition, KCC may have used its assets as security for the loan. There is a risk that the disclosure of any security given is not complete. | The loan correspondence should be reviewed to ascertain whether any security has been given, and this should be established as part of the bank confirmation process. |
| The current and quick ratios have decreased from 4·4 to 2·2 and 3·3 to 1·5 respectively. In addition, the cash balances have decreased over the year, there is a fall in demand and KCC have taken out a short-term loan of Shs 300 million, which needs to be repaid in 2025.  Although all ratios are above the minimum levels, this is still a significant decrease and along with the fall in both operating and gross profit margins, as well as the significant increase in payable days could be evidence of going concern difficulties. | Detailed going concern testing to be performed during the audit and discussed with the directors to ensure that the going concern basis is reasonable.  The team should discuss with the directors how the short-term loan of Shs 300 million will be repaid later in 2024. |

**3.6 Fraud, laws and regulations**

**Definition of fraud**

ISA 240 *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements* defines fraud as 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.

* Misstatements due to fraud are intentional whereas those due to error are unintentional.
* An auditor is mainly concerned with fraud that causes material misstatements in financial statements.
* There is management fraud (involving management) and employee fraud (involving only employees).

**Types of fraud that may cause material misstatement in financial statements**

* **Fraudulent financial reporting**

Involves intentional misstatements, including omissions of amounts or disclosures in financial statements, to deceive financial statement users. This may include:

* Manipulation, falsification or alteration of accounting records/supporting documents
* Misrepresentation (or omission) of events or transactions in the financial statements
* Intentional misapplication of accounting principles.
* **Misappropriation of assets**

Involves the theft of the entity's assets (e.g. cash and inventory) and is often perpetuated by employees in relatively small and immaterial amounts. It can also be carried out on a larger scale by management who may conceal the misappropriation in ways that are difficult to detect. It may include:

* Embezzling receipts (for example, diverting them to private bank accounts)
* Stealing physical assets or intellectual property (inventory, selling data)
* Causing an entity to pay for goods not received (payments to fictitious vendors)
* Using assets for personal use

**Fraud risk factors** (**Fraud triangle**)

Are 'events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud'. These are:

* **Pressure** or incentive on management to meet performance targets or other employees to commit fraud so as to pay personal debts etc.

|  |
| --- |
| * **Opportunity** for management or employees to commit fraud like large amounts of cash, small assets with high value and in high demand like jewellery, a weak board of directors or internal control and inadequate IT knowledge by management which enables employees to perpetrate fraud. |

* **Rationalisation** – this is the attitude that justifies fraud, for example, ‘I am only taking what I deserve’.

**Responsibility for the prevention and detection of fraud**

1. Management and those charged with governance are responsible for prevention and detection of fraud.

They should:

* Create a culture of honesty and ethical behaviour.
* Implement a system of internal control to mitigate the risk of fraud.

1. The auditor’s responsibilities in ISA 240:
2. The auditor should obtain **reasonable assurance** that the financial statements are free from material misstatement, whether caused by fraud or error.
3. In order to fulfill this responsibility, the auditor is required to identify and **assess the risks of material misstatement** of the financial statements due to fraud.
4. The auditor needs to **obtain sufficient appropriate audit evidence** regarding the assessed risks of material misstatement due to fraud through designing and implementing appropriate responses. In addition, the auditor must respond appropriately to fraud or suspected fraud identified during the audit.
5. Maintaining **professional scepticism** throughout the audit, considering the potential for management override of controls and recognising the fact that audit procedures which are effective in detecting error may not be effective in detecting fraud.
6. To ensure that the whole engagement team is aware of the risks and responsibilities for fraud and error, there should be a **discussion within the team** on how and where the financial statements may be susceptible to fraud.
7. If the auditor identifies fraud or receives information that a fraud may exist, the auditor should report this on a **timely basis** to the **appropriate level of management**.

**Risk assessment procedures** in identifying the risks of material misstatement due to fraud include:

1. **Enquiries of management** about their assessmentof fraud risk in financial statements, communication to those charged with governance and knowledge of any actual, suspected or alleged fraud.

b) **Enquiries of internal audit** for knowledge of any actual, suspected or alleged fraud and its views on the risks of fraud

c) Obtaining an **understanding** of how those charged with governance **oversee** management's processes for identifying and responding to the risk of fraud and the internal control established to mitigate these risks

d) **Enquiries of those charged with governance** for knowledge of any actual, suspected or alleged fraud

e) Evaluating whether any unusual relationships have been identified in performing **analytical procedures** that may indicate risk of material misstatement due to fraud

f) Considering whether any **other information** may indicate risk of material misstatement due to fraud

g) Evaluating whether any **fraud risk factors** are present

**Laws and regulations**

According to ISA 250 *Consideration of laws and regulations in an audit of financial statements,* the auditor is not responsible for preventing non-compliance and cannot be expected to detect non-compliance with all laws and regulations.

The auditor’s responsibility is to:

1. Obtain reasonable assurance that financial statements are free from material misstatement whether due to fraud or error in respect of the legal and regulatory framework within which the entity operates.
2. Obtain **sufficient appropriate** audit evidence about compliance with those laws and regulations that have a direct effect on the determination of material amounts and disclosures in the financial statements (such as tax or pension laws and regulations).
3. Undertake specified audit procedures to help **identify non-compliance** with laws and regulations that may have a material effecton the financial statements or the entity’s ability to continue in business by reading minutes, enquiries of management and inspecting correspondence with the relevant licensing or regulatory authorities.
4. Request **written representations** from management that all known instances of noncompliance with laws and regulations when preparing the financial statements have been disclosed to the auditor.

