INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF UGANDA

EXTERNAL AUDIT MANUAL

PART I

2011

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ABOUT ICPAU

The Institute of Certified Public Accountants of Uganda (ICPAU) was established in 1992 by The Accountants Act, Cap 266. The functions of the Institute, as prescribed by the Act, are to regulate and maintain the standard of accountancy in Uganda and to prescribe or regulate the conduct of accountants in Uganda. Under its legal mandate, the Institute prescribes professional standards to be applied in the preparation and auditing of financial reports in Uganda.

Vision

To be a world class professional accountancy institute.

Mission

To develop and promote the accountancy profession in Uganda and beyond.

Core Values

1) Professional Excellence.
2) Integrity.
3) Commitment.
4) Good Governance.
5) Social Responsiveness.

International Affiliations

The Institute is a member of the International Federation of Accountants (IFAC), the Eastern Central and Southern African Federation of Accountants (ECSAFA) and the Pan African Federation of Accountants (PAFA).

Adoption of Standards

In pursuit of its statutory obligation, the Institute adopted the following standards for application, by reporting entities in Uganda:

Standard	Issuing Body	Date of Adoption
International Financial Reporting Standards (IFRS)	International Accounting Standards Board (IASB)	1998
International Standards on Auditing (ISA)	International Auditing and Assurance Standards Board (IAASB)	1999
International Public Sector Accounting Standards (IPSAS)	International Public Sector Accounting Standards Board (IPSASB)	2006
International Financial Reporting Standards for Small and Medium-sized Entities	International Accounting Standards Board (IASB)	2009

Clarity Project

Since 2004, the International Auditing and Assurance Standards Board (IAASB) has been working to update all the International Standards on Auditing (ISAs) in a consistent format designed to make the objectives of ISAs and their specific requirements clear. This is known as the 'Clarity Project'.

Under the 'Clarity Project', all of the ISAs were drafted in accordance with the IAASB's Clarity conventions subject to a single statement of authority. The completion of the 'Clarity Project' resulted in many improvements to the ISAs. These improvements go beyond the enhancement of the understandability of the ISAs through the application of the new Clarity conventions; they also include substantive changes to approximately half of the ISAs.

All 36 clarified ISAs come into effect for audits of financial statements for periods beginning on or after 15 December 2009.

List of Effective ISAs

1.	ISA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing
2.	ISA 210	Agreeing the Terms of Audit Engagements
3.	ISA 220	Quality Control for an Audit of Financial Statements
4.	ISA 230	Audit Documentation
5.	ISA 240	The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements
6.	ISA 250	Consideration of Laws and Regulations in an Audit of Financial Statements
7.	ISA 260	Communication with Those Charged with Governance
8.	ISA 265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
9.	ISA 300	Planning an Audit of Financial Statements
10.	ISA 315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment
11.	ISA 320	Materiality in Planning and Performing an Audit
12.	ISA 330	The Auditor's Responses to Assessed Risks
13.	ISA 402	Audit Considerations Relating to an Entity Using a Service Organization
14.	ISA 450	Evaluation of Misstatements Identified during the Audit
15.	ISA 500	Audit Evidence
16.	ISA 501	Audit Evidence-Specific Considerations for Selected Items
17.	ISA 505	External Confirmations
18.	ISA 510	Initial Audit Engagements-Opening Balances
19.	ISA 520	Analytical Procedures
20.	ISA 530	Audit Sampling
21.	ISA 540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
22.	ISA 550	Related Parties

23.	ISA 560	Subsequent Events
24.	ISA 570	Going Concern
25.	ISA 580	Written Representations
26.	ISA 600	Special Considerations-Audits of Group Financial Statements (Including the Work of Component Auditors)
27.	ISA 610	Using the Work of Internal Auditors
28.	ISA 620	Using the Work of an Auditor's Expert
29.	ISA 700	Forming an Opinion and Reporting on Financial Statements
30.	ISA 705	Modifications to the Opinion in the Independent Auditor's Report
31.	ISA 706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
32.	ISA 710	Comparative Information-Corresponding Figures and Comparative Financial Statements
33.	ISA 720	The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements
34.	ISA 800	Special Considerations-Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks
35.	ISA 805	Special Considerations-Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement
36.	ISA 810	Engagements to Report on Summary Financial Statements
37.	ISQC 1	Quality Controls for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements

Glossary of Terms

CAATs	Computer Assisted Auditing Techniques
CAF	Current Audit File
ECSAFA	East Central and Southern African Federation of Accountants
Entity	Refers to the audit client.
IAPS	International Auditing Practice Statements
IAASB	International Auditing and Assurance Standards Board
ICPAU	Institute of Certified Public Accountants of Uganda
IFAC	International Federation of Accountants
IFRS	International Financial Reporting Standard
ISA	International Standard on Auditing
ISQC 1	International Standard on Quality Control 1
PAF	Permanent Audit File

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Scope of the Manual

This Audit Manual has been designed to guide audits in accordance with the International Standards on Auditing. The Manual focuses on audits of small and medium sized incorporated companies and is largely aimed at owner-managed and director-controlled companies, but sufficient guidance is provided towards the audit of larger companies. The principles set out in the manual will be of general application to all audits, the audit approach can be applied to audits of 'special' entities such as audits of non-government organisations.

Disclaimer

This Audit Manual is designed to assist practitioners in the implementation of the International Standards of Auditing (ISAs) but is not intended to be a substitute for the ISAs themselves. The Audit Manual is a merely a guide and does not replace the need to refer to the ISAs.

The Audit Manual is intended to help the practitioner to develop an Audit Manual of their own.

Furthermore, a practitioner should utilize this Manual in light of his or her professional judgment and the facts and circumstances involved in each particular audit.

Preface

The Manual provides guidance on applying ISAs issued by the IAASB. The Manual is not to be used as a substitute for reading the ISAs, but rather as a supplement intended to help practitioners understand and consistently implement these standards on audits.

The Manual provides a detailed analysis of the ISAs and their requirement. It addresses, amongst other things: the key concepts underlying risk assessment; planning and execution of an audit; and reporting. In addition, the Manual offers some useful practice aids.

