

TOPIC 3 AUDIT PLANNING AND RISK ASSESSMENT

3.1 Audit risk and its components

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

- Audit risk is a function of the risks of material misstatement and detection risk.
- Risks of material misstatement is the risk that financial statements are materially misstated prior to audit.
- Risks of material misstatement consists of **inherent risk** and **control risk**, that is are the entity's risks.
- Material misstatements in financial statements may not be detected during the audit due to detection risk.
- The elements of audit risk are inherent risk, control risk and detection risk.
- In an audit risk model, $\text{Audit risk} = \text{Inherent risk} \times \text{Control risk} \times \text{Detection risk}$.
- Audit risk relates to material misstatements in financial statements. For example, if a company with profit before tax of Shs 100m incurred Shs 20m on replacement, refurbishment and repairs of plant during the year, the auditor should consider the audit risk arising from expenditure on repairs being recorded incorrectly as non-current assets, resulting in assets that do not exist being included in the statement of financial position.

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 (IR) is assessed by:

- Understanding the entity and its environment
- Understanding the applicable financial reporting framework

According to ISA 315 revised inherent risk factors the following:

- **Complexity** – the more complex the accounting or reporting requirements as in the audit of a large, multi-national insurance group, the higher the IR.
- **Subjectivity** – financial information involving management's selection of a valuation technique or model for a non-current asset such as investment properties or accounting estimates like depreciation have higher IR.
- **Change** in economic conditions, markets, customers, industry, supply chain, new products or services, new locations, entity structure like the acquisitions or merger, key personnel, IT environment, financial reporting framework, availability of capital and credit, investigations by regulatory bodies, new laws.
- **Uncertainty** – involving significant measurement uncertainty, including accounting estimates or arising from pending litigation and contingent liabilities such as sales warranties and environmental protection.
- **Susceptibility** to misstatement due to management bias or other fraud risk factors insofar as they affect inherent risk e.g. transactions with related parties and bonus schemes dependent on financial results.

Control risk is the risk that a misstatement which could occur in an assertion about a class of transaction, account balance or disclosure and which 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.

- Controls may be missing or may not operate effectively and threaten the achievement of the entity's objectives relevant to preparation of the entity's financial statements.
- However, internal control, no matter how well designed and operated, can only reduce, but not eliminate, risks of material misstatement in the financial statements, because of the inherent limitations of controls like the possibility of human errors or mistakes. Accordingly, some control risk will always exist.

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.

- The greater the risks of material misstatement the auditor believes exists, the less the detection risk that can be accepted and the more persuasive the audit evidence required by the auditor.
- Detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor. It is influenced by matters such as:
 - Adequate planning
 - Proper assignment of personnel to the engagement team
 - The application of professional skepticism
 - Supervision and review of the audit work performed,
- Detection risk, however, can only be reduced, not eliminated, because of the inherent limitations of an audit. Accordingly, some detection risk will always exist.

Management of audit risk

- Auditors must reduce audit risk to an acceptably low level by designing and performing audit procedures to reduce only detection risk they control.
- Where the chance of giving an inappropriate opinion and being sued is high, the audit should be rejected during the acceptance process.
- However, audit risk can never be entirely eliminated due to the inherent limitations of audit.
- Auditors decide what level of audit risk is acceptable and then determine the amount of audit work to reduce detection risk to a low level possible.
- There is no standard level of audit risk generally considered by auditors to be acceptable. This is a matter of audit judgement and will vary from firm to firm and audit to audit.
- Audit firms are likely to charge higher fees for higher risk clients. Regardless of the risk level of the audit, however, it is important that audit firms should always carry out high quality audit.

Business risk

Business risk is a risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies. Business risks relate to the aspects of an entity and include risks of material misstatement if they have an effect on financial statements. For example, technological developments might make a particular product obsolete, thereby causing inventory to be more susceptible to overstatement.

Risk-based audit

A **risk-based audit** is where auditors analyse the risks associated with the client's business, transactions and systems which could lead to misstatements in the financial statements and direct their testing to risky areas. A risk-based audit is more effective and efficient and is required by ISAs throughout the audit. An auditor should distinguish between business risk and audit risk.

A risk-based audit is in contrast to a **procedural approach** where the auditor performs a set of standard tests regardless of the client and its business. A procedural audit increases the risk of auditors giving a wrong opinion on the financial statements.

3.2 Materiality and performance materiality

Definition of materiality and performance materiality

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 levels of materiality:

- **Materiality for the financial statements as a whole** – this is the overall materiality level set initially at the planning stage and is used at the opinion stage to determine whether the aggregate of all misstatements do not exceed the materiality level set for the audit.
- **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 also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures. The lower figure enables the auditor to perform more audit procedures to detect smaller misstatements in particular areas of the financial statements.

- Materiality is a matter of the auditor's judgement made based on:
 - Expected to influence the economic decisions of users
 - Common financial information needs of users as a group.
 - Surrounding circumstances and is affected by the size and nature of a misstatement.
- Materiality depends on audit risk, the higher the expected risk, the lower the value of materiality will be. 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.

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.
- Illegal payments or executive expenses and personal use of assets by directors.
- Significant events like unusual events (e.g. destruction of assets), lawsuits.
- A transaction that affects the going concern assumption of the entity.
- Unusual events like destruction of assets or lawsuits.

Guidance on setting materiality

Materiality is based on draft financial statements or if these are not available, the audited financial statements for the previous period. Benchmark and percentages that are commonly used for financial statements as a whole.

Benchmark	Range %	Where commonly used
Profit before tax (PBT)*	5 – 10	- Profit-oriented entities generating profits from continuing operations with a relatively low total asset base. - Focus is on financial performance.
Revenue	0.5 – 2	- Profit-oriented entities where PBT from continuing operations is volatile. - Focus is on financial performance.
Total assets	1 – 2	- Entities with high total assets but low profits or financed mainly by debt. - Focus is on return on investment and ability to repay debt.
Total expenses	0.5 – 2	- Public sector and not-for-profit entities. - Focus is to evaluate the entity's spending with its objectives.

*Before significant directors' profit-related bonuses and remuneration and exceptional items.

Performance materiality is affected by:

- The nature and extent of misstatements identified in prior audits
- The auditor's understanding of the entity
- Result of risk assessment procedures

Performance materiality may be set between 60% and 75% of materiality, but actual percentages used vary in various audit firms as it is based on professional judgement.

Where overall materiality is set at Shs 10m, a misstatement of Shs 6m in receivables is considered immaterial. However, non-current assets may be overstated by 5m and inventories by Shs 4m. These three errors are individually immaterial but add up to Shs 15m that is cumulatively material. Therefore, performance materiality may be set using professional judgment at a lower amount, let us say at Shs 7m (70% of Shs 10m) so that it is more likely that at least one or all of the errors would be detected.

Where overall materiality is set at Shs 10m, a misstatement of Shs 7m in receivables is considered immaterial.