**Factors that may indicate non-compliance with laws and regulations**

* Investigations by regulatory authorities and government departments
* Payment of fines or penalties
* Payments for unspecified services or loans to consultants, related parties, employees or government employees
* Sales commissions or agents' fees that appear excessive
* Purchasing at prices significantly above/below market price
* Unusual payments in cash
* Unusual transactions with companies registered in tax havens
* Payment for goods and services made to a country different to the one in which the goods and services originated
* Existence of an information system that fails to provide an adequate audit trail or sufficient evidence
* Unauthorised transactions or improperly recorded transactions
* Matters raised by 'whistle-blowers'

**Audit procedures when non-compliance is identified or suspected**

1. Obtain an understanding of the nature of any acts and circumstances
2. Obtain further information to evaluate the possible effect on the financial statements
3. Discuss with management and those charged with governance unless laws and regulations prohibit such communication (for example, avoiding tipping off in cases of suspected money laundering) meaning legal advice may need to be sought by the auditor before proceeding with such enquiries
4. Consider the need to obtain legal advice if sufficient information is not provided and the matter is material
5. Evaluate the effect on the auditor's opinion if sufficient information is not obtained
6. Evaluate the implications of any identified or suspected non-compliance on risk assessment and the reliability of any written representations (especially if management or those charged with governance are involved in this non-compliance in some way)

**Reporting identified or suspected non-compliance**

1. The auditor should communicate with **those charged with governance**, but, if the auditor suspects that

those charged with governance are involved, the auditor shall communicate with the next highest level of

authority, such as the **audit committee or supervisory board**. If this does not exist, the auditor should consider the need to obtain **legal advice.**

1. The auditor should seek legal advice whether identified or suspected non-compliance has to be reported to **an appropriate authority outside the entity** in line with law, regulation or relevant ethical requirements.
2. If legally permitted, **withdrawal** from an audit engagement may be an option for an auditor who believes

that any identified or suspected non-compliance is sufficient to raise questions about the client's **integrity**.

However, this should only be undertaken after obtaining legal advice and sho**uld not be seen as a way of**

**avoiding other requirements** (such as informing an appropriate authority or even an incoming auditor).

**1.7 Overall audit strategy and audit plan**

**Importance of planning**

ISA 300 *Planning an audit of financial statements* requires an auditor to plan every audit as it ensures:

* That the auditor devotes appropriate attention to **key audit areas** and those with significant risks.
* That potential **problems** are identified and resolved on a timely basis.
* The audit is **properly** organized and completed expeditiously.
* Appropriate **audit staff** are selected and work is properly assigned to them.
* Proper **direction**, **supervision** **and review** of audit work.
* There is proper **coordination** of work done by experts and other auditors.

**Overall audit strategy**

After the engagement activities, the auditor establishes the overall audit strategy that sets the scope, timing and direction of the audit and guides the development of a more detailed audit plan. ISA 300 requires the overall audit strategy to include the following (*see Appendix 1*):

|  |  |
| --- | --- |
| **Main areas** | **Matters to consider include** |
| **Characteristics of the engagement** | * Financial reporting framework on which financial statements have been prepared. * Industry specific reporting requirements. * Availability of the work of internal auditors and the extent of reliance on such work. * Effect of information technology on audit procedures. * Availability of client personnel and data. |
| **Reporting objectives, timing of the audit & nature of communications** | * Entity's timetable for reporting such as at interim and final stages * Organisation of meetings with management and those charged with governance * Discussions with management and those charged with governance * Expected communications with third parties |
| **Significant factors & developments** | * Determination of materiality * Areas identified with higher risk of material misstatement * Need to maintain professional skepticism * Evidence of management's commitment to sound internal control * Volume of transactions and whether it is more efficient to rely on internal control * Significant business and industry developments * Significant changes in financial reporting framework |
| **Nature, timing and extent of resources** | * Selection of engagement team * Assignment of work to team members * Engagement budget |

**Audit plan**

The audit plan sets out detailed audit procedures to be performed by the engagement team members in order to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. It implements the audit strategy and includes the following:

1. A description of the nature, timing and extent of planned risk assessment procedures
2. A description of the nature, timing and extent of planned further audit procedures at the assertion level
3. Other planned audit procedures required to be carried out for the engagement to comply with ISAs

**Contents of an audit plan**

1. **Understanding the entity** and its environment including preliminary analytical review
2. **Preliminary risk assessment** – review of overall risk and key risks in individual audit areas and their impact on the audit taking into account:
3. Past experience.
4. Areas large in materiality.
5. Changes in financial reporting standards and accounting policies.
6. Areas where there is a significant risk of material misstatement or fraud.
7. Complex accounting areas including those involving accounting estimates.
8. The impact of information technology.
9. Conditions requiring special attention such as the existence of related party transactions, contingencies, market and industry conditions.
10. Any taxation aspects which may affect the audit.
11. Appropriateness of the going concern assumption.
12. **Materiality** for the financial statements as a whole and performance materiality and reasons for them.
13. **Auditor's response to assessed risk –** risks identified for each key audit area above and the planned response to such risks including the use of automated tools.
14. **Sampling techniques** to be adopted.
15. **Audit timetable** of planned audit work including
16. **Allocation of work** to audit team members including experts.
17. **Time and cost budgets** used in estimating an audit fee.
18. **Audit procedures** for each major audit areas (*see Appendix 2*).

The audit strategy and audit plan may be modified during the course of the audit due to unexpected events, changes in conditions or audit evidence obtained.

**An example** **of an audit timetable** **for** **a big client for the period ending 31.12.2024**

|  |  |
| --- | --- |
| January  – March 2024  October 2024 | **Initial visit:**  Audit planning:   * + - * Risk assessment, understanding the client and its environment, including performing preliminary analytical procedures.       * Documenting the client’s internal control system * Evaluating the design of the internal controls system * Developing the overall audit strategy & audit plan (including audit programs)   **Interim audit:**   * Tests of controls on internal controls in the first nine months * Substantive procedures on transactions and account balances for the first nine months. * Issuing an interim management letter with deficiencies, effects and recommendations. |
| December 2024 –  January 2025 onwards | **Final audit:**   * Performing substantive tests of details of balances and analytical procedures. * Preparing an audit report after the directors have signed the financial statements. * Issuing a final management letter.   (*Consider the dates for the annual general meeting*) |

**Interim** and **final audits**

An audit for a financial year may be performed in one or more phases, called **interim audit** and **final audit**.

* Interim audit is performed during the accounting period.
* Final audit is performed after the year end.