The Manual is intended to explain and illustrate so as to develop a deeper understanding of an audit conducted in compliance with the Clarified ISAs. Ultimately it should help practitioners conduct high quality, cost-effective audits and so enable them to better serve the public interest. Audit firms may also use the Manual as a basis for educating and training professional staff.

We hope that audit firms use the manual in ensuring compliance with ISAs and in meeting the requirements of the Institute's audit monitoring programme.

The Institute is committed to updating this Manual on a regular basis so as to ensure it reflects current standards and is as useful as possible. We welcome comments from practitioners on:

- Whether they find the Manual useful?
- Whether they believe the Manual has integrated all the relevant ISAs into the audit process?
- The ways in which the Manual can be made more useful.

Please submit your comments to icpau@icpau.co.ug or mail them to ICPAU, Plot 42 Bukoto Street, Kololo, P. O. Box 12464, Kampala, Uganda.

1. OVERALL AUDIT OBJECTIVES AND RESPONSIBILITY OF THE INDEPENDENT AUDITOR

1.1 Overall Objectives of the Auditor

Under the principles of ISA 200, "….the overall objectives of the auditor are:

(a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
(b) To report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings."

The objective applies to a full scope audit of any entity's financial statements, whether or not the entity is profit oriented or the assignment is a non-statutory audit.

1.2 Requirements of the Auditor

1.2.1 Ethical Requirements Relating to an Audit of Financial Statements.

The auditor's ethical requirements comprise the Code of Ethics as promulgated by ICPAU and the IFAC Code of Ethics. In general, each member of the engagement team is required to behave with integrity in all professional relationships which implies honesty, fair dealing, sincerity and professional independence. An auditor should be objective in all judgements and not allow prejudice, bias or any other interest to influence the auditor's objectivity. The auditor is required to respect the confidentiality of information obtained in the course of an audit and not disclose any information to a third party unless it is legally or professionally required of us. The firm should only undertake work which it is competent and experienced to perform and all professional work must be conducted with due care, skill and diligence.

1.2.2 Professional scepticism

The auditor should plan and perform an audit with professional scepticism recognising that circumstances may exist that cause the financial statements to be materially misstated. The engagement team is required to make a critical assessment of the validity of the audit evidence obtained and should be alert to evidence that contradicts or brings into question the reliability of documents and responses to inquiries and other information obtained from management and those charged with governance. The audit team needs to be alert to conditions that may indicate possible fraud and circumstances that suggest the need for audit procedures in addition to those required by the ISAs.

The attitude of professional scepticism is necessary throughout the audit to reduce the risk of overlooking unusual circumstances, of over-generalising conclusions drawn from audit observation, and of using incorrect assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results. The engagement team should obtain persuasive audit evidence that those charged with governance are honest and have integrity.

1.2.3 Professional Judgement

The auditor should exercise professional judgement in planning and performing an audit of financial statements. Professional judgment is essential to the proper conduct of an audit. This is because interpretation of relevant ethical requirements and the ISAs and the informed decisions required throughout the audit, cannot be made without the application of relevant knowledge and experience to the facts and circumstances.

1.2.4 Sufficient and Appropriate Audit Evidence and Audit Risk

In order to obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.

1.2.5 Conduct the Audit in Accordance with ISAs

ISAs provide the basic principles and essential procedures which have to be applied in the context of explanatory notes and appendices. The audit should comply with all the ISAs relevant to the audit engagement. The engagement team should not represent compliance with ISAs unless they have complied with all of the ISAs relevant to the audit. The auditor should have an understanding of the entire text of an ISA, including its application and other explanatory material, to understand its objectives and to apply its requirements properly.

1.3 Stages of an Audit

The suggested audit approach is designed to gather sufficient and reliable evidence to support the audit opinion in the most efficient and effective way and to enable the engagement team to fully understand the client's business. There is no difference between an audit of a large and a small entity except that the procedures adopted may differ depending on the particular circumstances of each audit.

1.3.1 Preliminary Engagement Activities

At the pre-planning stage engagement partner ensures that:

- The client acceptance and continuation procedures have been carried out;
- The terms of engagement have been agreed in writing;
- The quality control aspects for the assignment have been reviewed including review of compliance with independence and other ethical requirements.

1.3.2 Planning

Planning is an essential component in focusing the audit efforts. The key components of planning are:

1.3.2.1 Overall Audit Strategy

The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

In establishing the overall audit strategy, the auditor should:

- Identify the characteristics of the engagement that define its scope;

- Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required;
- Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts;
- Consider the results of preliminary engagement activities and, where applicable, whether knowledge gained on other engagements performed by the engagement partner for the entity is relevant; and
- Ascertain the nature, timing and extent of resources necessary to perform the engagement.

1.3.2.3 Audit Plan

The auditor shall develop an audit plan that shall include a description of:

- The nature, timing and extent of planned risk assessment procedures.
- The nature, timing and extent of planned further audit procedures at the assertion level.
- Other planned audit procedures that are required to be carried out so that the engagement complies with ISAs.

1.3.2.2 Risk Assessment

The auditor should form an understanding of the risks of material misstatement of the financial statements. The key components of risk assessment are to:

- Perform risk assessment procedures to understand the business and identify inherent and control risks.
- Identify relevant internal control procedures and assess their design and implementation.
- Assess the risks of material misstatement in the financial statements.
- Identify the significant risks that require special audit considerations and those risks for which substantive procedures alone are not sufficient.
- Communicate material weaknesses in the design and implementation of internal control to management and those charged with governance; and
- Make an informed assessment of the risks of material misstatement at the financial statements level and at the assertion level.

1.3.3 Execution

At this stage the auditor performs audit procedures that respond to the assessed risks of material misstatement and provide evidence necessary to support the audit opinion.

The key components of the execution stage are:

- Carrying out test of controls and substantive tests on transactions and balances including analytical procedures to obtain sufficient and appropriate audit evidence to enable the engagement team to draw reasonable conclusions on which to base the audit opinion.
- Evaluating significant assumptions used in fair value measurement to determine the reasonableness of the basis used and the disclosures.
- Identification of related parties and obtaining sufficient and appropriate audit evidence in respect of measurement and disclosure of related party transactions.

- Documenting the nature, timing and extent of the audit procedures performed and the results and conclusions drawn from the audit evidence obtained.

