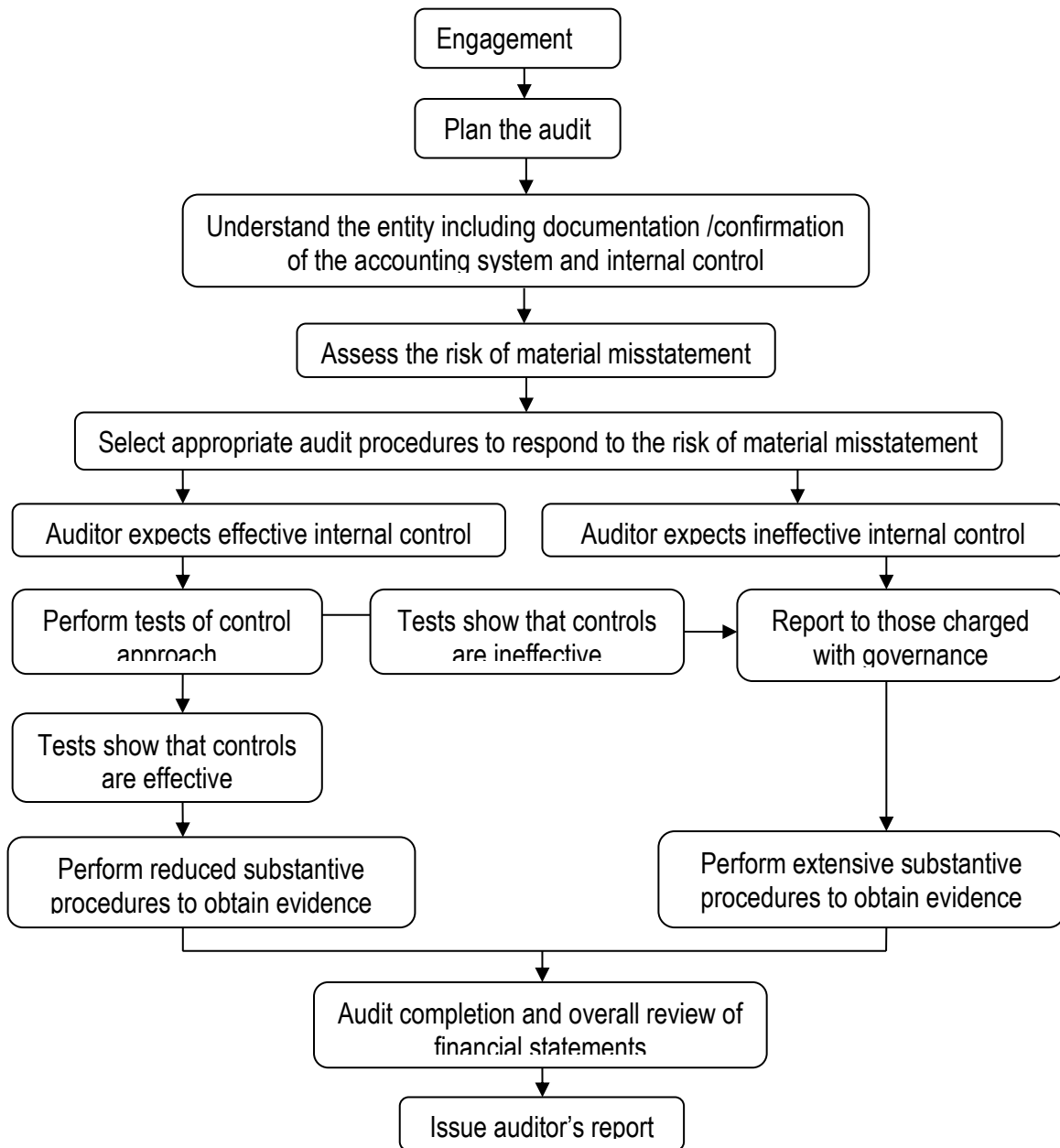


TOPIC 1 AUDIT PLANNING AND RISK ASSESSMENT

1.1 The audit process



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 and direct their testing to risky areas.

1.2 Audit risk

In order to obtain reasonable assurance that financial statements are free from material; misstatements, the auditor should obtain sufficient appropriate evidence to reduce audit risk to an acceptably low level to enable the auditor 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.