Purpose in interim audit

* The purpose of the interim audit is to carry out audit procedures that would be difficult to perform at the year-end because of limited time.
* Work performed tends to focus on risk assessment and documenting and testing internal controls.
* Limited substantive procedures may be carried out as the year-end statement of financial position figures to be reported on are not yet available.

Purpose of final audit

* Final audit is carried out on draft financial statements at the end of accounting period of every entity and ends with an audit report containing an opinion.
* The final audit opinion takes into account conclusions reached at both or all audit visits.
* Some audit procedures like agreeing the financial statements to the accounting records and examining adjustments made during their preparations are performed during final audit.

Typical procedures carried out during the interim and final audits

|  |  |
| --- | --- |
| Interim audit procedures may include: | Final audit procedures include: |
| * Understanding the entity and risk assessment * Recording the entity's system of internal control * Evaluating the design of internal controls * Carrying out tests of control on the entity's internal controls to ensure they are operating as expected * Performing limited substantive testing of transactions & balances to gain evidence that books and records can be used as a basis for the preparation of financial statements at year-end. * Identification of issues that may have an impact on work to take place at the final audit | * Substantive procedures involving verification of statement of financial position balances and amounts in the statement of profit or loss * Obtaining third-party confirmations * Analytical procedures on financial statements * Subsequent events review * Agreeing financial statements to accounting records * Examining adjustments made when preparing FSs * Reviewing the going concern status of the entity * Performing test to ensure that conclusions formed at the interim audit are still valid * Obtaining written representations from management * Reviewing audit evidence and compliance with the financial reporting framework. * Preparing and issuing an audit report and issuing a final management letter |

Impact of interim audit work on the final audit in general

* The benefit of spreading audit procedures over an interim and final audit is that it is possible to provide

shareholders and other users of the financial statements with the audited accounts sooner than if all audit

procedures were carried out at a final audit taking place after the year end.

* Performing audit procedures before the period end can **assist in identifying significant matters at an**

**early stage** of the audit and help resolve them with management's assistance or develop an effective audit

approach to address them. This **reduces the time taken at the final audit** to gain the remaining sufficient

appropriate audit evidence needed.

Impact of interim audit work relating to internal controls on the final audit

If the auditors are to place reliance on internal controls they must obtain evidence that **controls** have

operated effectively **throughout the period**. If the auditor obtains audit evidence about the operating

effectiveness of controls at the interim audit, when it comes to the final audit, instead of having to gain

evidence over controls covering the whole year the auditor can focus on:

* Obtaining audit evidence about **significant changes to those controls** subsequent to the interim period
* Determining the **additional audit evidence** to be obtained for the remaining period

While at the final audit, the amount of work needed to gain additional audit evidence about controls that

were operating during the period between the interim audit and the year-end will depend on:

* The significance of the assessed risks of material misstatement at the assertion level
* The specific controls that were tested during the interim period, and significant changes to them since they were tested, including changes in the information system, processes and personnel
* The degree to which audit evidence about the operating effectiveness of those controls was obtained
* The length of the remaining period
* The extent to which the auditor intends to reduce further substantive procedures based on the reliance of controls
* The control environment

Impact of substantive procedures performed during the interim audit on the final audit

* If substantive procedures are performed at an interim date, the auditor must cover the remaining period by

performing substantive procedures, or substantive procedures combined with tests of controls for the intervening period.

* Conclusions will have been reached on the testing carried out at the interim audit and the auditor essentially has to carry out any procedures necessary to provide a reasonable basis for extending the audit conclusions from the interim date to the period end.
* One approach an auditor who has carried out an interim audit can take is to compare and reconcile information concerning the balance at the period end with the comparable information at the interim date. Essentially, because the interim balance has been audited, the auditor can focus on auditing the movements in the balance between the interim date and the year end.
* A point to note is that when misstatements that the auditor did not expect when assessing the risks of material misstatement are detected at an interim date, the auditor may need to modify the planned nature, timing or extent of substantive procedures covering the remaining period. This may result in repeating the procedures in full that were performed at the interim date. Therefore part of the expected benefit of carrying out the interim audit will have been lost.

**3.8 Audit documentation**

**Objective**

Audit documentation is the record of audit procedures performed, relevant audit evidence obtained and conclusions reached. There also called working papers or work papers.

ISA 230 *Audit Documentation* requires the auditor to prepare documentation on a timely basis as it:

* Provides evidence on the achievement of the overall objectives of the auditor.
* Provides evidence that the audit was planned and performed in accordance with ISAs and applicable laws.
* Assists the engagement team in planning and performing the audit.
* Assists the engagement team supervisors in directing, supervising reviewing audit work.
* Enables the engagement team to be accountable for its work.
* Is a record of matters of continuing significance to future audits.
* Enables the conduct of quality control reviews and inspections both internal and external.

**Content and form**

The auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand audit procedures performed, audit evidence obtained, significant matters arising during the audit and conclusions reached together with judgments made.

**Audit files**

Working papers may be divided into permanent audit files and current audit files.

1. A **permanent audit file** contains information of continuing importance the audit and includes:
2. Client acceptance questionnaire
3. Engagement letters
4. Memorandum and articles of association of the company
5. Legal documents like loan and lease agreements
6. Entity business history and industry information
7. Previous years' signed financial statements and reports to management
8. Accounting systems notes and internal control questionnaires

A typical working paper

|  |
| --- |
| **Client:** NMS **Ref:** A 1.1  **Year end:** 30 June 2024 **Prepared by:** **Date:**  **Reviewed by: Date:**  **Subject: Y**ear-end inventory count  **Audit objective**: To test the accuracy of year-end inventory  **Work done:**   * Sample selection * Work done * Source of information * Key to any audit risks * Appropriate cross-referencing   **Results:**  Weaknesses in internal controls or misstatements detected  **Conclusions:**  Whether the audit area would make financial statements show a true and fair view. |

1. A**current audit file** contains information relevant to the current year’s audit and includes:

|  |
| --- |
| 1. Financial statements 2. Accounts checklists 3. Summary of unadjusted errors 4. Report to partner including details of significant events and errors 5. Review notes 6. Audit strategy and planning memorandum 7. Accounting systems notes and internal control questionnaires 8. Time budgets and summaries 9. Written representations 10. Management letter 11. Notes of board minutes 12. A lead schedule for each balance in the financial statements and a list of audit procedures performed together with the results and conclusions of the testing.  * The final audit file should be completed within 60 days from the date of the audit report.   **Safe custody and retention of working papers**  Working papers are the property of the auditors and must be **kept safely and confidential.**  Information in working papers should not be made available to third parties without the permission of the entity.  Working papers must be kept for a period of not less than **five years** from the date of the auditor's report. |

**3.9 Audit evidence and financial statement assertions**

**Definition of audit evidence**

Audit evidence is information used by the auditor in arriving at conclusions on which the opinion is based.