Materiality may be revised as the audit progresses due to new information received and the auditor should revise the nature, timing and extent of the further audit procedures remain appropriate.

Importance of materiality during the audit

The assessment of materiality assists in:

- Identifying and assessing the risks of material misstatement when planning the audit to ensure material misstatements are identified.
- Determining the nature, timing and extent of further audit procedures – this influences the amount of audit work to be done.
- Evaluating the effect of uncorrected misstatements, if any, on the financial statements.
- Forming the opinion in the auditor's report.

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.

2021 2020 2019

	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

Set materiality and performance materiality when planning the audit of Bitabuse Ltd.

Solution

The main users of the financial statements are the banks and owners. Considering user needs and this small company, materiality is assessed at 1% of revenue as this is a more stable benchmark than profit before tax. Therefore, materiality for 2021 is Shs 2.5m. Using professional judgment, which is largely based on previous periods, performance materiality is set at Shs 2m which is about 80% of materiality.

3.3 Understanding the entity and its environment

Importance

ISA 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment* requires an auditor to obtain an understanding of the entity and its environment in order to:

- Identify and assess the risks of material misstatement in the financial statements
- Enable the auditor to design and perform further audit procedures
- Provide a frame of reference for exercising audit judgement, for example, when setting audit materiality

Matters the engagement team need to gain understanding of

- **Industry**, regulatory and other external factors, including the applicable financial reporting framework:
- Nature of the **entity** operations, ownership and governance, investments, structure and financing
- Entity's selection and application of **accounting policies**
- **Objectives** and strategies and related business risks that might cause material misstatement in the FSs
- Measurement and review of the entity's **financial performance**
- **Internal control**

Key areas and the related risks of material misstatement

Area	Scope of understanding and possible risks of misstatement
	• Industry conditions, for example: - 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.

Industry, regulatory and other external factors	- 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: - 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: - 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. - Increases pressure on companies to perform as well as or better than competitors as shareholders expect consistent improvements in profits.
Nature of the entity	• Structure & ownership: - Complex structures may lead to wrong accounting for goodwill and investments. • Business operations including: - Revenue sources, products or services, major expenses, use of electronic commerce such as Internet sales. ➤ 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): ➤ 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. ➤ 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. - A pending acquisition may increase pressure of manipulating financial statements to increase the purchase price.

	• Financing activities – debt structure, terms, major liabilities & leasing arrangements. - 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.
Accounting policies	• 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	• 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.
Measurement and review of financial performance	• Key performance indicators, trends, budgets and variance analyses. • Comparison of the entity performance with that of competitors. • Employee performance measures and incentive compensation policies. • Pressure to achieve performance targets increases risks of material misstatement, e.g. performance bonuses increase the risk of recognizing revenue before selling goods. • Competitors
Internal control (Covered in Topic 4)	• Control environment. • Risk assessment process. • Information system relevant to financial reporting. • Control activities relevant to the audit. • Monitoring of controls to improve financial reporting.

Additional sources of information:

- The permanent audit file where information of continuing importance to the audit is kept (covered later).
- Audit working papers from the previous year's audit file
- Information from the client's website
- Publications or websites related to the industry the client operates in.
- Other information obtained from client acceptance or continuance processes is relevant.
- Non-audit engagements with the client.
- Other information from prior year audits, considering changes that have occurred.

Audit procedures

Inspection of records and physical assets

- Inspection is the examination of the entity's records or documents, whether internal or external, in paper form, electronic form, or other media or a physical examination of tangible assets.
- For example, an auditor:
 - Inspects business plans, accounting manuals, organisation charts, major contracts like loan agreements.
 - Reads internal reports and minutes internal audit reports and minutes of directors' meetings.

- Reads trade journals, reports from consultants and regulatory authorities, accesses the internet.
- Inspects sales invoices and the delivery notes when auditing the occurrence of sales transactions.
- Physically inspects a sample of inventory items to verify the accuracy of the count by the client.
- 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.

Observation

- Involves watching procedures or processes being performed by others.
- For example, an auditor observes whether the entity's personnel follow instructions when counting inventory or paying cash wages.
- 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. Therefore, evidence from observation should later be corroborated with evidence from other procedures.

Inquiry

- Inquiry is obtaining information from knowledgeable persons within or outside the entity.
- Enquiries of:
 - Accounts department staff (this is the main source of planning information).
 - Management (e.g. environment for preparation of financial statements, incentive plans, knowledge of fraud or suspected fraud, unusual events, major business risks).
 - Internal auditors e.g. design and effectiveness of internal control and response to their audit findings
 - Lawyers e.g. cases in court, compliance with laws and regulations.
 - Marketing/sales personnel e.g. marketing strategies and sales trends.
 - Inquiry should be used together with other procedures as entity staff may give biased information in the client's favour. For example, to test the operating effectiveness over cash receipts, the auditor makes inquiries of entity personnel and supplements this by observing the procedures for receiving cash receipts and inspects documentation about the operation of such internal control at other times.

Re-performance

- Re-performance involves the auditor independently carrying out procedures or controls which were originally performed by the client as part of the entity's internal control to check their effectiveness.
- For example, the auditor re-performs the year-end bank reconciliation to ensure it was done accurately or recounts inventory to check the accuracy of the count procedures by the entity staff.
- Re-performance is however only limited to controls present in the system.

External confirmation

- Is a process of obtaining direct written audit evidence in paper form, electronic form or by other medium directly from an external third party in response to the auditor's request.
- For example, the auditor confirms the existence and accuracy of receivable balances by writing to customers.
- External confirmation may provide highly reliable evidence as it from sources independent of the client.

Recalculation

- Recalculation is checking the mathematical accuracy of documents or records.
- For example, the auditor recalculates the depreciation expense for property.
- Recalculation gives reliable information on the accuracy of figures as the evidence is obtained directly by the auditor.

Analytical procedures

- Analytical procedures consist of evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also include investigation of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.
- Analytical procedures include:
 - Comparisons with:
 - ✓ Similar information for prior periods
 - ✓ Anticipated results of the entity, from budgets or forecasts
 - ✓ Predictions prepared by the auditors
 - ✓ Industry information
 - Comparison of financial information that are expected to conform to a predicted pattern based on the entity's experience, such as the relationship of gross profit to sales.
 - Comparison of financial information and relevant non-financial information, such as the relationship of payroll costs to number of employees.
- Analytical procedures are performed using a simple analysis of figures or ratio analysis.
- Analytical procedures at the risk assessment stage of the audit are usually based on interim financial information, budgets or management accounts.
- **Generally, the reliability of evidence (from higher to lower) is as follows: inspection of physical assets, recalculation, reperformance, confirmation, analytical procedures, inspection of records, observation and inquiry.**
- Understanding the entity and its environment continues throughout the audit.
- Understanding an entity is more detailed during the first audit and in the subsequent audits the focus is on what has changed since then.