- a) The industry in which the audit client operates e.g. one with rapid technological developments.
- b) Any regulations it is subject to
- c) Whether the financial statements:
 - i) Include complex calculations
 - ii) Are subject to complex accounting standards like financial instruments
 - iii) 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 collusion.

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:

- a) Auditor's lack of experience
- b) Time pressure
- c) Financial constraints
- d) Poor planning
- e) New client
- f) Lack of industry knowledge

1.3 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.

There are two aspects of materiality:

- Quantitative materiality
- Qualitative materiality

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.

The materiality level set influences:

- a) 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.
- b) Whether to use sampling techniques
- c) 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:

- a) Elements of financial statements e.g. assets, liabilities, revenue, expenses and equity
- b) Whether they are items on which users tend to focus
- c) Nature of the entity, industry and economic environment
- d) Entity's ownership structure and financing
- e) 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	<ul style="list-style-type: none">• Profit-oriented entities with a relatively low total asset base.• Focus is on financial performance.
Revenue	0.5 – 1	<ul style="list-style-type: none">• Profit-oriented entities where PBT from operations is volatile.• Focus is on financial performance.
Total assets	1 – 2	<ul style="list-style-type: none">• Entities with high total assets but low profits.• Focus is on return on investment and ability to repay debt.
Gross profit	0.5 – 1	<ul style="list-style-type: none">• Profit-oriented entities where PBT from operations is volatile.
Total expenses	0.5 – 2	<ul style="list-style-type: none">• Public sector and not-for-profit entities.• Focus is to evaluate the entity's spending with its objectives.
Net assets	2 – 5	<ul style="list-style-type: none">• Focus is on return on investment and ability to repay debt.

Performance materiality

Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.

Performance materiality means the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

If the materiality for the financial statements as a whole was applied directly to different account balances such as receivables and inventory, a number of balances (or elements making up those balances) may be untested as they are considered immaterial. However, a number of errors or misstatements could exist in those untested balances and these could add up to a material misstatement.

Therefore, the auditor sets performance materiality levels which are lower than the materiality for the financial statements as a whole for performing audit procedures on particular balances, transactions and disclosures where there is increased risk or qualitative considerations necessitate it. The lower figure enables the auditor to perform more audit procedures to detect smaller misstatements in particular areas.

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.

	2025	2024	2023
	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 the materiality and performance levels when planning the audit of Bitabuse Ltd in 2025.

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 2025 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.

1.4 Understanding the entity and its environment

Auditors need to understand the following:

- a) Industry, regulatory and other external factors.
- b) Nature of the entity operations
- c) Selection and application of accounting policies
- d) Objectives and strategies related business risks
- e) Financial performance
- f) Internal control

Factors to consider and related risks of material misstatement

Factor	Scope and risks of misstatement
Industry, regulatory and other external factors	<ul style="list-style-type: none">• Industry conditions, for example:<ul style="list-style-type: none">- Market and competition for the goods/services, for example, a declining industry with high business failures may increase pressure on management to overstate profits and not fully disclose the going concern uncertainty.- 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.- Energy supply and cost, for example, fluctuations in oil prices may lead to overstatement of profits.- Supplier & customer relationships, for example, long-term contracts may involve significant estimates of revenues and expenses that increase the risks of material misstatement.- Technological developments make manufacturing plant and products like mobile phones obsolete and more susceptible to overstatement.• Regulatory framework, taxation, interest rates, for example:<ul style="list-style-type: none">- An increase in the tax rate may lead to non-compliance and fines that may be underestimated or completely omitted.- Non-compliance to laws may even lead to closure of the business which may also make financial statements prepared on a going concern basis misleading.- A floating foreign exchange rate may lead to foreign currency being translated at wrong rates.• General economic conditions including recession, availability of financing, inflation and currency revaluation, for example, an economic recession:<ul style="list-style-type: none">- Makes receivables difficult to collect and may lead to understatement of bad debts and overstatement of receivables.- Leads to low inventory turnover that may in turn lead to overvaluation of inventory if an appropriate write-down is not made by the entity.