**Sufficient appropriate audit evidence**

ISA 500 *Audit evidence* requires the auditor to obtain **sufficient appropriate** audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.

**Sufficient** is the quantity of audit evidence to support the audit opinion. Factors to consider are:

1. Risk assessment
2. Nature of accounting and internal control systems
3. Materiality of the item
4. Experience gained during the previous audits
5. Results of audit procedures
6. Source and reliability of information available

**Appropriate** means relevant and reliable evidence.

* Evidence must be relevant to financial statement assertions.
* **Reliability** of evidencevaries:
* Evidence from **external sources** is more reliable than that from internal sources.
* **Auditor generated** evidence is better than client generated.
* Internal evidence is more reliable when **controls are effective.**
* **Written/documentary** evidence is better than oral evidence.
* **Original** documents are more reliable than photocopies of faxes which can easily be altered.

**Financial statement assertions**

Assertions are representations, explicit or otherwise, with respect to the recognition, measurement, presentation and disclosure of information in the financial statements which are inherent in management representing that the financial statements are prepared in accordance with the applicable financial reporting framework.

Assertions are used by the auditor to consider the different types of potential misstatements that may occur when identifying, assessing and responding to the risks of material misstatement.

Evidence must be relevant to the particular financial statement assertion the auditor is to test.

ISA 315 (Revised) lists two types of assertions.

1. **Assertions about classes of transactions and events and related disclosures (OCCCAP)**
2. **Occurrence** – transactions and events that have been recorded or disclosed have occurred and pertain to the entity.
3. **Completeness** – all transactions and events that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
4. **Cut-off** – transactions and events have been recorded in the correct accounting period.
5. **Classification** – transactions and events have been recorded in the proper accounts.
6. **Accuracy** – amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.
7. **Presentation** – transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.
8. **Assertions about account balances and related disclosures at the period end (COVECP)**
9. **Completeness** – all assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
10. **Obligations and rights** – the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
11. **Valuation, accuracy and allocation** – assets, liabilities and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded and related disclosures are appropriately measured and described.
12. **Existence** – assets, liabilities and equity interests exist.
13. **Classification** – assets, liabilities and equity interests have been recorded in the proper accounts.
14. **Presentation** – assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

**Procedures for obtaining audit evidence**

Sufficient appropriate evidence is collected using tests of controls and substantive procedures.

1. **Tests of controls** are audit procedures designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.

Tests of controls are only performed:

* When control risk has initially been assessed as low i.e. controls are expected to operate effectively
* When substantive procedures alone do not provide sufficient appropriate evidence for example, when an entity conducts its business using IT systems which do not produce documentation of transactions

1. **Substantive procedures** are audit procedures designed to detect material misstatements at the assertion

level.

Substantive procedures comprise:

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

Substantive procedures must always be carried out on material classes of transactions, account balances and disclosures.

Auditors obtain evidence by performing one or more of the following audit procedures (**AEIOU**).

|  |  |  |
| --- | --- | --- |
| **Audit procedure** | **Description, examples and comments** | **Type of procedure** |
| Analytical procedures | The evaluation of financial information by comparing financial and non-financial data and the investigation of significant differences and relationships which are inconsistent with other information.   * Compare gross profit to revenue in 2024 and 2023 * Compare payroll costs to number of employees | Substantive procedure |
| Enquiry & confirmation | Enquiry is seeking information from knowledgeable persons within or outside the entity.  Inquiry of:   * Management about incentive plans like bonuses. * Lawyers about cases in court. * Strength of evidence depends on the knowledge and integrity of source of information. * Enquiry alone does not provide sufficient audit evidence to detect a material misstatement at assertion level, nor is it sufficient to test the operating effectiveness of controls.   Confirmation is obtaining representations directly from a third party.   * Confirmation of trade receivables from debtors * Confirmation of bank balances from banks * External confirmation may provide highly reliable evidence as it from sources independent of the client. | * Both a test of controls & a   substantive procedure   * Substantive procedure |
| Inspection | Examining records and tangible assets   * Inspection of assets recorded in the asset register * Inspection of inventories during the counting * Inspection of records provides evidence that is readily available and widely used at a relatively low cost. * The reliability of evidence from inspection of records depends on the effectiveness of internal control and whether they are from internal or external sources. * Inspection of tangible assets that are recorded in the accounting records confirms existence, but does not necessarily confirm rights and obligations or valuation. * Confirmation that assets seen are recorded in accounting records gives evidence of completeness. | Both |
| Observation | Looking at a process or procedure being performed by others.   * Observe whether the entity’s personnel follow instructions when counting inventory * Observe the dispatch of goods * The reliability of the evidence is limited to the point in time at which the observation takes place and by the fact that the presence of the auditor may influence the way the procedures are carried out. * Evidence from observation should later be corroborated with evidence from other procedures. | Test of controls |
| Recalculation &  Re-performance | Recalculation is verifying the mathematical accuracy of documents or records.   * Recalculate the depreciation expense for buildings * Recalculate the finance cost for a bank loan. * Recalculation gives reliable information on the accuracy of figures as the evidence is obtained directly by the auditor.   Re-performance is the auditor's independent execution of procedures and re-performance of controls.   * Re-perform the year-end bank reconciliation * Recount inventory to check the accuracy of the count   Re-performance is however only limited to controls present in the system. | * Substantive procedure * Test of controls |

**Using analytical procedures as substantive procedures**

The auditor can use three types of analytical procedures.