Ratio analysis in analytical procedures:

Profitability ratios

1) 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 2022 may indicate:
 - That the entity has had a bad year in 2022, with potential impact on the assessment of going concern
 - That the entity had a particularly good year in 2021 and 2022 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 2022.

2) 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.

3) Return on capital employed =
$$\frac{\text{Profit before interest and tax} \times 100}{\text{Capital employed}}$$

- 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.

Efficiency ratios

1) Inventory turnover 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.

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

- An increase in the receivables collection period in 2022 compared to 2021 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.

3) 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.

Liquidity ratios

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

2) Quick ratio =
$$\frac{\text{Current assets less inventory}}{\text{Current liabilities}}$$

Lack of cash may lead to non-remittance of PAYE or NSSF deductions and understatement or not accruing penalties.

Long term financial stability ratios

1) Debt ratio =
$$\frac{\text{Total debt}}{\text{Total assets}}$$

2) Gearing ratio =
$$\frac{\text{Long term debt} \times 100\%}{\text{Shareholders' equity} + \text{Long term debt}}$$

3) Interest cover =
$$\frac{\text{Profit before interest and tax}}{\text{Interest expense}}$$

- 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 2021. 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 2021.

Financial statement extracts for year ended 30 June 2021

	DRAFT 2021 Shs 000	ACTUAL 2020 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	31,100	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):

	2021	2020
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 turnover days	$1,900/7,000 \times 365 = 99$ days	$1,400/8,000 \times 365 = 64$ days
Receivable days	$3,100/12,500 \times 365 = 91$ days	$2,000/15,000 \times 365 = 49$ days
Payable days	$1,600/7,000 \times 365 = 83$ 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
Receivable days have increased from 49 to 91 days and management has significantly extended the credit terms given to customers. This leads to an	Extended post year-end cash receipts testing and a review of the aged receivables ledger to be performed to assess valuation.

increased risk of recoverability of receivables as they may be overvalued.	
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. In addition, inventory days have increased from 64 to 99 days and inventory turnover has fallen from 5.7 in 2020 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 <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 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 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.
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 2022 and so should be disclosed as a current liability.	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.
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 2022. 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 2021.
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3.4 Assessing the risks of material misstatement

ISA 315 requires an auditor:

- Identify risks when obtaining an understanding of the entity and its environment including significant risks.
- Assess the identified risks and evaluate whether they relate to the financial statements as a whole.
- Relate the risks to what can go wrong at the assertion level for classes of transactions, account balances and disclosures.
- Consider the likelihood of the risks causing a material misstatement

Assertions are 'representations by management that are embodied in financial statements that are used by the auditor to consider the different types of potential misstatements that may occur'

Significant risks are risks that require special audit attention.

Factors that indicate significant risks include:

- The risk of fraud (see 3.6).
- When related to recent significant economic, accounting or other developments.
- The complexity of transactions.
- Significant transactions with related parties.
- High subjectivity in the measurement of the financial information.
- Unusual transactions likely to have more:
 - Management intervention
 - Complex accounting principles or calculations
 - Manual intervention
 - Opportunity for control procedures not to be followed

When a significant risk is identified, obtain an understanding of the entity's controls relevant to that risk.

Example

You are involved with the audit of Tencent Co, a small company. You have been carrying out procedures to gain an understanding of the entity. The following matters have come to your attention.

The company offers standard credit terms to its customers of 60 days from the date of invoice. Statements are sent to customers on a monthly basis. However, Tencent does not employ a credit controller and, other than sending the statements on a monthly basis, it does not communicate with its customers on a systematic basis.

Occasionally, the sales ledger accountant may telephone a customer if the company has not received a payment for some time. Some customers pay regularly according to the credit terms offered to them, but others delay to pay and do not provide a remittance advice. Sales ledger receipts are entered onto the sales ledger but not matched to invoices remitted. The company does not produce an aged list of balances.

Required:

From the above information, assess the risks of material misstatement arising in the financial statements. Outline the potential materiality of the risks and discuss factors in the likelihood of the risks arising.

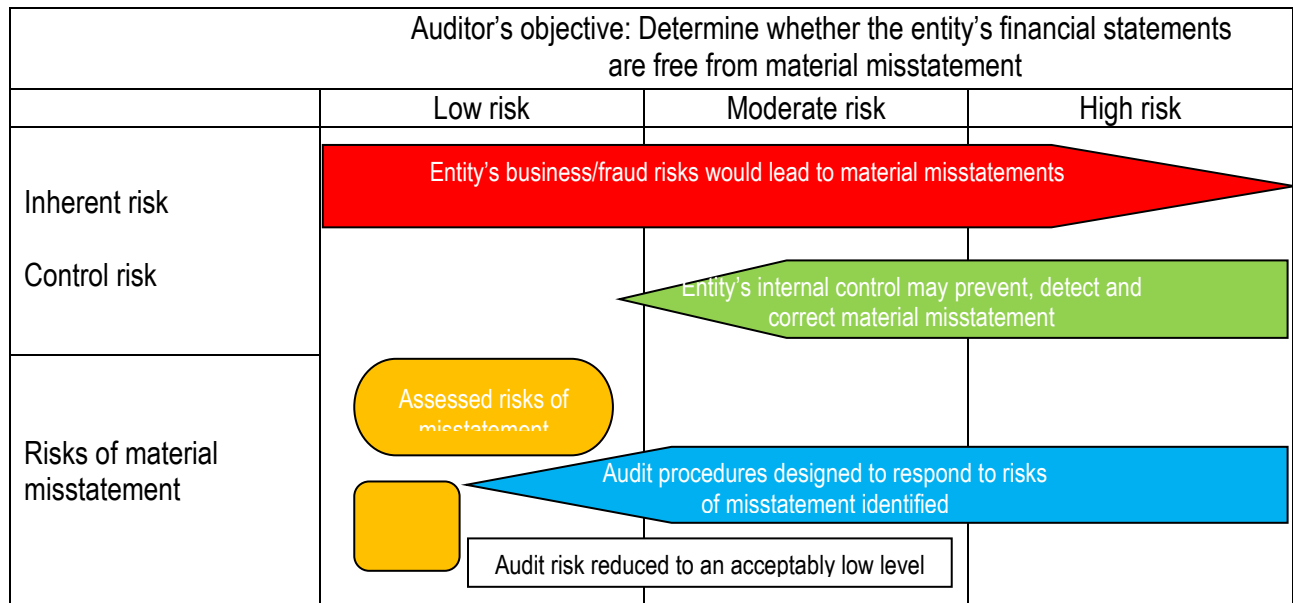
Answer

- ✓ The key risk is that trade receivables may be wrongly valued in the financial statements as some may be irrecoverable.
- ✓ As receipts are not matched against invoices in the ledger, the balance in the ledger may include old invoices that may not be paid by customers.
- ✓ It is difficult to assess at this stage whether this will be material. Trade receivables is likely to be a material balance in the financial statements, but the number of irrecoverable balances may not be material.
- ✓ The auditor should plan to use analytical procedures, for example, to see if the level of receivables has risen year-on-year in a manner that is not explained by price rises or levels of production.
- ✓ A key factor affecting the likelihood of the material misstatement arising is the poor controls over the sales ledger. The fact that invoices are not matched against receipts increases the chance of old unpaid invoices remaining unidentified by Tencent. Trade receivables balance may be overstated in this instance.