	<ul style="list-style-type: none"> - Increases pressure on companies to perform as well as or better than competitors as shareholders expect consistent improvements in profits.
Nature of the entity	<ul style="list-style-type: none"> • Structure & ownership: <ul style="list-style-type: none"> - Complex structures may lead to wrong accounting for goodwill and investments. • Business operations including: <ul style="list-style-type: none"> - Revenue sources, products or services, major expenses, use of electronic commerce such as Internet sales. <ul style="list-style-type: none"> ➤ Product warranties to customers may lead to understatement of the provision for warranties in the financial statements. - Production methods and activities exposed to environmental risks. - Alliances, joint ventures and outsourcing activities. - Location of production facilities, warehouses (and amount of inventories): <ul style="list-style-type: none"> ➤ Multiple locations of factories and warehouses and offices may lead control problems and omission of some inventories at some locations. - Key customers and suppliers, employment terms including incentive bonuses. <ul style="list-style-type: none"> ➤ Dependence on a few major customers may result in material losses from bad debts or obsolete inventory. ➤ Bonus related pay may lead management to overstate profits in order to earn higher bonus. - Transactions with related parties may not be at arm's length or may be illegal like loans to directors and may not be properly disclosed. • Investment activities – planned or recent acquisitions or divestitures. <ul style="list-style-type: none"> - A pending acquisition may increase pressure of manipulating financial statements to increase the purchase price. • Financing activities – debt structure, terms, major liabilities & leasing arrangements. <ul style="list-style-type: none"> - Breach of loan terms may lead the bank to recall the debt that may create going concern uncertainty which may not be properly disclosed. • Financial reporting – for example, industry-specific accounting practices like research and development for pharmaceutical entities.
Selection and application of accounting policies	<ul style="list-style-type: none"> • The methods the entity uses to account for significant and unusual transactions. • The effect of significant accounting policies in areas without authoritative guidance. • Changes in the entity's accounting policies. • Financial reporting standards and laws and regulations that are new to the entity and how they are to be adopted – this may lead to improper implementation and errors before staff become conversant with it.
Objectives & strategies	<ul style="list-style-type: none"> • Industry developments – the entity may lack personnel with the expertise to deal with changes in the industry that may lead to misstatements. • New products (e.g. defects in car models) and services may increase product liability claims that may be understated in the financial statements. • Expansion of the business may increase the risk of a breakdown in controls or may lead to wrong estimation of demand that may increase inventory obsolescence. • Use of a new IT system may lead to processing errors.
Financial performance	<ul style="list-style-type: none"> • Key performance indicators • Budget and forecasts • Comparison of the entity performance with that of competitors. • Employee performance measures and incentive compensation policies.

	<ul style="list-style-type: none"> • Pressure to achieve performance targets increases risks of material misstatement, e.g. performance bonuses increase the risk of recognizing revenue before selling goods.
Internal control	<ul style="list-style-type: none"> • Control environment. • The entity's risk assessment process i.e. <ul style="list-style-type: none"> - Identifying business risks relevant to financial reporting(see inherent risk factors) - Assessing the significance of risks - Addressing risks • The information system and communication. • Control activities. • The entity's process to monitor internal control: <ul style="list-style-type: none"> - How the entity monitors the effectiveness of controls and how it remedies the deficiencies identified - The sources of information used to monitor controls

Methods used to obtain understanding of the entity

a) Inquiry

Most of the information is obtained from staff in the accounts department. They may also make inquiries of:

- Management about the environment for preparation of financial statements.
- Lawyers about cases in court and compliance with laws and regulations.
- Marketing/sales personnel about marketing strategies and sales trends.

b) Observation of the normal operations of an entity

c) Inspection of manuals (e.g. finance/procurement) about entity operations and visiting entity premises.

d) Analytical procedures mean the analysis of relationships to identify inconsistencies and unexpected relationships.

The auditor should apply analytical procedures as risk assessment procedures and in the overall review of financial statements at the end of the audit. They may also be used as substantive procedures to collect audit evidence.

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

a) Gross profit margin = $\frac{\text{Gross profit} \times 100}{\text{Revenue}}$

- A change in revenue is discussed with the client.
- A drop in revenue in 2025 may indicate:
 - That the entity has had a bad year in 2025, with potential impact on the assessment of going concern
 - That the entity had a particularly good year in 2024 and 2025 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 2025.

b) Net profit margin =
$$\frac{\text{Profit before interest \& tax} \times 100}{\text{Revenue}}$$

- Profit before interest and tax figure does not 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 improve 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.

c) Return on capital employed =
$$\frac{\text{Profit before interest and tax} \times 100}{\text{Share capital} + \text{Reserves} + \text{Non-current liabilities}}$$