1. **Variance analysis** e.g. compare the current year financial information to prior period or budget information.
2. **Ratio analysis** – calculation of ratios and analysis and investigation of significant differences.
3. **Proof in total** – use of financial and non-financial data to estimate an expected value in the financial statements and investigation of significant differences.

Destiny Ltd received a loan of Shs 200 million on 1 January 2023 to finance the construction of a road. The loan carries a fixed interest of 2% per month payable at the end of each month. The company repaid Shs 50 million of the loan on 1 May 2023. Finance cost in the statement of profit or loss for the year ended 31 December 2023 is Shs 48 million. You are required to verify the finance cost for the year using a proof in total.

Solution

Finance cost: 1.1.2023 to 30.4.2023 = (200m X 2% X 4 months) = 16m.

Finance cost: 1.5.2023 to 31.12.2023 = (200m – 50m) X 2% X 8 months = 24m.

Total 40m

Finance cost is Shs 40m and profit is understated by Shs 8m.

**Factors to consider when using analytical procedures**

1. The **suitability** of analytical procedures to a particular assertion.
2. The **reliability of data** from which the expected amounts or ratios are developed.
3. Whether the expectation is sufficiently precise to identify a **material** misstatement.
4. The amount of any **difference that is acceptable** without further investigation being required.

**Tests of details**

They are substantive procedures that involved details of classes of transactions, account balances and disclosures by inspection of accounting records and assets. Examples include:

* Inspection of invoices to verify the accuracy of the amounts recorded in financial statements.
* Physical inspection of non-current assets and inventory to verify their existence.
* Review of after date money received per cash book in order to verify the valuation of receivables.

**Tests of controls versus substantive procedures**

Collecting evidence using tests of controls differs from using substantive procedures. Below is an example on bank reconciliation.

|  |  |
| --- | --- |
| **Tests of controls** | **Substantive procedures** |
| The focus is on:   * Understanding of the control being in place * Testing that it has operated effectively throughout the audit | The focus is on the auditor performing detailed procedures on figures in the financial statements |
| Include:   * Observing the control taking place * Re-performing the control * Inspecting evidence that the control has taken place | Include:   * Analytical procedures * Enquiry * Confirmation * Inspection * Recalculation |
| Tests include:   * Re-perform the bank reconciliation to ensure it has been accurately done * Review the bank reconciliation for evidence of the supervisor/manager review being done | Tests include:   * Obtain bank confirmation letters from banks of the client * Verify the accuracy of bank reconciliation |

**Directional testing**

Substantive tests are performed to detect:

* **Errors** resulting in understatements and overstatements
* **Omissions** resulting in understatements

**Tests designed to discover errors** start with the accounting records in which the transactions are recorded to supporting documents or other evidence.

* Such tests detect any overstatement and also any understatement through causes other than omission.
* To test whether sales are priced correctly, select invoices from the sales ledger and check prices to the official price list.

**Tests designed to discover omissions** start from outside the accounting records and then traced to those records.

* Understatements due to omission will never be revealed by starting with the account itself as there is no chance of selecting items that have been omitted from the account.
* To detect whether all raw material purchases have been properly processed, select goods received notes and agree them to the inventory records or payables ledger.

To verify overstatements (*occurrence*) *of transactions/existence of assets*)

To verify understatements (*completeness*) *of account balances or transactions*)

Auditors design tests to detect both errors and omissions.

The type of test and the direction of the test should be recognized before selecting the sample.

The concept of directional testing is based on the principle of **double-entry bookkeeping** where for every debit there should be a corresponding credit.

* Any misstatement of a debit entry will result in either a corresponding misstatement of a credit entry or a misstatement in the opposite direction, of another debit entry.
* By designing audit tests carefully, auditors make conclusions not only about the debit or credit entries that they have directly tested, but also about the corresponding credit or debit entries that are necessary to balance the books.

Tests are therefore designed in the following way:

|  |  |
| --- | --- |
| **Test item** | **Example** |
| **Test debit items** (expenditure or assets) for overstatement by selecting debit entries recorded in the nominal ledger and checking value, existence and ownership. | If a non-current asset entry in the nominal ledger of Shs 10 million is selected, it would be overstated if:   * It was recorded at anything less than Shs 10 million or * If the company did not own it or * If it did not exist (e.g. it had been sold or the amount of Shs10 million represented a revenue expense. |
| **Test credit items** (income or liabilities) for understatement by selecting items from appropriate sources independent of the nominal ledger and ensuring that they result in the correct nominal ledger entry | Select a goods despatched note and agree that the recorded sale has been recorded in the nominal ledger sales account. Sales would be understated if:   * The nominal ledger did not reflect the transaction at all (completeness) or * Reflected it at less than full value (say, if goods valued at Shs 10 million were recorded in the sales account at Shs 9 million, there would be an understatement of Shs 1 million. |

* A test for the overstatement of an asset simultaneously gives comfort on understatement of other assets, overstatement of liabilities, overstatement of income and understatement of expenses.
* So by performing the primary tests, the auditors obtain audit assurance in other audit areas. Successful completion of the primary tests will therefore result in them having tested all account areas for both overstatement and understatement.

**Example 2**

You are an audit supervisor of Cane & Co planning the audit of Ham Co, a listed company, for the year ending 31 December 2021. The company manufactures computer components and forecast profit before tax is Shs 336m and total assets are Shs 793m.

Ham Co distributes its products through wholesalers as well as via its own website. The website was upgraded during the year at a cost of Shs 11m. Additionally, the company entered into a transaction in November to purchase a new warehouse which will cost Shs 32m. Ham Co’s legal advisers are working to ensure that the legal process will be completed by the year end. The company issued Shs 50m of irredeemable preference shares to finance the warehouse purchase.

During the year the finance director has increased the useful economic lives of fixtures and fittings from three to four years as he felt this was a more appropriate period. The finance director has informed the engagement partner that a revised credit period has been agreed with one of its wholesale customers, as they have been experiencing difficulties with repaying the balance of Shs 12m owing to Ham Co. In October 2021, Ham Co introduced a new bonus based on sales targets for its sales staff. This has resulted in a significant number of new wholesale customer accounts being opened by sales staff. The new customers have been given favourable credit terms as an introductory offer, provided goods are purchased within a two-month period. As a result, revenue has increased by 5% on the prior year.