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 RMM 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 RMM, the auditor is guided by materiality.

3.5 Fraud and non-compliance with 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 causing 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.

Includes:

- 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 like cash and inventory.

Employees may be involved in such fraud in small and immaterial amounts, but it can also be carried out on a larger scale by management who may then conceal the misappropriation by false or misleading records.

Includes:

- 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.
 - Establish an internal audit function that reviews systems and controls and make recommendations as to how they can be improved. This reduces the likelihood of fraud taking place and increases the chance of detecting fraud where it has occurred. Internal auditors also conduct investigations where there is a suspicion 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 risk of not detecting a material misstatement from fraud is higher than from error because:
 - Fraud may involve sophisticated schemes designed to conceal it.
 - Fraud may be perpetrated by individuals in collusion.
 - Management fraud is harder to detect because management is in a position to manipulate accounting records or override control procedures.
- The auditor is required to:
 - Maintain **professional scepticism** throughout the audit that management may override of controls and audit procedures may not be effective in detecting fraud.
 - Make enquiries of (*and obtain written representations from*) management and those charged with governance regarding:
 - ✓ Assessment of fraud risk
 - ✓ Internal control established to mitigate these risks
 - ✓ The process for identifying and responding to the risk of fraud
 - ✓ Knowledge of any actual, suspected or alleged fraud
 - ✓ Evaluating whether any fraud risk factors are present

- Design and perform audit procedures to:
 - ✓ Incorporate unpredictability in the selection of the nature, timing and extent of audit procedures
 - ✓ Test the appropriateness of journal entries and other adjustments
 - ✓ Review accounting estimates for bias
 - ✓ Evaluate whether significant transactions outside the normal course of business involve fraudulent financial reporting or conceal misappropriation of assets
- Discuss how the entity's financial statements may be susceptible to material misstatement due to fraud and the information should be communicated to team members not present in the meeting.
- Communicate any fraud identified on a timely basis to the appropriate level of management and consider the implications on the audit report and their responsibility to report to regulatory authorities.

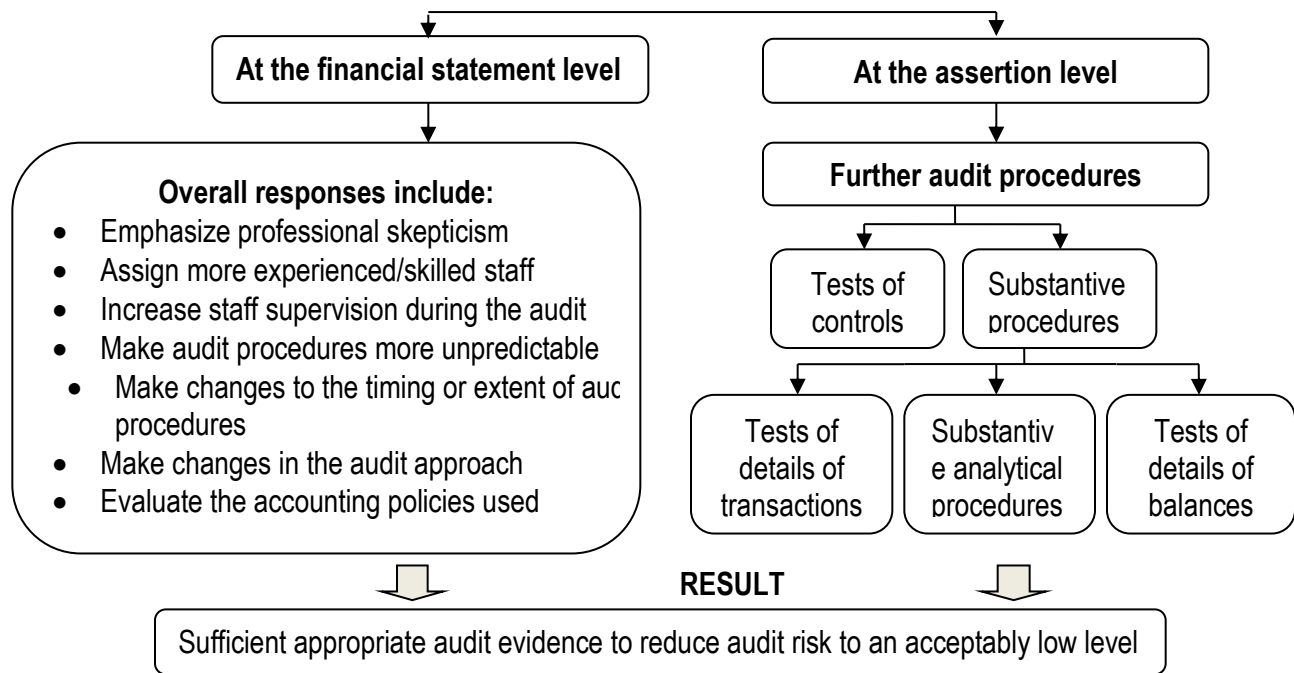
Compliance with laws and regulations

- ISA 250 *Consideration of laws and regulations in an audit of financial statements* requires an auditor to:
 - To obtain sufficient appropriate audit evidence regarding compliance with the provisions of laws and regulations that have a direct effect on material amounts and disclosures in the financial statements.
 - To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements.
 - To respond appropriately to non-compliance or suspected noncompliance with laws and regulations identified during the audit.
- Management is responsible for operations being conducted in accordance with laws and regulations.
- The engagement team should obtain an understanding of the legal and regulatory framework applicable to the entity and how the entity is complying with the framework from (among others):
 - Inquiry with management as to whether they have complied with all applicable laws and regulations, about investigations by government departments and payment of fines and penalties.
 - Inspection of correspondence with the relevant licensing or regulatory authorities, minutes of directors and management meeting and reports from regulatory authorities.
 - Independent confirmations from the entity's lawyers concerning litigation, claims and assessment.
 - Audit tests of the details of classes of transactions, account balances or disclosures e.g. payments for unspecified services or unusual payments in cash.
- When any non-compliance is detected, the auditor should obtain an understanding of the act and evaluate the possible effects on the financial statements including:
 - The potential financial consequences such as fines, penalties, enforced discontinuation of operations.
 - Whether the financial consequences require disclosure.
 - Whether the potential consequences affect the true and fair view given by the financial statements.
- An auditor should consider reporting any non-compliance to those charged with governance, users of financial statements or regulatory authorities.
- An auditor should consider withdrawal from the engagement (if permitted) in instances where the entity does not take remedial action and should seek legal advice.