While pre-printed forms and programmes are available in the Manual, the extent and the timing of the tests should be tailored to the specific assignment. Different tests will be appropriate for different assignments. The control of the audit at this stage must be maintained by a senior team member with the appropriate experience and expertise.

1.3.4 Review and Completion

The review and completion procedures focus on ensuring that sufficient and appropriate evidence has been obtained to support the audit opinion. This involves ensuring that:

- All outstanding matters have been cleared.
- Consultations on difficult or contentious matters have been documented and adequately resolved and conclusions there from are implemented.
- Analytical procedures have been performed to form a conclusion on whether the financial statements taken as a whole are consistent with the firm's knowledge of the business.
- Where other appropriate audit evidence cannot be reasonably obtained, written management representations have been obtained on areas material to the financial statements.
- Review has been carried out of any material uncertainty relating to events or conditions that may exist which alone or in aggregate cast a significant doubt on the entity's ability to continue as a going concern.
- There is evidence that the engagement team has considered and confirmed that the financial reporting framework adopted by the entity is suitable, and that the financial statements comply with the framework as to both recognition and measurement, and presentation and disclosure. In the context of Uganda, this in most cases will be the IFRSs.
- The engagement partner has reviewed the audit file and has satisfied himself that sufficient and appropriate evidence has been obtained to support the conclusions derived and the audit opinion to be issued. As much of the audit evidence obtained is persuasive rather than conclusive, absolute certainty is rarely obtainable and therefore the engagement partner should ensure that the audit risk is reduced to the lowest level possible.
- Where applicable, sufficient and appropriate procedures have been performed to identify subsequent events up to the date of the audit report and ensure that all items that require adjustment or disclosure in the financial statements have been appropriately dealt with.
- Where appropriate, an engagement quality control review has been undertaken and all the issues arising from the review have been fully dealt with and cleared with the reviewer.
- At the end of each audit, the engagement team is de-briefed, the audit objectives set out for the assignment have been achieved and that the engagement team has gained experience from the assignment which will enhance their personal development.

Though not covered by the terms of audit engagement, the engagement team may, as part of the audit process carry out a business review of the key issues facing the entity and take a strategic look at the business and at areas where the firm can add value to the entity. In providing other value added services, the firm and in particular the engagement partner should be conscious of the independence requirements of the Code of Ethics.

1.3.5 Supervision of the Engagement Team

A key aspect of a successful engagement is the supervision of the engagement team at all the stages of an audit. At the planning stage, the engagement partner needs to communicate the audit objectives to the engagement team either directly or through the audit manager. This is necessary to assist the less experienced members of the engagement team to clearly understand the objectives of the assigned work. Effective supervision includes:

- Tracking the progress of the engagement.
- Considering the competence and capabilities of the individual members of the engagement team, including whether they have sufficient time to carry out their work, whether they understand the instructions and ensuring that the work is being carried out in accordance with the planned approach of the audit engagement.
- Addressing significant issues arising during the engagement, considering their significance and modifying the planned approach appropriately.
- Identifying matters for consultation or consideration by more experienced engagement team members.

1.3.6 Overall Review Responsibilities

Review responsibilities are determined on the basis that the more experienced engagement team members, including the engagement partner, review work performed by the less experienced engagement team members. Reviewers consider whether:

- The work has been performed in accordance with professional standards and legal and regulatory requirements.
- Significant matters have been raised for further consideration.
- Appropriate consultations have taken place and the resulting conclusions documented and implemented.
- There is need to revise the nature, timing and the extent of work performed.
- The work performed supports the conclusions reached and is appropriately documented.
- The evidence obtained is sufficient and appropriate to support the report.
- The objectives of the engagement have been achieved.

1.4 Use of Standard Forms and Programmes

The use of pre-printed forms, programmes and standard letters is to:

- Help ensure the quality of work.
- Provide an aid to training and for guidance purposes.
- Help achieve efficiency.

However, each audit is unique and requires the approach to be tailored. It is therefore the responsibility of the engagement partner to ensure that the standard checklists and programmes are tailored to take into consideration the audit strategy and plan for each assignment.

1.5 Responsibility for the Financial Statements

The responsibility for the preparation and presentation of the financial statements in accordance with an applicable financial reporting framework is that of management of the entity, with oversight from directors. The management is also responsible for identifying the financial reporting framework to be used in the preparation of the financial statements.

The term 'financial statements' is referred to in ISA 200 as a structured representation of historical financial information, including related notes, intended to communicate an entity's economic resources or obligations at a point in time or the changes therein for a period of time in accordance with a financial reporting framework. The term can refer to a complete set of financial statements, but can also refer to a single financial statement e.g. a statement of changes in equity.

The auditor's responsibility is to determine whether the financial reporting framework adopted by the management is acceptable in view of the nature of the entity and the objectives of the financial statements in the context of the financial reporting framework for statutory reporting to members as promogulated by ICPAU. However, where reporting is done for other purposes e.g. a not-for-profit organisation or reporting to the parent, the engagement team at the planning stage needs to consider the appropriateness of the framework adopted by the management.

1.6. Responsibilities of the Engagement Team

1.6.1. General Responsibilities

These include:

- Maintaining the very highest ethical and professional standards in the conduct of their work.
- Maintaining an attitude of professional scepticism and having the ability to apply professional judgement.
- Develop an understanding of the industry in which the entity operates and the issues affecting the industry.
- Appropriate understanding of the entity's operations including knowledge of relevant information technology.
- Appropriate understanding of the professional standards, regulatory and legal requirements.
- Demonstrating a genuine interest in the requirements of the entity, including attending promptly to any specific issues.
- Carrying out the audit in accordance with the audit plan and within the time budget.
- Reviewing the engagement.
- Identifying areas of time saving and increased efficiency in future audits.
- Developing the engagement team by providing on-the-job training to persons being directly supervised.

ISA 220 places the responsibility for the implementation of the quality control procedures applicable to the engagement on the engagement partner.

1.6.2. Engagement Partner

The engagement partner has the principle responsibility for the assignment and for the overall quality on each audit. The engagement partner is responsible for the direction, supervision and performance of the audit engagement in compliance with professional standards, legal and regulatory requirements and ensuring that the audit approach adopted provides sufficient and relevant evidence to support the audit opinion, which is appropriate in the circumstances. An engagement partner is also expected to discuss the audit with the engagement team. Where more than one partner is involved in the conduct of an engagement, responsibilities need to be clearly defined and understood by the engagement team.