The company has launched several new products this year and all but one of these new launches have been successful. Feedback on product Lima, launched four months ago, has been mixed, and the company has just received notice from one of their customers, Panta Co, of intended legal action. They are alleging the product sold to them was faulty, resulting in a significant loss of information and an ongoing detrimental impact on profits. As a precaution, sales of the Lima product have been halted and a product recall has been initiated for any Lima products sold in the last four months.

The finance director is keen to announce the company’s financial results to the stock market earlier than last year and in order to facilitate this, he has asked if the audit could be completed in a shorter timescale. In addition, the company is intending to propose a final dividend once the financial statements are finalised.

Required:

Describe SEVEN audit risks, and explain the auditor’s response to each risk, in planning the audit of Ham Co. Note: Prepare your answer using two columns headed Audit risk and Auditor’s response respectively.

Solution

Audit risk and auditor’s response

|  |  |
| --- | --- |
| Audit risk | Auditor’s response |
| Ham Co upgraded their website during the year at a cost of Shs 11m. The costs incurred should be correctly allocated between revenue and capital expenditure.  As the website has been upgraded, there is a possibility that the new processes and systems may not record data reliably and accurately. This may lead to a risk over completeness and accuracy of data in the underlying accounting records. | Review a breakdown of the costs and agree to invoices to assess the nature of the expenditure and if capital, agree to inclusion within the asset register or agree to the statement of profit or loss.  The audit team should document the revised system and undertake tests over the completeness and accuracy of data recorded from the website to the accounting records. |
| Ham Co has entered into a transaction to purchase a new warehouse for Shs 32m and it is anticipated that the legal process will be completed by the year end.  Only assets which physically exist at the year-end should be included in property, plant and equipment. If the transaction has not been completed by the year end, there is a risk that assets are overstated if the company incorrectly includes the warehouse at the year end. | Discuss with management as to whether the warehouse purchase was completed by the year end. If so, inspect legal documents of ownership, such as title deeds ensuring these are dated prior to 1 January 2022 and are in the company name. |
| Significant finance has been obtained in the year, as the company has issued Shs 50m of irredeemable preference shares.  This finance needs to be accounted for correctly, with adequate disclosure made. As the preference shares are irredeemable, they should be classified as equity rather than non-current liabilities. Failing to correctly classify the shares could result in understated equity and overstated non-current liabilities. | Review share issue documentation to confirm that the preference shares are irredeemable. Confirm that they have been correctly classified as equity within the accounting records and that total financing proceeds of Shs 50m were received.  In addition, the disclosures for this share issue should be reviewed in detail to ensure compliance with relevant accounting standards. |
| The finance director has extended the useful lives of fixtures and fittings from three to four years, resulting in the depreciation charge reducing. Under IAS 16 *Property, Plant and Equipment*, useful lives are to be reviewed annually, and if asset lives have genuinely increased, then this change is reasonable.  However, there is a risk that this reduction has occurred in order to boost profits. If this is the case, then fixtures and fittings are overvalued and profit overstated. | Discuss with the directors the rationale for any extensions of asset lives and reduction of depreciation rates. Also, the four-year life should be compared to how often these assets are replaced, to assess the useful life of assets. |
| A customer of Ham Co has been encountering difficulties paying their outstanding balance of Shs 12m and Ham Co has agreed to a revised credit period.  If the customer is experiencing difficulties, there is an increased risk that the receivable is not recoverable and hence is overvalued. | Review the revised credit terms and identify if any after date cash receipts for this customer have been made.  Discuss with the finance director whether he intends to make an allowance for this receivable. If not, review whether any existing allowance for uncollectable accounts is sufficient to cover the amount of this receivable. |
| A sales-related bonus scheme has been introduced in the year for sales staff, with a significant number of new customer accounts on favourable credit terms being opened before the year end. This has resulted in a 5% increase in revenue.  Sales staff seeking to maximise their current year bonus may be tempted to open new accounts from poor credit risks leading to irrecoverable receivables. In addition, there is a risk of sales cut-off errors as new customers could place orders within the two-month introductory period and subsequently return these goods post year end. | Increased sales cut-off testing will be performed along with a review of any post year-end returns as they may indicate cut-off errors. In addition, increased after date cash receipts testing to be undertaken for new customer account receivables. |
| Ham Co has halted further sales of its new product Lima and a product recall has been initiated for any goods sold in the last four months.  If there are issues with the quality of the Lima product, inventory may be overvalued as its NRV may be below its cost.  Additionally, products of Lima sold within the last four months are being recalled, this will result in Ham Co paying customer refunds. The sale will need to be removed; a refund liability should be recognised along with the reinstatement of inventory, although the NRV of this inventory could be of a minimal value. Failing to account for this correctly could result in overstated revenue and understated liabilities and inventory. | Discuss with the finance director whether any write downs will be made to this product, and what, if any, modifications may be required with regards the quality.  Testing should be undertaken to confirm cost and NRV of the Lima products in inventory and that on a line-by-line basis the goods are valued correctly.  Review the list of sales made of product Lima prior to the  recall, agree that the sale has been removed from revenue and the inventory included. If the refund has not been paid pre-year end, agree it is included within current liabilities. |
| Panta Co, a customer of Ham Co, has announced that they intend to commence legal action for a loss of information and profits as a result of the Lima product sold to them.  If it is probable that the company will make payment to the customer, a legal provision is required. If the payment is possible rather than probable, a contingent liability disclosure would be necessary. If Ham Co has not done this, there is a risk over the completeness of any provisions or the necessary disclosure of contingent liabilities. | Cane & Co should write to the company’s lawyers to  enquire of the existence and likelihood of success of any claim from Panta Co. The results of this should be used to assess the level of provision or disclosure included in the financial statements. |
| The finance director has requested that the audit completes one week earlier than normal as he wishes to report results earlier. A reduction in the audit timetable will increase detection risk and place additional pressure on the team in obtaining sufficient and appropriate evidence.  In addition, the finance team of Ham Co will have less time to prepare the financial information leading to an increased risk of errors arising in the financial statements. | The timetable should be confirmed with the finance director. If it is to be reduced, then consideration should be given to performing an interim audit in late March or early April; this would then reduce the pressure on the final audit.  The team needs to maintain professional scepticism and be alert to the increased risk of errors occurring. |
| The company is intending to propose a final dividend once the financial statements are finalised. This amount should not be provided for in the 2021 financial statements, as the obligation only arises once the dividend is announced, which is post year end.  In line with IAS 10 *Events after the Reporting Date* the dividend should only be disclosed. If the dividend is included, this will result in an overstatement of liabilities and understatement of equity. | Discuss the issue with management and confirm that the dividend will not be included within liabilities in the 2021 financial statements.  The financial statements need to be reviewed to ensure that adequate disclosure of the proposed dividend is included. |

**3.10 Revision questions**

1. ISA 315 Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment (Revised) requires an auditor to assess the risks of material misstatement.