3.6 Responses to assessed risks

ISA 330 *The auditor's responses to assessed risks* requires the auditor to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks at the overall financial statement level and assertion level for classes of transactions, account balances and disclosures (See diagram).

Assessed risks & auditor's



Responses at financial statement levels

These responses are incorporated in the overall audit strategy and audit plan after assessing control risk covered in Topic 4. Overall responses at financial statement level are required to reduce detection risk and audit risk and some are explained in the following paragraphs:

- Unpredictability can be achieved by performing audit procedures on account balances not usually tested due to their materiality or risk or counting inventory at locations not tested in the previous periods.
- Changes to the timing or extent of audit procedures may for example be done as follows:
 - Perform substantive procedures at the period end instead of at an interim date.
 - Perform a physical inspection of certain assets.
 - Perform further work to evaluate the reasonableness of management estimates.
 - Increase sample sizes or perform analytical procedures at a more detailed level.
- Changes in the audit approach involve the following:
 - If the internal control is effective, the auditor may have more confidence in the reliability of evidence generated by internal control and therefore:
 - Adopts a combined audit approach which uses both tests of controls and substantive procedures.
 - Conducts more audit work during interim audit rather than during final audit.
 - If internal control is not effective, the auditor:
 - Adopts a substantive approach where more audit evidence is obtained using substantive procedures.
 - Conducts more substantive procedures during the final audit rather than during the interim audit.
 - Increases the number of locations to be included in the audit scope.
- Accounting policies especially those for subjective measurements and complex transactions are reviewed as they may lead to fraudulent financial reporting.

Responses to assessed risks at the assertion level

Further audit procedures at the assertion level (e.g. sales, receivables and inventory) are designed in accordance with the audit approach adopted in response to the assessed risks of material misstatement at the financial statement level. The two types of audit procedures performed to collect evidence at the assertion level are tests of controls and substantive procedures.

Tests of controls

- 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.
- When risk assessment shows that controls are expected to operate effectively, the auditor designs and performs tests of controls to obtain sufficient appropriate audit evidence that the controls are operating.
- Tests of controls are also performed when it is not possible to obtain sufficient appropriate audit evidence simply from substantive procedures, for example, when an entity conducts its business using IT systems which do not produce documentation of transactions.
- In carrying out tests of control, auditors use enquiry, reperformance and inspection.
- If an entity carries out a year-end inventory count, controls over the inventory count can only be tested at the year end.
- For other controls that operate all year round, the auditor needs to test that those controls have been effective throughout the period.
- For some controls tested in prior audits, the auditor may choose to rely on that evidence of their effectiveness. If this is the case, the auditor should obtain evidence about any changes since the controls were last tested and should test the controls if they have changed.
- Controls should be tested for effectiveness at least once in every three audits.
- If there is significant risk, the auditor should not rely on testing done in prior years, but should perform testing in the current year

Substantive procedures

- Substantive procedures are audit procedures designed to detect material misstatements at the assertion level. They consist of tests of details (of classes of transactions, account balances and disclosures) and substantive analytical procedures.
- The auditor should always carry out substantive procedures on each material class of transactions, account balance and disclosure.
- In addition, the auditor should carry out the following substantive procedures:
 - Agreeing or reconciling the financial statements to the underlying accounting records
 - Examining material journal entries
 - Examining other adjustments made in preparing the financial statements
- Tests of detail may be appropriate to get evidence on account balances e.g. inventory and receivables.
- Tests of detail are likely to be more appropriate to transactions and account balances with significant risks.
- Analytical procedures as substantive procedures tend to be appropriate for large volumes of predictable transactions like wages and salaries.
- Significant risks are likely to be the most difficult to obtain sufficient appropriate audit evidence about.

Examples of responses to audit risks (*some will become clearer after Topic 4 and 5*).

Risks	Possible responses
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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).	• 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 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

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 <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.	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.

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.	
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.	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.

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.	
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 <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.	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.

3.7 Overall audit strategy and audit plan

Overall audit strategy

After preliminary engagement activities (i.e. ensuring that ethical requirements are met and the terms of the engagement are understood), an auditor establishes the overall audit strategy (also called an **audit planning memorandum**). The audit strategy sets the scope, timing and direction of the audit. It includes the following.

Main areas	Matters to consider
Characteristics of the audit	- 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	- Entity's timetable for reporting - Organisation of meetings with management and those charged with governance

audit & nature of communications	• 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 • 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 • Other significant recent developments
Nature, timing and extent of resources	• 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 2022 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:

	2022 Forecast (Shs 000)	2021 Actual (Shs 000)	Difference
Revenue	4,592,800	4,082,500	4,592,800-4082500/4082500 0.124
Cost of sales	3,799,800	3,187,400	19%
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:

	2022 Forecast (Shs 000)	2021 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 2022. 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 2021.

Solution

Working paper: Audit strategy

Client: Templa Ltd

Year end: Year ended 31 December 2021

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 overall audit strategy guides the development of a more detailed audit plan.
- The audit plan sets out detailed audit procedures to be performed in order to implement the audit strategy.
- In practice, the audit strategy and audit plan are developed together.
- An audit plan is normally prepared by an audit manager and approved by an engagement partner.
- Components of an audit plan:
 - Terms of the auditor's engagement
 - Understanding the entity and its environment and risk assessment, including key changes.
 - Laws and regulations including the entity's compliance
 - Understanding the entity's design and operation of the entity's internal control.
 - Fraud and error assessment.
 - Materiality & performance materiality and the reasons for choosing them.
 - Perform preliminary analytical procedures
 - Staff allocation to audit areas including experts i.e. revenue, expenses, non-current assets, inventory, receivables, cash & bank, liabilities.
 - Audit timetable (see table below)
 - Time and cost budgets used in estimating an audit fee.
 - Audit programs for major audit areas showing audit procedures to performed (see example below).

**The audit strategy and audit plan are updated and changed as necessary during the course of the audit.*

An example of an audit timetable for a big entity for the period ending 31.12.2021

January – March 2021	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)
October 2021	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 2021 – January 2022 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. <i>(Consider the dates for the annual general meeting)</i>

Time budget example

Position	Name	Rates (Shs)	Budget (Hrs)*	Budget (Shs)	Actual (Hrs)	Actual (Shs)
Partner		900,000	10	9,000,000		
Director		600,000	10	6,000,000		
Manager		500,000	30	15,000,000		
Senior associate		100,000	90	9,000,000		
Associate 1		80,000	120	9,600,000		

Associate 2		70,000	120	8,400,000		
Associate 2		70,000	80	5,600,000		
			460	62,600,000		

**Based on time for planning, fieldwork, audit review and reporting.*

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 audit and final audit

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.