- A change in 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.

d) Asset turnover =
$$\frac{\text{Revenue}}{\text{Share capital} + \text{Reserves} + \text{Non-current liabilities}}$$

Liquidity ratios

a) Current ratio =
$$\frac{\text{Current assets}}{\text{Current liabilities}}$$

b) Quick ratio (Acid test) =
$$\frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$$

Efficiency ratios

a) Inventory holding period = $\frac{\text{Inventory} \times 365 \text{ days}}{\text{Cost of sales}}$

- 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.

b) Receivables collection period = $\frac{\text{Trade receivables} \times 365 \text{ days}}{\text{Credit sales}}$

- An increase in the receivables collection period in 2025 compared to 2024 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.

c) Payables payment period = $\frac{\text{Trade payables} \times 365 \text{ days}}{\text{Credit purchases}}$

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

a) Debt /Equity ratio = $\frac{\text{Interest bearing debt}}{\text{Share capital \& Reserves}}$

b) Interest cover = $\frac{\text{Profit before interest and tax}}{\text{Finance costs}}$

- 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

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 2025. 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 2025.

Financial statement extracts for year ended 30 June 2025

	DRAFT 2025 Shs 000	ACTUAL 2024 Shs 000
Revenue	12,500	15,000
Cost of sales	<u>(7,000)</u>	<u>(8,000)</u>
Gross profit	5,500	7,000
Operating expenses	<u>(5,000)</u>	<u>(5,100)</u>
Profit before interest and taxation	<u>500</u>	<u>1,900</u>
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:

- Calculate **FIVE** ratios for **BOTH** years, which would assist the audit senior in planning the audit of KCC.
- 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):

	2025	2024
Gross 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	$1,900/7,000 \times 365 = 99$ days	$1,400/8,000 \times 365 = 64$ days
Receivable collection period	$3,100/12,500 \times 365 = 91$ days	$2,000/15,000 \times 365 = 49$ days
Payable payment period	$1,600/7,000 \times 365 = 83$ days	$1,200/8,000 \times 365 = 55$ days
Current ratio	$5,800/2,600 = 2.2$	$5,300/1,200 = 4.4$
Quick ratio	$(5,800 - 1,900)/2,600 = 1.5$	$(5,300 - 1,400)/1,200 = 3.3$

Risk	Audit response
<p>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.</p>	<p>Extended post year-end cash receipts testing and a review of the aged receivables ledger to be performed to assess valuation.</p>
<p>Due to the fall in demand for KCC's houses, there are some houses where the selling price may be below cost. IAS 2 <i>Inventories</i> requires that inventory should be stated at the lower of cost and NRV.</p> <p>In addition, inventory days have increased from 64 to 99 days and inventory turnover has fallen from 5.7 in 2024 to 3.7 in the current year. There is a risk that inventory is overvalued.</p>	<p>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.</p>
<p>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 <i>Property, Plant and Equipment</i>, useful lives are to be reviewed annually, and if asset lives have genuinely increased, then this change is reasonable.</p> <p>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.</p>	<p>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.</p>
<p>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.</p>	<p>Throughout the audit, the team will need to be alert to this risk and maintain professional scepticism. They will need to 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.</p>
<p>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.</p>	<p>Review the level of the warranty provision in light of the increased level of claims to confirm completeness of the provision.</p>
<p>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.</p>	<p>During the audit, the team would need to 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.</p>

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 2025.