1.6.2.1 Preliminary engagement activities:

- Ensuring that the engagement acceptance and continuation procedures have been complied with.
- Agreeing the terms of engagement in writing with the entity.
- Ensuring compliance with the ethical and independence requirements, and assigning an engagement team, including specialist staff, who possess the necessary capability and competence and have sufficient time to perform the engagement.
- Ensuring that the quality control procedures that are applicable to the audit engagement are complied with.

1.6.2.2 Planning:

- Contact the entity especially with those charged with governance.
- Where necessary, the engagement partner should seek appropriate consultations and ensure that the conclusions there from are implemented.
- Preliminary discussions with the engagement team or the audit manager (or the audit senior for small or medium audits depending on the structure of the firm) and briefing them on the responsibility of the engagement team, the audit risk, the problems that may be encountered and on any other key factors.
- Setting the overall objectives for the assignment.
- Follow-up with the entity on issues identified in the previous year's management letter.
- To sign-off the audit strategy and the audit plan including the risk and proposed response to identified risks, audit materiality, analytical procedures, budgets and the audit programmes.

1.6.2.3 Execution:

- To oversee the audit and ensure that the audit is proceeding according to plan and to interject and guide the engagement team when required.
- Conducting timely reviews at appropriate stages to ensure that significant matters are resolved on a timely basis, and where appropriate, modifying the planned audit approach.
- Identifying matters for consultation or consideration by more experienced members of the engagement team.

1.6.2.4 Review:

The engagement partner need not review all audit documentation. The engagement partner should however review critical areas, especially those relating to judgement, contentious matters identified during the audit, significant risks and other areas considered important by the engagement partner. A detailed review of the audit file should cover:

- Matters for partner's attention and ensuring that these are satisfactorily disposed of.
- Summary of unadjusted errors and ensuring that these are not individually and collectively material.
- Lead schedules and audit conclusions for each material area and where necessary, a more detailed review of the specific areas.
- Audit strategy and plan to ensure that the original strategy and plan is still appropriate and consider any further tests and evidence required.
- Time budgets compared against the actual time spent.
- Sufficiency and appropriateness of the audit evidence to support the audit opinion and the adequacy of the management representations being obtained from the entity.
- Financial statements and ensuring that they comply with the reporting framework adopted by the entity, and the appropriateness of the reporting framework adopted.
- A detailed review of any documentation to be sent to the entity including:

    a. Audited financial statements.
    b. Draft letter of representation.
    c. Management letter.

A new engagement partner taking over an audit during engagement must review the work performed to the date of change and ensure that the engagement has been planned and performed in accordance with the professional standards and the legal and regulatory requirements.

1.6.2.5 Reporting:

- Ensuring that all engagement partners' review notes have been cleared satisfactorily prior to signing the financial statements.
- Ensuring that all consultations have been documented and any contentious issues are fully resolved and the conclusions from the consultations implemented.
- Ensuring that where necessary, an engagement quality control review has been undertaken by an engagement quality control reviewer and all issues arising have been satisfactorily dealt with.
- Ensuring that the work has been performed in accordance with professional standards, legal and regulatory requirements.
- Discussing the financial statements, key audit issues, management letter and other strategic business issues with the entity and providing assistance where necessary, without compromising independence.
- Signing all the checklists including independence, engagement partner's review and audit finalisation.
- Signing and dating the audit report.

1.6.2.6 De-briefing:

- De-brief the audit team.
- Appraise the team and identify areas of potential training.
- Review and approve any post-meeting action programme. This task can be delegated to the manager, and the partner will only appraise the audit manager in this case.

1.6.3. Quality Control Reviewer

If the engagement is one that requires the appointment of an engagement quality control reviewer, the engagement quality control reviewer is required to conduct the review in a timely manner and at appropriate stages thereby ensuring that significant matters are promptly resolved prior to the issue of the report. The reviewer should be introduced to the audit team and where appropriate, to the entity. The role of the reviewer includes:

- Discussing the scope of the assignment with the engagement partner.
- Reviewing the independence of the firm and the engagement team.
- Ensuring that the working papers selected for review reflect the work performed in relation to significant judgements and support the conclusions reached.
- Reviewing significant risks identified during the engagement and responses to those risks including the engagement team's assessment of, and response to, the risk of fraud.
- Reviewing judgements made, particularly with respect to materiality and significant risks.
- Ensuring that appropriate consultations have taken place on matters involving differences of opinion or on difficult and contentious matters, and that the matters have been satisfactorily concluded.
- Reviewing the significance and disposition of adjusted and unadjusted misstatements identified during the assignment.
- Ensuring that, where applicable, matters to be communicated to the management and those charged with governance and to other parties including regulatory authorities have been done.
- Reviewing the appropriateness of the auditor's report to be issued.

1.6.4. Manager

The manager has the overall responsibility for achieving the objectives set by the engagement partner. The manager's key responsibilities will be to manage the services provided to the entity, and to ensure that the audit is conducted efficiently and effectively. The specific responsibilities at each stage include:

1.6.4.1 Planning

- Initial discussion with the partner.
- Planning the detailed audit work, concentrating on:
  - Changes in the entity's business.
  - Likely problems, including points brought forward from last year.
  - Critical audit areas including: the audit risks identified for each audit area; the risk of error or fraud; results of the analytical procedures; and the assessment of the control environment and internal controls.
  - Levels of materiality.

- Informing the audit senior of all factors relevant to the audit.
- Reviewing the time costs and expenses budget.
- Organising and attending the pre-audit meeting with the entity.
- Developing the audit strategy and the audit plan for partner approval taking into consideration the risk and proposed response to identified risks, audit materiality, analytical procedures, budgets and the audit programmes.
- Briefing the engagement team.

1.6.4.2 Execution

- Monitoring the progress of the audit, including progress against the audit plan and performance of the engagement team.
- Approving any changes to the audit plan and programmes after consultation with the engagement partner.
- Keeping the engagement partner abreast of the progress of the audit, and of any important issues arising.