Interim audit is done when auditing large entities in order to reduce work at year end and ensure timely completion of the audit. Limited substantive procedures may be carried out as the year-end statement of financial position figures to be reported on are not yet available.

Final audit is carried out on draft financial statements at the end of accounting period of every entity and ends with an audit report. It may commence before or after closing books of accounts.

Interim audit procedures may include:	Final audit procedures include:
• Understanding the business 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 • Review of subsequent events • Agreeing financial statements to accounting records • Examining adjustments made when preparing financial statements • Reviewing the going concern status of the entity • Completion of tests of controls and substantive tests of transactions 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

Performing audit procedures during the interim audit:

- Assists in identifying significant matters at an early stage and helps in resolving them with management's assistance or develop an effective audit approach to address them.
- Reduces time taken during final audit to collect sufficient appropriate audit evidence needed.

If the auditor obtains audit evidence about operating effectiveness of controls during the interim audit, during final audit, the auditor's focus is on:

- Obtaining audit evidence about significant changes to those controls after the interim period.
- Determining the additional audit evidence to be obtained for the remaining period based on:
 - Assessed risks of material misstatement at the assertion level.
 - The length of the remaining period
 - The control environment

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.
- Should focus on auditing the movements in the balance between the interim date and the year end.

Benefits of audit 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 managed efficiently and effectively.
- Competent audit **team members** are selected and work is properly assigned to them.
- Proper direction and **supervision** of the engagement team and review of their work.
- There is proper **coordination** (where possible) of work done by experts and auditors of subsidiaries.

3.8 Audit documentation

Purpose

Audit documentation (or audit working papers) is a record of audit procedures performed, relevant audit evidence obtained and conclusions reached. 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 members of the engagement team in directing and supervising 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.

Form and content

ISA 230 requires working papers to be sufficiently complete and detailed to provide an overall understanding of the audit.

Client: NMS

Year end: 30 June 2022

Ref:

Prepared by:

Date:

Reviewed by:

Date:

Subject: Year-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.

Audit files

For recurring audits, working papers may be split between a permanent audit file and a current audit file.

- A **permanent audit file** contains information used in many audits which is updated annually and includes:
 - Client acceptance questionnaire
 - Engagement letters
 - Memorandum and articles of association of the company
 - Loan and lease agreements
 - Entity business history and industry information

- Board minutes
 - Names of management, directors, shareholders
 - Previous years' signed accounts, analytical review and reports to management
 - Accounting systems documentation
 - Previous years' signed accounts, analytical procedures and management letters
 - Accounting systems notes, previous years' control questionnaires
- A **current audit file** contains information relevant to the current year's audit and includes the following:
 - Financial statements
 - Accounts checklists
 - Management accounts details
 - Reconciliations of management and financial accounts
 - A summary of unadjusted errors
 - Report to partner including details of significant events and errors
 - Review notes
 - Audit planning memorandum
 - Time budgets
 - Written representations
 - Management letter
 - Notes of board minutes
 - Communications with third parties such as experts or other auditors
 - For each audit area, risk assessments, audit programs with details of substantive tests and tests of control, sampling plans, a lead schedule, including details of the figures to be included in the accounts
- ✓ Working papers are organized by the stage in the audit process and financial statement area to enable specific working papers to be easily located.
 - ✓ Working papers to be kept for a period of not less than five years from the date of the auditor's report.
 - ✓ Working papers are the property of the auditors.
 - ✓ Auditors must follow ethical guidance on the confidentiality of audit working papers

3.9 Audit evidence and financial statement assertions

Audit evidence

Audit evidence is information used by the auditor in arriving at conclusions on which the opinion is based. The evidence is obtained from records underlying financial statements and sources outside the entity.

ISA 500 *Audit evidence* requires the auditor to design and perform audit procedures to obtain **sufficient appropriate** audit evidence.

- Appropriateness of audit evidence is the measure of the quality of audit evidence, i.e. its relevance and its reliability regarding auditor's opinion. Evidence should be relevant relates to audit objective and assertion.
- Sufficiency of audit evidence is the measure of the quantity of audit evidence. This is affected by the auditor's assessment of the risks of material misstatement and the quality of evidence.

Reliability is influenced by the source and nature of the information, including controls over its preparation.

Generalisations in assessing the reliability of audit evidence:

- Audit evidence from **external sources** is more reliable than that obtained from the entity's records because it is from an independent source.
- Evidence obtained **directly by auditors** is more reliable than that obtained indirectly or by inference.
- Evidence obtained from the entity's records is more reliable when the **related control system operates effectively**.
- Evidence in the form of **documents** (paper or electronic) or written representations are more reliable than oral representations, since oral representations can be retracted.
- **Original** documents are more reliable than photocopies which can easily be altered by the client.

The reliability of evidence in descending order is third party evidence is the most reliable, followed by auditor-generated evidence, client-generated written evidence and client-generated verbal evidence.

Financial statement assertions

Financial statement assertions are representations by management embodied in financial statements that are used by the auditor to consider the different types of potential misstatements that may occur.

- Assertions relate to classes of transactions and events and related disclosures, and account balances at the period end and related disclosures.
- Audit tests are designed to obtain evidence about the financial statement assertions.

ISA 315 requires the auditor to use assertions for classes of transactions and related disclosures (i.e. statement of profit or loss) and account balances and related disclosures (i.e. statement of financial position) in the assessment of risks of material misstatement and the design and performance of further audit procedures.

ISA 315 (Revised) lists two types of assertions:

- Assertions about classes of transactions and events and related disclosures for the period under audit:
 - **Occurrence** – transactions and events that have been recorded or disclosed, have occurred, and such transactions and events pertain to the entity.
 - **Completeness** – all transactions and events that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
 - **Accuracy** – amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.
 - **Cut-off** – transactions and events have been recorded in the correct accounting period.
 - **Classification** – transactions and events have been recorded in the proper accounts.
 - **Presentation** – transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.
- Assertions about account balances and related disclosures at the period end:
 - **Existence** – assets, liabilities and equity interests exist.
 - **Rights and obligations** – the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
 - **Completeness** – all assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
 - **Accuracy, valuation and allocation** – assets, liabilities and equity interests have been included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments have been appropriately recorded and related disclosures have been appropriately measured and described.
 - **Classification** – assets, liabilities and equity interests have been recorded in the proper accounts.