Required:

1. Describe a risk-based audit.
2. Define audit risk and the components of audit risk.
3. Identify **SIX** key areas that should be examined by an auditor when understanding an entity and its environment and assessing the risks of material misstatement.
4. Describe **FOUR** risk assessment procedures used by the auditor in understanding an entity and its environment and for each procedure give one example showing how the procedure is used.

**2)** ISA 320 *Materiality in planning and performing an audit* provides guidance on the concept of materiality in planning and performing an audit.

Required:

**a)** Definemateriality and performance materiality.

**b)** Explain factors used by the auditor in determining materiality.

**c)** You are carrying the audit of NSSF with PBT of Shs 100 billion and total assets of Shs 2 trillion. You have discovered fraud of Shs 20 million by the managing director. Explain whether this matter affects the users of the financial statements of NSSF.

1. ISA 240 *The auditor’s responsibility relating to fraud in an audit of financial statements* gives guidance on fraud. Explain the external auditor’s responsibilities in relation to the prevention and detection of fraud and error.

**4)** ISA 330 *The auditor’s responses to assessed risks* requires the auditor to respond to the assessed risks of material misstatement. Explain how the assessed risk determines the audit approach.

**5)** ISA 300 *Planning an audit of financial statements* requires an auditor to plan every audit.

1. Explain the benefits of audit planning.
2. Distinguish between an audit strategy and an audit plan.
3. Identify THREE main matters other than the characteristics of the audit that should be included in the audit strategy document for a client and for each area provide an example relevant to the audit.
4. Distinguish between internal audit and external audit and for each type of audit describe THREE audit procedures that may be undertaken in each audit.

**6)** ISA 230 *Audit Documentation* requires the auditor to prepare documentation. State FOUR benefits of documenting audit work.

7) ISA 500 *Audit evidence* requires auditors to obtain sufficient and appropriate audit evidence.

Identify and explain **THREE** factors that influence the reliability of audit evidence.

**8)** You are an audit supervisor of Newman & Co and are planning the audit of Kampala Paint Ltd for the year ending 31 December 2024. The company develops and manufactures paint products and has been a client of your firm for several years. The audit manager has attended a planning meeting with the finance director and has provided you with the following notes of the meeting and financial statement extracts. You have been asked by the audit manager to undertake preliminary analytical procedures using the financial statement extracts.

Planning meeting notes

During the year Kampala Paint Ltd has spent Shs 90m, which is included within intangible assets, on the development of new product lines, some of which are in the early stages of their development cycle. Additionally, as the company is looking to expand production, during the year it purchased and installed a new manufacturing line. All costs, incurred in the purchase and installation of that asset, have been included within property, plant and equipment. These capitalized costs include the purchase price of Shs 220m, installation costs of Shs 40m and a five-year servicing and maintenance plan costing Shs 50m. In order to finance the development projects and the new manufacturing line, the company borrowed Shs 400m from Stanbic bank that is to be repaid in instalments over eight years at an interest rate of 18%. Developing new products and expanding production is important as the company intends to undertake a stock exchange listing in the next 12 months.

The company started a number of initiatives during the year in order to boost revenue. It offered extended credit terms to its customers on the condition that their sales order quantities were increased. In addition, Kampala Paint Ltd announced in January 2024 of its ‘price promise’ that it would match the prices of any competitor for similar products purchased. Customers who are able to prove that they could purchase the products cheaper elsewhere are asked to claim the difference from, within one month of the date of purchase of goods, via its website.

The company intends to include a refund liability of Shs 25m, which is based on the monthly level of claims to date, in the draft financial statements.

The finance director informed the audit manager that a problem arose in September 2024 in relation to the mixing of materials within the production process for one particular product line. A number of these faulty paint products had already been sold and the issue was identified following a number of complaints from customers about the paint consistency being incorrect. As a precaution, further sales have been stopped and a product recall has been initiated for any of these specific paint products sold since June. Management is investigating whether the paint consistency of the faulty products can be rectified and subsequently sold.

Financial statement extracts for year ending 31 December

Forecast Actual

2024 2023

Shs 000 Shs 000

Revenue 1,985,000 1,699,000

Cost of sales (1,244,000) (1,080,000)

Gross profit 741,000 619,000

Inventory 185,000 133,000

Trade receivables 275,000 178,000

Bank (81,000) 56,000

Trade payables 197,000 119,000

Required:

1. Calculate THREE ratios, for BOTH years, to assist you in planning the audit of Kampala Paint Ltd.
2. Using the information provided and the ratios calculated, describe EIGHT audit risks and explain the auditor’s response to each risk in planning the audit of Kampala Paint Ltd. Note: Prepare your answer using two columns headed Audit risk and Auditor’s response respectively.

***Appendix 1 Audit strategy***

You are the audit manager in charge of the audit of Templa Ltd. The company’s year end is 31 December 2024 and Templa Ltd has been a client for seven years. The company purchases and resells tractors.