1.6.4.3 Review:

- Reviewing the financial statements in detail to ensure that they comply with the financial reporting framework as to both recognition and measurement, and presentation and disclosure, and that the significant assumptions made by the management are appropriate to the entity.
- Assessing the results of the analytical procedures adopted at the planning, execution and review stages.
- Reviewing any adjusting journal entries made in the accounting records.
- Ensuring key issues have been satisfactorily treated.
- Ensuring the audit file contains sufficient and appropriate audit evidence to support the audit opinion.
- Reviewing and editing the points for partner's attention, management letter, letter of representation, audit time summary schedule and the proposed fee.
- Reviewing the audit senior's working papers, and ensuring the audit senior has satisfactorily reviewed the assistants' working papers.
- Ensuring all review points have been satisfactorily cleared.

1.6.5. Audit Senior

The audit senior has an overall responsibility for ensuring the objectives set by the engagement partner and manager, are attained and to carry out the audit in accordance with the audit plan and programmes. The audit senior's key responsibilities will be to deal with the entity's affairs on a day-today basis, and to ensure the audit work is carried out thoroughly and completed within budgets and deadlines. The specific responsibilities include:

1.6.5.1 Planning:

- Assisting the manager in drafting the audit plan and programmes.
- Preparing the time costs and expenses budgets.
- Briefing audit assistants.

1.6.5.2 Fieldwork:

- Completing the work in accordance with the timetable and budgets.
- Allocating work to and controlling the work of assistants.
- Providing on-the-job training to assistants.
- Keeping the manager informed of any problems which arise (whether technical or administrative).
- Implementing any changes to the audit plan and programmes, after discussion with the manager.
- Ensuring that all the conclusions are supported by the work done and the audit evidence obtained is sufficient and appropriate to support the audit conclusion.
- Noting any evidence necessary to support suggestions and recommendations to be included in the management letter.

1.6.5.3 Review:

- Reviewing the financial statements for compliance with local legislation and with the financial reporting framework using, where necessary, appropriate checklists.
- Drafting the points for partner's attention.
- Preparing summary of outstanding issues and summary of unadjusted errors.
- Noting any points to be carried forward to the subsequent audit.
- Drafting the management letter.
- Drafting the letter of representation.
- Completing other tasks as required.
- Reviewing the work of audit assistants.
- Ensuring that all review points are cleared and all evidence obtained is satisfactory.

1.6.6. Assistant

The assistant is primarily responsible for performing the procedures delegated by the senior. The specific responsibilities of an assistant include:

- Carrying out tasks in specific areas.
- Informing the audit senior promptly of any problems experienced or discrepancies found.
- Providing explanations, on-the-job training, and appraisals to assistants with less experience.

2. ETHICAL REQUIREMENTS AND QUALITY CONTROL FOR AN AUDIT OF FINANCIAL STATEMENTS

Each firm should develop policies to comply with the requirements of ISQC 1 and the Code of Ethics and procedures to monitor compliance with such policies. The policy and procedures in relation to ISQC1 and the Code of Ethics should be communicated to the firm's personnel and others subject to them.

2.1. Ethical Requirements in Respect to Audit Engagements

ISQC 1 requires that the firm establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with the relevant ethical requirements, while ISA 220 requires the engagement partner to consider whether members of the engagement team have complied with the ethical requirements.

The engagement partner must remain alert to evidence of non-compliance with ethical requirements. If such matters come to the engagement partner's attention through the firm's systems or through inquiry and observation during the engagement, the partner, along with other partners, should determine the appropriate course of action.

2.1.1 Integrity

Integrity means to be straightforward and honest in all professional and business relationships. The principle of integrity imposes an obligation on all professional accountants to be straight forward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.

2.1.2 Objectivity

Objectivity means to not allow bias, conflict of interest or undue influence of others to override professional or business judgments. The principle of objectivity imposes an obligation on all professional accountants not to compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others.

2.1.3 Professional Competence and Due Care

This means to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.

2.1.4 Confidentiality

This means to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.

2.1.5 Professional Behaviour

Professional behaviour means to comply with relevant laws and regulations and avoid any action that discredits the profession.

2.1.6 Independence

Independence comprises of:

a. *Independence of Mind*

The state of mind that permits the expression of a conclusion without being affected by influences, that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional scepticism.

b. *Independence in Appearance*

The avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a firm's, or a member of the audit team's, integrity, objectivity or professional scepticism has been compromised.

2.2 Threats

Compliance with the fundamental principles may potentially be threatened by a broad range of circumstances and relationships.

2.2.1 Self-Interest Threats

Examples of circumstances that create **self-interest threats** for a professional accountant in public practice include:

- A member of the assurance team having a direct financial interest in the assurance client.
- A firm having undue dependence on total fees from a client.
- A member of the assurance team having a significant close business relationship with an assurance client.
- A firm being concerned about the possibility of losing a significant client.
- A member of the audit team entering into employment negotiations with the audit client.
- A professional accountant discovering a significant error when evaluating the results of a previous professional service performed by a member of the professional accountant's firm.

2.2.2 Self-Review Threats

Examples of circumstances that create **self-review threats** for a professional accountant in public practice include:

- A firm issuing an assurance report on the effectiveness of the operation of financial systems after designing or implementing the systems.
- A firm having prepared the original data used to generate records that are the subject matter of the assurance engagement.
- A member of the assurance team being, or having recently been, a director or officer of the client.

- A member of the assurance team being, or having recently been, employed by the client in a position to exert significant influence over the subject matter of the engagement.
- The firm performing a service for an assurance client that directly affects the subject matter information of the assurance engagement.

2.2.3 Advocacy Threats

Examples of circumstances that create **advocacy threats** for a professional accountant in public practice include:

- The firm promoting shares in an audit client.
- A professional accountant acting as an advocate on behalf of an audit client in litigation or disputes with third parties.

2.2.4 Familiarity Threats

Examples of circumstances that create **familiarity threats** for a professional accountant in public practice include:

- A member of the engagement team having a close or immediate family member who is a director or officer of the client.
- A member of the engagement team having a close or immediate family member who is an employee of the client who is in a position to exert significant influence over the subject matter of the engagement.
- A director or officer of the client or an employee in a position to exert significant influence over the subject matter of the engagement having recently served as the engagement partner.
- A professional accountant accepting gifts or preferential treatment from a client, unless the value is trivial or inconsequential.
- Senior personnel having a long association with the assurance client.