- **Presentation** – assets, liabilities and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

When auditing, the auditor verifies the assertions as follows:

- **Occurrence** – *the auditor verifies whether the recorded transactions occurred and the financial statements are not overstated e.g. the auditor checks whether the recorded sales are for goods that were dispatched to existing customers.*
- **Completeness** – *the auditor verifies whether all transactions have been recorded and the financial statements are not understated e.g. the auditor checks whether all sales that occurred have been recorded.*
- **Accuracy** – *the auditor verifies whether transactions and events are recorded appropriately and the financial statements are not misstated e.g. the auditor checks whether sales were invoiced and the invoices were recorded correctly.*
- **Cut-off** – *the auditor verifies whether transactions and events are recorded in the correct accounting period and there are no cut-off errors e.g. the auditor checks whether sales transactions were recorded in the correct period.*
- **Classification** – *the auditor verifies whether transactions and events are recorded in proper accounts and are not wrongly classified e.g. the auditor checks whether sales transactions are properly classified.*
- **Presentation** – *the auditor checks whether transactions and events are properly presented and disclosed in in the financial statements.*
- **Existence** – *the auditor verifies whether assets, liabilities and equity included in the statement of financial position existed at the reporting date and are not overstated e.g. the auditor checks whether all the inventory exists at the balance sheet date.*
- **Completeness** – *the auditor verifies whether all assets, liabilities and equity have been included in the financial statements and are not understated e.g. the auditor checks whether all existing inventory has been counted and included in the inventory shown in the statement of financial position.*
- **Rights and obligations** – *the auditor verifies whether the entity controlled assets and had obligations for liabilities in the statement of financial position at the reporting date e.g. the auditor checks whether the entire inventory shown in the statement of financial position were for the entity and had not been pledged as security for loans.*
- **Valuation and allocation** – *the auditor verifies whether assets, liabilities and equity have been included in financial statements at appropriate amounts e.g. the auditor checks whether inventory shown in the statement of financial position was properly valued as at the lower of cost and net realizable value.*
- **Presentation** – *the auditor verifies whether assets, liabilities and equity interests are properly presented and disclosed in accordance with the requirements of the applicable financial reporting framework.*

3.10 Revision questions

- 1) ISA 200 *Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing* identifies the general principles of an external audit.

Required:

- a) Identify and explain the general principles of an external audit.
 - b) Identify the THREE main phases in an audit of financial statements and describe the main procedures performed in each phase.
- 2) 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:

- a) Describe a risk-based audit.
 - b) Define audit risk and the components of audit risk.
 - c) 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.
 - d) 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.
- 3) ISA 320 *Materiality in planning and performing an audit* provides guidance on the concept of materiality in planning and performing an audit.

Required:

- a) Define and explain materiality and performance materiality.
 - b) Explain factors used by the auditor in determining materiality.
 - c) Explain the importance of materiality in an audit.
 - d) Explain the relationship between materiality and audit risk.
 - e) 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.
- 4)
- a) ISA 240 *The auditor's responsibility relating to fraud in an audit of financial statements* gives guidance on fraud.

Required:

- i) Distinguish between fraud and error.
 - ii) Describe the external auditor's responsibilities in relation to the prevention and detection of fraud and error.
 - iii) Distinguish between fraudulent financial reporting and misappropriation of assets.
 - iv) The fraud triangle provides a useful model to identify circumstances that might give rise to a fraud. Discuss the elements of the fraud triangle and explain how they may assist the external auditor in identifying fraud arising from fraudulent financial reporting and the misappropriation of assets.
- b) Explain the responsibilities of management and auditors of an entity in relation to compliance with law and regulations under ISA 250 *Consideration of laws and regulations in an audit of financial statements*.
- 5) (a) Explain the pillars of corporate governance and its importance to companies.
- (b) The Capital Markets Authority has issued corporate guidelines to listed companies in Uganda on the following areas:
- (i) The board of directors.
 - (ii) Rights of shareholders.
 - (iii) Position of chairperson and chief executive.
 - (iv) Accountability and the role of audit committees.

Required:

For each of the above areas, briefly explain the guidelines that are of major importance to the auditor.

- (c) Listed companies in Uganda that are required to have Audit Committees.

Required:

- (i) State the functions of an Audit Committee.
 - (ii) State the advantages and disadvantages of having an Audit Committee in a company.
- 6) ISA 330 *The auditor's responses to assessed risks* requires the auditor to respond to the assessed risks of material misstatement.
- a) Explain how the assessed risk determines the audit approach.
 - b) Define a 'test of control' and give an example of a test of control in relation to the audit of revenue.
 - c) Define a 'substantive procedure' and provide an example of a substantive procedure in relation to the audit of non-current assets.
- 7) ISA 300 *Planning an audit of financial statements* requires an auditor to plan every audit.
- a) Explain the benefits of audit planning.
 - b) Distinguish between an audit strategy and an audit plan.
 - c) Identify THREE main areas 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.
 - d) Distinguish between internal audit and external audit and for each type of audit describe THREE audit procedures that may be undertaken in each audit.
- 8) ISA 230 *Audit Documentation* requires the auditor to prepare documentation.

Required:

- a) State FOUR benefits of documenting audit work.
 - b) List and explain the purpose of FOUR items that should be included on every audit working paper.
- 9)
- a) ISA 315 *Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment* (Revised) lists two types of assertions.

Required:

- i) Define an assertion in an audit of financial statements and explain their importance to the auditor.
 - ii) Identify the two broad categories of financial statement assertions and explain **FOUR** financial statement assertions relevant to one type of assertion.
 - iii) Identify and explain FOUR assertions made by the directors of a company about:
 - Sales transactions of the company during the period.
 - Reporting wages expenses of Shs 200 million in the financial statements of the company.
- b) ISA 500 *Audit evidence* requires auditors to obtain sufficient and appropriate audit evidence.

Required:

- i) Describe **FIVE** types of procedures for obtaining audit evidence and for each procedure, describe an example that may be used in the audit of non-current assets in the financial statements.
 - ii) Identify and explain **THREE** factors that influence the reliability of audit evidence.
- 10) You are an audit supervisor of Newman & Co and are planning the audit of Kampala Paint Ltd for the year ending 31 December 2021. 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 2021 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 2021 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 2021 Shs 000	Actual 2020 Shs 000
Revenue	1,985,000	1,699,000
Cost of sales	(1,244,000)	(1,080,000)
Gross profit	<u>741,000</u>	<u>619,000</u>
Inventory	185,000	133,000
Trade receivables	275,000	178,000
Bank	(81,000)	56,000
Trade payables	197,000	119,000

Required:

a) Calculate THREE ratios, for BOTH years, to assist you in planning the audit of Kampala Paint Ltd.

- b) 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.