The following is information on the company’s financial performance:

|  |  |  |
| --- | --- | --- |
|  | 2024 Forecast (Shs 000) | 2024 Actual (Shs 000) |
| Revenue | 4,592,800 | 4,082,500 |
| Cost of sales | 3,799,800 | 3,187,400 |
| Gross profit | 793,000 | 895,100 |
| Administrative costs | 499,400 | 475,800 |
| Distribution costs | 250,000 | 250,000 |
| Net profit | 43,600 | 169,300 |

The following is information on the company’s financial position:

|  |  |  |
| --- | --- | --- |
|  | 2024 Forecast (Shs 000) | 2024 Actual (Shs 000) |
| Non-current assets (NBV) | 360,000 | 450,000 |
| Current assets |  |  |
| Inventories | 20,000 | 127,800 |
| Receivables | 600,000 | 405,200 |
| Cash and bank | 50,000 | 159,000 |
| Total assets | **1,030,000** | **1,142,000** |
| Equity |  |  |
| Share capital | 100,000 | 100,000 |
| Retained earnings | 530,000 | 576,400 |
| Total equity | 630,000 | 676,400 |
| Non-current liabilities | 100,000 | 205,800 |
| Current liabilities | 300,000 | 259,800 |
| Total equity & liabilities | **1,030,000** | **1,142,000** |

Other information

* The industry that Templa trades in has seen moderate growth of 7% over the last year.
* Non-current assets mainly relate to company premises for storing inventory. Two delivery vehicles are owned with a net book value of Shs 100,000,000.
* One of the directors purchased one of the company old vehicles.
* Inventory is stored in five different locations across the country, with your firm having offices close to two of those locations.
* A computerized inventory system was introduced in August 2024. Inventory balances are now obtainable directly from the computer system. The client does not intend to count inventory at the year end but rely instead on the computerized inventory system.

Required:

Using the information provided above, prepare the audit strategy for Templa Ltd for the year ending 31 December 2024.

Solution

**Working paper:** Audit strategy  **WP Reference:**

**Client:** Templa Ltd **Prepared by:** Audit Manager **Date:**

**Year end:** Year ended 31 December 2024 **Reviewed by:** Reporting partner **Date:**

*Engagement team (including specialists & experts):*

* The engagement team has been given engagement responsibilities by the Audit Manager based on their knowledge and skill and assessment of the risks of material misstatement due to fraud for the engagement.
* Team members confirmed their independence of the client and compliance with ethical requirements.
* Below are team members and specialists (names, roles, qualifications & experience of partner, associate director, manager and associates etc.).

*Scope of the engagement:*

**(S**ee terms in the audit engagement letter).

*Characteristics of the audit:*

* Templa Ltd requires a normal statutory audit and there are no audit or filing exemptions available.
* The financial reporting framework is the International Financial Reporting Standards and there are no industry specific reporting requirements.

*Key dates in the audit timetable:*

* Interim audit
* Final audit
* Meeting with audit committee
* Financial statements approved by management
* Specific dates are to be confirmed

*Understanding the entity and its environment*

* Templa Ltd buys and sells tractors. The company has five stores, two of which are located near our offices.
* The industry has grown by 7% during the year. Templa’s revenue has increased by 12% indicating that the company has performed above the industry average.
* There are no changes in the financial reporting standards, laws and regulations that would require a change in accounting policies of Templa during the year.

*Materiality*

* Materiality will initially been set at ½ to 1% of revenue as this figure appears to be more accurate than profit before tax.

*Areas with higher risk of misstatement*

A review of the draft financial statements for the company shows the following risks:

* Revenue has increased by 12% but cost of sales by 19%. There is a risk of cost of sales being overstated.
* Inventory in the statement of financial position has significantly reduced compared to the previous year indicating that there may be valuation or counting errors.
* Receivables have increased by about 50%, significantly more than the increase in revenue. This indicates that the company may have debt collection problems. Additional testing may be required on after date collections to identify bad debts.
* Non-current assets have fallen by Shs 90 million, which is significant given that most non-current assets are land and buildings. The reason for the sale must be ascertained.
* Non-current liabilities have also fallen by Shs 100 million. While not necessarily linked to the fall in non-current assets, there is a possibility that non-current assets have been sod to pay off the liabilities.

*Audit approach*

* Audit testing will focus on compliance testing where possible. However, changes have been made to the inventory system limiting the extent of compliance testing.
* Client systems have changed in the new year with a new computerized inventory system. Unfortunately, the change was not identified until audit planning started.

Three actions are necessary in respect of this system:

* Audit the initial installation of the system including transfer of balances. One of the reasons for the low inventory value could be omission of inventory balances on transfer.
* Test count inventory at the year end and agree to the computerized inventory records (and vice versa) to test their accuracy. Note that the client will not be counting inventory at the year end but relying on the computerized system.
* Test check bookings into and out of inventory from the purchases and sales system.

*Other risk areas*

* The client appears to be a going concern. Although the fall in gross profit must be investigated.
* Cash and profit forecasts for the next twelve months must also be obtained to confirm continuous profitability and that the fall in cash balances will not continue.
* There is a possibility of related party transactions. On of the directors purchased an old vehicle from the company during the year. Checks should be made to determine whether company assets were assets were purchased, and if so, whether they were in the normal course of business.
* Assistance may be required on the inventory count as three stores are located away from our offices.

***Appendix 2 An example of an audit program*** (*Sample size and the items in the sample are not included*)

Audit program: Sales WP Ref.:

Prepared by: Date:

Reviewed by: Date:

Client:

Period:

|  |  |  |  |
| --- | --- | --- | --- |
| Audit procedures | Audit assertion | Done by | WP Ref |
| 1. Carry out a sequence test for goods despatch notes. 2. Select a sample of goods despatch notes and for each inspect the corresponding sales invoices and trace each sales invoice to the sales journal. 3. Carry out a sequence test for sales invoices in the sales journal. 4. Trace a sample of sales invoices from the sales journal to: 5. Duplicate sales invoice and check for the total amount recorded in the journal, date, customer name, and account classification. 6. Goods despatch note and test for customer name, product description, quantity and date. 7. Duplicate sales order and test for customer name, product description, quantity, date. 8. Customer order and test for customer name, product description, quantity, date and credit approval. 9. The receivables ledger and test for amount, date, and invoice number.   5) Check the pricing, extensions, and footings.  6) Inspect the supporting documents for evidence of verification.  7) Trace sales journal total to the general ledger | Occurrence    Completeness  Accuracy  Cut-off  Classification |  |  |