2.2.5 Intimidation Threats

Examples of circumstances that create **intimidation threats** for a professional accountant in public practice include:

- A firm being threatened with dismissal from a client engagement.
- An audit client indicating that it will not award a planned non-assurance contract to the firm if the firm continues to disagree with the client’s accounting treatment for a particular transaction.
- A firm being threatened with litigation by the client.
- A firm being pressured to reduce inappropriately the extent of work performed in order to reduce fees.
- A professional accountant feeling pressured to agree with the judgment of a client employee because the employee has more expertise on the matter in question.
- A professional accountant being informed by a partner of the firm that a planned promotion will not occur unless the accountant agrees with an audit client’s inappropriate accounting treatment.

2.3 Safeguards

Safeguards that may eliminate or reduce threats to an acceptable level fall into two broad categories:

(a) Safeguards created by the profession, legislation or regulation; and
(b) Safeguards in the work environment.

Examples of safeguards created by the profession, legislation or regulation are described in the Code of Ethics.

In the work environment, the relevant safeguards will vary depending on the circumstances. Work environment safeguards comprise firm-wide safeguards and engagement-specific safeguards.

Examples of firm-wide safeguards in the work environment include:

- Leadership of the firm that stresses the importance of compliance with the fundamental principles.
- Leadership of the firm that establishes the expectation that member of an assurance team will act in the public interest.
- Policies and procedures to implement and monitor quality control of engagements.
- Documented policies regarding the need to identify threats to compliance with the fundamental principles, evaluate the significance of those threats, and apply safeguards to eliminate or reduce the threats to an acceptable level or, when appropriate safeguards are not available or cannot be applied, terminate or decline the relevant engagement.
- Documented internal policies and procedures requiring compliance with the fundamental principles.
- Policies and procedures that will enable the identification of interests or relationships between the firm or members of engagement teams and clients.
- Policies and procedures to monitor and, if necessary, manage the reliance on revenue received from a single client.
- Using different partners and engagement teams with separate reporting lines for the provision of non-assurance services to an assurance client.
- Policies and procedures to prohibit individuals who are not members of an engagement team from inappropriately influencing the outcome of the engagement.
- Timely communication of a firm’s policies and procedures, including any changes to them, to all partners and professional staff, and appropriate training and education on such policies and procedures.
- Designating a member of senior management to be responsible for overseeing the adequate functioning of the firm’s quality control system.
- Advising partners and professional staff of assurance clients and related entities from which independence is required.
- A disciplinary mechanism to promote compliance with policies and procedures.
- Published policies and procedures to encourage and empower staff to communicate to senior levels within the firm any issue relating to compliance with the fundamental principles that concerns them.

Examples of engagement-specific safeguards in the work environment include:

- Having a professional accountant who was not involved with the non-assurance service review the non-assurance work performed or otherwise advise as necessary.
- Having a professional accountant who was not a member of the assurance team review the assurance work performed or otherwise advise as necessary.
- Consulting an independent third party, such as a committee of independent directors, a professional regulatory body or another professional accountant.
- Discussing ethical issues with those charged with governance of the client.
- Disclosing to those charged with governance of the client the nature of services provided and extent of fees charged. Involving another firm to perform or re-perform part of the engagement.
- Rotating senior assurance team personnel.

Depending on the nature of the engagement, a professional accountant in public practice may also be able to rely on safeguards that the client has implemented.
However it is not possible to rely solely on such safeguards to reduce threats to an acceptable level.

Examples of safeguards within the client's systems and procedures include:

- The client requires persons other than management to ratify or approve the appointment of a firm to perform an engagement.
- The client has competent employees with experience and seniority to make managerial decisions.
- The client has implemented internal procedures that ensure objective choices in commissioning non-assurance engagements.
- The client has a corporate governance structure that provides appropriate oversight and communications regarding the firm's services.

At least annually the firm should obtain a written confirmation from its personnel that they have met independence requirements.

A **Specimen Independence Confirmation** is set out in **Appendix 1.**

ISA 220 states that it is the responsibility of the engagement partner to ensure that the engagement team complies with the independence requirements for each audit engagement In particular, he should:

♦ Obtain relevant information from the firm and, where applicable, network firms to identify and evaluate circumstances that could create threats to independence.
♦ Evaluate information on identified breaches, in any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement.
♦ Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards. The engagement partner should promptly report to the firm any failures to resolve the matter for appropriate action.

Where the engagement partner concludes that the safeguards may not be able to eliminate or reduce the threat to an acceptable level, he should with appropriate consultation, determine the appropriate course of action which may include eliminating the activity or interest that creates the threat or withdraw from the audit engagement. Such decisions and conclusions should be documented.

2.4 Rotation of Engagement Partner

Each firm should establish its own criteria on rotation of the engagement partner and senior members of the engagement team based on factors such as:

- The length of time that the individual member has been a member of the assurance team.
- The role of the person on the team.
- The structure of the firm.
- The nature of the assurance engagement.
- Whether the client's management team has changed; and
- Whether the nature or complexity of the client's accounting and reporting issues has changed.

The significance of the threat should be evaluated and, if the threat is other than significant, the following safeguards should be considered:

- Rotating the senior personnel on the team.
- Involve an additional professional accountant who is not a member of the engagement team to review the work done by the senior members or otherwise advice as necessary.
- Regular independent internal or external quality reviews of the engagement.

In case of sole proprietors or small audit firms where the rotation of the engagement partner may not be possible and there is no limit set by legal or professional requirements, it is a good practice to rotate the audit manager on the team once every five to seven years and other senior members of the team once every three years. The persons rotated should not participate in the engagement for at least two years from the date of rotation. Moreover, such engagements must undergo a quality control review at least once every five to seven years.

2.5 Quality Control

The firm should ensure that it fully complies with the quality control requirements as stipulated in ISQC 1. Each partner and each of the firm's personnel have a personal responsibility for quality and are expected to comply with the firm's requirements in respect to quality.

ISA 220 requires that the engagement partner take the responsibility for the overall quality on each audit engagement he undertakes. The Manual covers the quality control requirements in relation to audit engagements, but does not cover all the quality control requirements of ISQC 1.