1.5 Assessing the risks of material misstatement

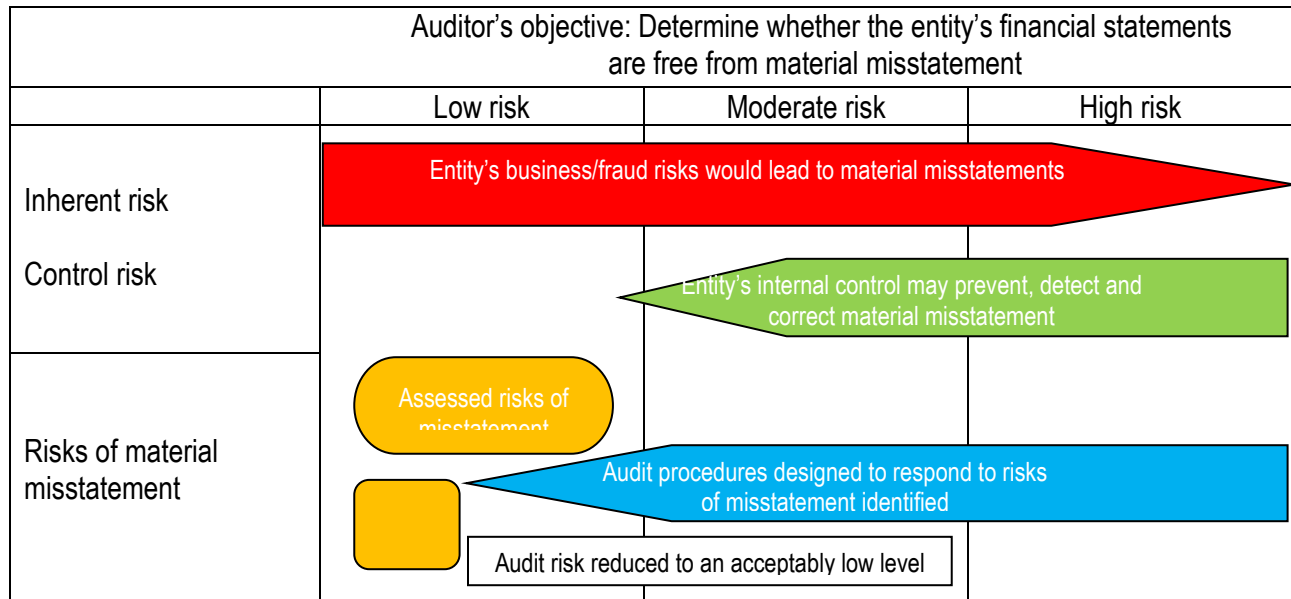
After understanding the entity and its environment, the auditor assesses the risk of material misstatement in the financial statement and identifies significant risks.

Significant risk is an identified risk of material misstatement arising from high inherent risk that requires special audit attention. ISA 315 gives the following examples of inherent factors.

Risk factor	
Complexity	<ul style="list-style-type: none"> • 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: <ul style="list-style-type: none"> • Wide range of possible accounting estimates e.g. depreciation • Management choice of valuation technique
Change	Changes in: <ul style="list-style-type: none"> • 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 – IT environmental change, new IT systems for financial reporting
Uncertainty	<ul style="list-style-type: none"> • Financial reporting – estimation uncertainty • Pending litigation and contingent liabilities
Management bias or fraud risk	<ul style="list-style-type: none"> • 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.



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.

Risks	Possible responses
Inventory has a lower net realisable value than cost and is therefore overstated (eg NRV falls due to the client being in an industry where tastes/fashions change quickly).	<ul style="list-style-type: none"> • 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.	<ul style="list-style-type: none"> • 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	<ul style="list-style-type: none"> • 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.

misstatement of assets/expenses (e.g. refurbishment of non-current assets where judgement is needed on classifying work as enhancement or repair).	<ul style="list-style-type: none"> • 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).	<ul style="list-style-type: none"> • 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).	<ul style="list-style-type: none"> • 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.	<ul style="list-style-type: none"> • 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.	<ul style="list-style-type: none"> • 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.	<ul style="list-style-type: none"> • 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 the company can continue as a going concern.
New client system/ controls/ staff increasing the risk of errors and controls not operating effectively.	<ul style="list-style-type: none"> • 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).	<ul style="list-style-type: none"> • Increased testing on judgement areas in financial statements e.g. revenue recognition accounting policies and provisions.
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1.6 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.

Such fraud may be carried out by overriding controls, for example, by recording fictitious journal entries and improperly adjusting assumptions or estimates used in financial reporting

• 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 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

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.

ISA 240 requires an auditor to obtain reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error.

- The auditor is required to maintain **professional scepticism** throughout the audit considering the possibility of management override of controls and recognizing that the audit procedures effective in for detecting errors may not be effective for detecting fraud.
- Where the auditor's risk assessment suggests there is a risk of material misstatement due to fraud, the risk should be treated as a significant risk.
- In this event the auditor should:
 - Assign and supervise audit staff taking into account their knowledge, skill and ability.
 - Evaluate whether the client's accounting policies may indicate fraudulent financial reporting.
 - Incorporate unpredictability in the selection of the nature, timing and extent of audit procedures.
- There should be a **discussion** among team members that places particular emphasis on how and where the financial statements may be susceptible to fraud.
- 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**.
- If the auditor identifies or suspects fraud involving management, employees with significant roles in internal control, and others where fraud could have a material effect on the financial statements, they should communicate this on a **timely basis to those charged with governance**.
- The auditor also needs to consider whether there is a responsibility to report to the **regulatory or enforcement authorities** – the auditor's professional duty of **confidentiality** may be **overridden** by **laws and statutes**.