Solution

- a) Ratios to assist the audit supervisor in planning the audit:

	2021	2020
Gross margin	$741,000/1,985,000 = 37.3\%$	$619,000/1,699,000 = 36.4\%$
Inventory holding period	$(185,000/1,244,000) \times 365 = 54 \text{ days}$	$(133,000/1,080,000) \times 365 = 45 \text{ days}$
OR Inventory turnover	$1,244,000/185,000 = 6.7$	$1,080,000/133,000 = 8.1$
Receivables collection period	$(275,000/1,985,000) \times 365 = 51 \text{ days}$	$(178,000/1,699,000) \times 365 = 38 \text{ days}$
Payables payment period	$(197,000/1,244,000) \times 365 = 58 \text{ days}$	$(119,000/1,080,000) \times 365 = 40 \text{ days}$
Current ratio	$46,000/(197,000 + 81,000) = 1.65$	$367,000/119,000 = 3.08$
Quick ratio	$275,000/(197,000 + 81,000) = 0.99$	$(367,000 - 133,000)/119,000 = 1.97$

- b) Audit risks and auditor's response

Audit risk	Auditor's response
During the year, Kampala Paint Ltd (KPL) has spent Shs 90m on developing new product lines, some of which are in the early stages of their development cycle. This expenditure is classed as research and development under IAS 38 <i>Intangible Assets</i>. The standard requires research costs to be expensed to profit or loss and only development costs to be capitalised as an intangible asset. The company has included all of this expenditure as an intangible asset. If research costs have been incorrectly classified as development expenditure, there is a risk that intangible assets could be overstated and expenses understated.	Obtain a breakdown of the expenditure and verify that it relates to the development of the new products. Review expenditure documentation to determine whether the costs relate to the research or development stage. Discuss the accounting treatment with the finance director and ensure it is in accordance with IAS 38.
KPL purchased and installed a new manufacturing line. The costs include purchase price (Shs 220m), installation costs (Shs 40m) and a five-year servicing and maintenance plan (Shs 50m). As per IAS 16 <i>Property, Plant and Equipment</i>, the cost of an asset includes its purchase price and directly attributable costs only. IAS 16 does not allow servicing and maintenance costs to be capitalised as part of the cost of a non-current asset, as they are not directly related to the cost of bringing the asset to its working condition. The servicing costs relate to a five-year period and so should be charged to profit or loss over this time. The	Review the purchase documentation for the new manufacturing line to confirm the exact cost of the servicing and that it does relate to a five-year period. Discuss the accounting treatment with the finance director and the level of any necessary adjustment to ensure treatment is in accordance with IAS 16.

upfront payment represents a prepayment for five years; as the services are received, the relevant proportion of the cost should be charged to profit or loss. If the service for 2021 has been carried out, then Shs 10m (Shs 50m/5) should be charged to profit or loss. Therefore property, plant and equipment (PPE) and profits are overstated and prepayments are understated.	
The company has borrowed an eight-year loan of Shs 400m from Stanbic bank. The loan should be split between current and non-current liabilities to ensure correct disclosure.	During the audit, the team need to confirm that Shs 400 million loan finance was received. In addition, the split between current and non-current liabilities and the disclosures for this loan should be reviewed in detail to ensure compliance with relevant accounting standards and local legislation. Details of security should be agreed to the bank confirmation letter.
As the level of debt has increased, there should be additional finance costs as the loan has an interest rate of 18%. There is a risk that this has been omitted from the statement of profit or loss leading to understated finance costs and overstated profit.	The finance costs should be recalculated and any increase agreed to the loan documentation for confirmation of the 18% interest rate. Interest payments should be agreed to the cash book and bank statements to confirm the amount was paid and is not therefore a year-end payable.
KPL intends to undertake a stock exchange listing in the next 12 months. In order to maximise the success of the potential listing, KPL will need to present financial statements that show the best possible position and performance. The directors therefore have an incentive to manipulate the financial statements, by overstating revenue, profits and assets.	Newman & Co should ensure that there is a suitably experienced audit team. Also, adequate time should be allocated for team members to obtain an understanding of the company and the significant risks of overstatement of revenue, profits and assets, including attendance at an audit team briefing. The team needs to maintain professional scepticism and be alert to the increased risk of manipulation. Significant estimates and judgements should be carefully reviewed in light of the misstatement risk.
The receivables collection period has increased from 38 to 51 days and management has extended the credit terms given to customers on the condition that sales order quantities were increased. The increase in receivable days could be solely due to these increased credit terms. However, it could also be due to an increased risk over recoverability of receivables as they may be overvalued and expenses understated.	Review and test the controls surrounding how KPL identifies receivables balances which may not be recoverable and procedures around credit control to ensure that they are operating effectively. Extended post year-end cash receipts testing and a review of the aged receivables ledger to be performed to assess valuation. Also consider the adequacy of any allowance for receivables.
This year the company made a 'price promise' to match the price of its competitors for similar products. Customers are able to claim the difference from the company for one month after the date of purchase of goods.	Discuss with management the basis of the refund liability of Shs 25m and obtain supporting documentation to confirm the reasonableness of the assumptions and calculations.

The company should account for the price promise in accordance with IFRS 15 <i>Revenue from Contracts with Customers</i>. As the company may be required to provide a refund, the anticipated refund amount should not be initially recognised as revenue but instead as a refund liability until the one-month price promise period has ended. This is a highly subjective area, with many judgements required with regards to the level of likely refund due. As this is a new liability, the directors may not have correctly accounted for this sum resulting in overstated revenue, under/overstated profits and liabilities.	
KPL has stopped further sales of one of its paint products and a product recall has been initiated for any goods sold since September. This product recall will result in KPL paying refunds to customers. The sales will need to be removed from the 2019 financial statements and a refund liability recognised. Also inventory will need to be reinstated, although at a possibly written down value. Failing to account for this correctly could result in overstated revenue, understated liabilities and misstated inventory.	Review the list of sales of the paint product made between September and the date of the recall, agree that the sales have been removed from revenue and the inventory included. If the refunds have not been paid before the year end, review the draft financial statements to confirm that it is included within current liabilities.
The company is holding a number of damaged paint products in inventory and overall the inventory holding period has increased from 45 days to 54 days. The quality of these products is questionable and management is investigating whether these products can be rectified. There is a risk that this inventory may be overvalued as its net realisable value may be below cost.	Discuss with the finance director whether any write down will be made to this product, and what, if any, modifications will be required to rectify the quality of the product. Testing should be undertaken to confirm cost and NRV of the affected paint products held in inventory and that on a line by line basis the goods are valued correctly.
Revenue has increased by 16.8% in the year; and the gross margin has increased slightly from 36.4% to 37.3%. This is a significant increase in revenue and, along with the increase in gross margin, may be related to the increased credit period and price promise promotion or could be due to an overstatement of revenue.	During the audit, a detailed breakdown of sales will be obtained, discussed with management and tested in order to understand the sales increase. Also increased cut-off testing should be undertaken to verify that revenue is recorded in the right period and is not overstated.
The payables payment period has increased from 40 to 58 days. The current ratio has decreased from 3.08 to 1.65. The quick ratio has also decreased from 1.97 to 0.99. In addition, the bank balance has moved from Shs 56m to an overdraft of Shs 81m. These are all indicators that the company could be experiencing a reduction in its cash flow which could result in going concern difficulties or uncertainties. These uncertainties may not be adequately disclosed in the financial statements.	Detailed going concern testing to be performed during the audit, including the review of cash flow forecasts and the underlying assumptions. These should be discussed with management to ensure that the going concern basis is reasonable.