2.6 Engagement Quality Control Review

ISQC 1 requires the firm to establish policies and procedures requiring, for appropriate engagements, an engagement quality control review that provides an objective evaluation of significant judgements made by the engagement team and the conclusions reached in arriving at the audit opinion. An engagement quality control is required for all audits of listed entities. As a guide, a quality control review should be carried out before the audit report is issued for:

- All audits of companies whose equity and debt securities are listed on a securities exchange.
- All engagements of public interest entities. This would include audits of banks, insurance companies, mutual funds and collective investment schemes, Security brokers, retirement benefit schemes, micro-finance institutions and SACCOs which are of public nature.
- Engagements or classes of engagements which display unusual circumstances or risk. This could include sectors facing an economic downturn.

The extent of the review depends on the complexity of the engagement and the risk that the audit report may not be appropriate in the circumstances. Where the engagement quality control reviewer makes recommendations that the engagement partner does not accept and the matter is not resolved to the reviewer's satisfaction, the report should not be issued until the matter is resolved following the firm's procedures for dealing with differences of opinion. This could involve the use of an arbitrator who possesses the relevant experience and has the independence to make appropriate recommendations.

2.7 Engagement Quality Control Reviewer

ISQC 1 requires that the firm develops policies and procedures covering the appointment of engagement quality control reviewers and establish their eligibility through defining the:

- Technical qualifications, experience and the authority required to perform the role.
- The degree to which an engagement quality control reviewer can be consulted on an engagement without compromising the reviewer's objectivity.

ISQC 1 defines an "engagement quality control reviewer" as a partner, other person in the firm, suitably qualified external person, or a team made up of such individuals, none of whom is part of the engagement team with sufficient and appropriate experience and authority to objectively evaluate, before the auditor's report is issued, the significant judgements the engagement team has made and the conclusions they reached in formulating the auditor's report.

On the aspect of technical qualification and experience, as a minimum, the person should be a member of a recognised professional accounting body with sufficient and appropriate experience in handling the type of engagements being undertaken by the firm.

On the issue of authority, the reviewer should be sufficiently independent reporting directly to the partner or the board of partners who have the ultimate responsibility for the firm's system of quality control. To ensure that the authority and the objectivity of the reviewer be maintained, he should not:

- Be selected by the engagement partner.
- Participate in the engagement.
- Make decisions for the engagement team.
- Be subject to considerations that would threaten his objectivity.

In the case of sole proprietors and small firms, suitably qualified external persons may be contracted to carry out the engagement quality control review, or alternatively the group of firms may use each other to facilitate the reviews. In all such cases, it is important to ensure that the authority of the reviewer is maintained. This is demonstrated by ensuring that all the procedures in respect of the review are duly carried out, and that all the issues arising out of the review are resolved to the satisfaction of the reviewer prior to the issue of the audit report.

The engagement partner may consult the engagement quality control reviewer, but such consultations should not compromise the reviewer's eligibility to perform the review or his objectivity. Where such consultations compromise the objectivity, another suitably qualified person should be engaged to take on the role of the engagement quality control reviewer or the person to be consulted. Situations which may lead to the engagement quality control reviewer's objectivity being compromised when consulted include:

- Where the unadjusted errors are individually or collectively material.
- Which display unusual circumstances or risk.
- Of companies which are required by law or regulations to undergo such reviews.
- Where there are unresolved differences between the partner and other members of the engagement team on fundamental matters, or engagements where the partner is going to take a firm stand with the client on a particular accounting or disclosure issue or over fees.

2.8 Consultations

The engagement partner is responsible for undertaking appropriate consultation on difficult or contentious matters which would include significant technical and ethical matters and judgements and estimates, conclusions drawn from audit procedures adopted or any other matter deemed appropriate. Consultations could also be undertaken where there are issues on client acceptance and continuation considerations. Such consultations, through the use of collective experience and the technical expertise of the team, help to promote quality and improve the application of professional judgement. The firm should promote a culture in which consultation is recognised as a strength and a key component of quality control and reduction of audit risk.

Consultations should be obtained from individuals within or outside the firm who have the specialised expertise to resolve such difficult or contentious matters. Effective consultation requires that those consulted be given all the relevant facts that will enable them to provide advice on technical, ethical or other matters. Sole proprietors and small firms which may not have such expertise in-house should develop relationships with other practitioners, network firms or other relevant bodies that have the necessary experience and expertise to provide such consultations.
All consultations, including those obtained verbally, should be sufficiently documented to enable an understanding of the issue on which the consultation was sought, the results of the consultation, the decision taken and the basis of the decision, and how they were implemented.
It is also important to record as to who was consulted, and if necessary on highly technical matters the reason for selecting the person.

ISA 220 requires the engagement partner to:

- Be responsible for the engagement team undertaking appropriate consultation on difficult or contentious matters.
- Be satisfied that appropriate consultation have been undertaken during the course of the engagement both within the engagement team and between the engagement team and others at appropriate levels within or outside the firm.
- Be satisfied that the nature and scope of, and conclusions resulting from such consultations are documented and agreed with parties consulted.
- Determine that the conclusions resulting from the consultations have been implemented.

2.9 Resolving Differences in Opinions

There are a number of possible situations which could result in differences in opinion:

- Differences within the engagement team.
- Differences between the engagement partner and the engagement quality control reviewer.
- Differences between the engagement partner and those consulted.
- Difference within the firm on how to deal with a particular technical issue that affects a cross section of engagements.
- Differences between the engagement partner and the client.

The audit report should not be issued until all differences of opinion are satisfactorily resolved. Each firm based on its size and structure, should develop a structure to resolve such differences. This could involve the use of another practitioner who possesses the relevant experience and has the independence to make appropriate recommendations.

All differences in opinion should be sufficiently documented to enable an understanding of the issue on which the difference arose, the person consulted, the results of the consultation and the basis on which the difference was resolved.

3. AUDIT FILES AND WORKING PAPERS

3.1. Types of Audit Files

The purpose of this section is to explain how typical audit files should be structured and what they should contain. Depending on the size of the assignment, it is recommended that at least two types of files be maintained, one a current audit file ("CAF") and the other a permanent audit file ("PAF").