Risk assessment procedures to obtain information in identifying the risks of material misstatement due to fraud include the following:

a) **Enquiries of management** regarding:

- Management's assessment** of the risk that the financial statements may be misstated due to fraud
- Management's process** for identifying and responding to the risk of fraud
- Management's communication to those charged with governance** in respect of its process for identifying and responding to the risk of fraud
- Management's communication to employees** regarding its views on business practices and ethical behaviour

- v) **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:

- a) Obtain reasonable assurance that financial statements are free from material misstatement whether due to fraud or error, and in this respect, the auditor must take into account the legal and regulatory framework within which the entity operates.
- b) 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).
- c) Undertake specified audit procedures to help **identify non-compliance** with laws and regulations that may have a material effect on the financial statements that do not have a direct effect on the determination of material amounts and disclosures in the financial statements but where compliance may be fundamental to operating aspects, ability to continue in business, or to avoid material penalties e.g. compliance with the terms of an operating licence. These include enquiries of management and inspecting correspondence with the relevant licensing or regulatory authorities.
- d) Request **written representations** from management that all known instances of noncompliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing the financial statements have been disclosed to the auditor.

Instances of non-compliance may be detected using audit procedures that include the following:

- Reading minutes
- Making enquiries of management and legal advisers regarding litigation, claims and assessments
- Performing substantive tests of details of classes of transactions, account balances or disclosures

Examples of laws and regulations include the following:

- Fraud, corruption and bribery
- Money laundering, terrorist financing and proceeds of crime
- Securities markets and trading
- Banking and other financial products and services
- Data protection

- Tax and pension liabilities and payments
- Environmental protection
- Public health and safety

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

- Obtain an understanding of the nature of any acts and circumstances
- Obtain further information to evaluate the possible effect on the financial statements
- 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
- Consider the need to obtain legal advice if sufficient information is not provided and the matter is material
- Evaluate the effect on the auditor's opinion if sufficient information is not obtained
- 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

- 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**.
- 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.
- 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 **should not be seen as a way of avoiding other requirements** (such as informing an appropriate authority or even an incoming auditor).

Example

You are an audit supervisor of Cane & Co planning the audit of Ham Co, a listed company, for the year ending 31 December 2025. 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 2025, 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.	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.
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.	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.

<p>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.</p> <p>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.</p>	<p>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 2026 and are in the company name.</p>
<p>Significant finance has been obtained in the year, as the company has issued Shs 50m of irredeemable preference shares.</p> <p>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.</p>	<p>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.</p> <p>In addition, the disclosures for this share issue should be reviewed in detail to ensure compliance with relevant accounting standards.</p>
<p>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 <i>Property, Plant and Equipment</i>, 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.</p>	<p>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.</p>
<p>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.</p> <p>If the customer is experiencing difficulties, there is an increased risk that the receivable is not recoverable and hence is overvalued.</p>	<p>Review the revised credit terms and identify if any after date cash receipts for this customer have been made.</p> <p>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.</p>
<p>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.</p> <p>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</p>	<p>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.</p>

<p>new customers could place orders within the two-month introductory period and subsequently return these goods post year end.</p>	
<p>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.</p> <p>If there are issues with the quality of the Lima product, inventory may be overvalued as its NRV may be below its cost.</p> <p>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.</p>	<p>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.</p> <p>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.</p> <p>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.</p>
<p>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.</p> <p>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.</p>	<p>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.</p>
<p>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.</p> <p>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.</p>	<p>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.</p> <p>The team needs to maintain professional scepticism and be alert to the increased risk of errors occurring.</p>
<p>The company is intending to propose a final dividend once the financial statements are finalised. This amount should not be provided for in the 2025 financial statements, as the obligation only arises once the dividend is announced, which is post year end.</p>	<p>Discuss the issue with management and confirm that the dividend will not be included within liabilities in the 2025 financial statements.</p>

In line with IAS 10 <i>Events after the Reporting Date</i> the dividend should only be disclosed. If the dividend is included, this will result in an overstatement of liabilities and understatement of equity.	The financial statements need to be reviewed to ensure that adequate disclosure of the proposed dividend is included.
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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:

Main areas	Matters to consider
Characteristics of the engagement	<ul style="list-style-type: none"> • Financial reporting framework. • Industry specific reporting requirements. • Expected audit coverage. • Nature of business segments to be audited and the need for specialized knowledge. • Availability of the work of internal auditors and the extent of reliance on such work. • Use of service organisations. • Effect of information technology on audit procedures. • Availability of client personnel and data.
Reporting objectives, timing of the audit & nature of communications	<ul style="list-style-type: none"> • Entity's timetable for reporting • 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	<ul style="list-style-type: none"> • Determination of materiality • Areas identified with higher risk of material misstatement • Results of previous audits • Need to maintain professional skepticism • Evidence of management's commitment to design, implementation and maintenance of sound internal control • Changes in applicable reporting framework with significant new or revised disclosures • Volume of transactions • Process used by management to identify and prepare disclosures • Significant business developments • Significant industry developments • Significant changes in financial reporting framework

	<ul style="list-style-type: none"> • Other significant recent developments
Nature, timing and extent of resources	<ul style="list-style-type: none"> • Selection of engagement team • Assignment of work to team members • Engagement budget

Example

You are the audit manager in charge of the audit of Templa Ltd. The company's year end is 31 December 2025 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:

	2025 Forecast (Shs 000)	2025 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:

	2025 Forecast (Shs 000)	2025 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 2025. 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 2025.

Solution

Working paper: Audit strategy

Client: Templa Ltd

Year end: Year ended 31 December 2025

WP Reference:

Prepared by: Audit Manager **Date:**

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:

(See 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 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. Materiality on the statement of financial position will be based on net asset values.

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 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 sold 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. One of the directors purchased an old vehicle from the company during the year. Checks should be made to determine whether company 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.

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:

- a) A description of the nature, timing and extent of planned risk assessment procedures
- b) A description of the nature, timing and extent of planned further audit procedures at the assertion level
- c) Other planned audit procedures required to be carried out for the engagement to comply with ISAs

Contents of an audit plan

- a) **Understanding the entity** and its environment including preliminary analytical review
- b) **Preliminary risk assessment** – review of overall risk and key risks in individual audit areas and their impact on the audit taking into account:
 - i) Past experience.
 - ii) Areas large in materiality.

- iii) Changes in financial reporting standards and accounting policies.
 - iv) Areas where there is a significant risk of material misstatement or fraud.
 - v) Complex accounting areas including those involving accounting estimates.
 - vi) The impact of information technology.
 - vii) Conditions requiring special attention such as the existence of related party transactions, contingencies, market and industry conditions.
 - viii) Any taxation aspects which may affect the audit.
 - ix) Appropriateness of the going concern assumption.
- c) **Materiality** for the financial statements as a whole and performance materiality and reasons for them.
- d) **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.
- e) **Sampling techniques** to be adopted.
- f) **Audit timetable** of planned audit work including
- g) **Allocation of work** to audit team members including experts.
- h) **Time and cost budgets** used in estimating an audit fee.
- i) **Audit procedures** for each major audit areas (see example below).

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 31.12.2025

January – March 2025	<p>Initial visit:</p> <p>Audit planning:</p> <ul style="list-style-type: none"> • 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)
October 2025	<p>Interim audit:</p> <ul style="list-style-type: none"> • 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 2025 – January 2026 onwards	<p>Final audit:</p> <ul style="list-style-type: none"> • 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. <p><i>(Consider the dates for the annual general meeting)</i></p>

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.	Occurrence		
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.	Completeness		
4) Trace a sample of sales invoices from the sales journal to:	Accuracy		
i) Duplicate sales invoice and check for the total amount recorded in the journal, date, customer name, and account classification.	Cut-off		
ii) Goods despatch note and test for customer name, product description, quantity and date.	Classification		
iii) Duplicate sales order and test for customer name, product description, quantity, date.			
iv) Customer order and test for customer name, product description, quantity, date and credit approval.			
v) 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			

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:
<ul style="list-style-type: none"> • 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 	<ul style="list-style-type: none"> • 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 financial statements • 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