The distinction between the two files is as follows:

- CAF- contains information and audit evidence relating to the accounting period currently under review, the purpose of which is to support the opinions and statements made in the audit report.

- PAF- contains information of continuing importance which may be updated at each audit. Such information could be useful background; other information would include terms of engagement, internal control and accounting systems notes and other documents of historical record which are unlikely to be directly relevant to the current year audit e.g. signed copies of leases and signed copies of financial statements for prior years.

The auditor may also maintain a correspondence file and a tax file. The correspondence file should keep: copies of correspondences; to the client; from the client; and to and from relevant stakeholders. The tax file would keep: copies of any correspondences on tax matters with the URA or the Tax client; returns; evidence of settlement of tax liabilities; agreed accounts; tax computation and information relevant to tax rates.

3.2. Layout of Audit Files

All files should follow a standard numerical and alphabetical sequence. This degree of standardisation of layout is desirable from the points of view of efficiency and minimising risk. The use of hard section dividers or coloured paper dividers should be used to clearly distinguish the file sections. Individual working papers should be numbered and filed logically within a common framework.

3.3. Working Papers Contents

In accordance with ISA 230, the working papers should be sufficiently complete and detailed to provide an overall understanding of the audit.

The auditor should prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

a. The nature, timing and extent of the audit procedures performed to comply with the ISAs and applicable legal and regulatory requirements;
b. The results of the audit procedures performed, and the audit evidence obtained; and
c. Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgments made in reaching those conclusions.

In documenting the nature, timing and extent of audit procedures performed, the auditor should record:

a. The identifying characteristics of the specific items or matters tested;
b. Who performed the audit work and the date such work was completed; and
c. Who reviewed the audit work performed and the date and extent of such review.

The auditor shall document discussions of significant matters with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place.

In addition, on areas involving difficult questions of principles or judgement, the working papers should contain the relevant facts that were known by the engagement team at the time the conclusions were reached.

3.3.1. Why Document?

Working papers:

a. Provide evidence of the auditor's basis for a conclusion about the achievement of the overall objectives of the auditor; and
b. Provide evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements.
c. Assist the engagement team to plan and perform the audit.
d. Assist members of the engagement team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities.
e. Enables the engagement team to be accountable for its work.
f. Retains a record of matters of continuing significance to future audits.
g. Enabling the conduct of quality control reviews and inspections.
h. Enables the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

The use of standardised working papers e.g. checklists, specimen letters and working papers can improve the efficiency with which working papers are prepared and reviewed. They facilitate the delegation of work while providing a means to control quality.

3.3.2. Form and Contents of Working Papers

ISA 230 states that the form and contents of the working papers is affected by the:

- The size and complexity of the entity.
- The nature of the audit procedures to be performed.
- The identified risks of material misstatement.
- The significance of the audit evidence obtained.
- The nature and extent of exceptions identified.
- The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained.
- The audit methodology and tools used.

The contents should include the following:

- Information obtained in understanding the entity and the environment in which it operates.

- Evidence of the auditor's understanding of the accounting and internal control and assessment of the control environment.
- Evidence of the planning process including audit programmes and changes thereto.
- Evidence of the auditor's consideration of the work of the internal audit function and the conclusions there from.
- Analysis of significant trends and ratios.
- Analysis of transactions and balances, including the nature, extent and timing of the tests.
- Identified and assessed risks of material misstatement at the financial statement and assertion level.
- Record of the nature, timing and extent of the audit procedures performed in response to risk at the assertion level and the results of such procedures.
- An indication as to who performed the audit procedures and when they were performed.
- Evidence that the work performed by assistants was supervised and reviewed.
- Correspondence and notes of discussions including engagement letters and material weaknesses in internal controls.
- Letters of representation.
- Conclusions reached by the engagement team on significant aspects of the audit, including how exceptional and unusual matters, if any, disclosed by the audit procedures were resolved.
- Evidence that consultations have been documented and any contentious issues fully resolved.
- Copies of the financial statements and the auditor’s report.

3.3.3. Preparation of Working Papers

The objective of this section is to guide the engagement team on the presentation of working papers.

All working papers, except those prepared electronically, should be clean, neat, legible and prepared in ink. To ensure that working papers are easily identifiable, they should clearly contain the:

- Client's name
- Subject matter
- Accounting period
- Preparer's initials and the date prepared
- Reviewer's initials and the date reviewed
- Schedule reference (within a sequential indexing system, following the main schedule references listed on a master index).

The Table of Contents (**Appendix 2 and 3**) should be updated by cancelling sections not containing working papers. If this is not done, papers may be thought to be missing in sections not cancelled.

A lead schedule should be prepared for each audit section which agrees with the figure or note reflected on the financial statements. The schedule should include comparative figures; an overall conclusion for the section, if this is not given elsewhere; and should be cross-referenced to supporting schedules. Lead schedules must be updated to reflect audit adjustments to the client draft financial statements.

For each test of transaction and balance carried out, the audit schedule should normally contain:

- The objective of the test.
- The work done.
- The method of determining the sample size.
- The source of information (if this is not evident from the work performed).
- Audit ticks or symbols used and their explanation.
- Cross-references to other supporting schedules.
- Results of the test.
- An evaluation of errors cross-referenced to the Summary of Unadjusted Errors.
- Evaluation and reasons for any judgements made and the adequacy of the disclosure in the financial statements.
- The conclusions drawn from results of the test.
- Recommendations or points carried forward, if any.

The above requirements can be regarded as satisfied if some of the information is summarised or recorded elsewhere and can easily be found by the reviewer.

Wherever possible, entity should be requested to prepare schedules and other documentation as this helps utilise the audit time to other areas. The audit client schedule requirement including the schedule formats should be communicated to the client in advance. ISA 230 requires that the auditor satisfies himself that all such materials have been properly prepared by the client. In addition, such material should be marked as "Prepared by Client" together with the date obtained.

File notes should be prepared of all telephone and other conversations with clients or with third parties, concerning the entity's affairs. The notes should record the entity's name and date of conversation, the persons involved, the matters discussed and any conclusions reached or action agreed. The note should be filed in the audit file, and if appropriate, a copy sent to the other party to confirm the accuracy.

Care should be taken to safeguard working papers and working paper files. When working at a client's premises, wherever possible, files should not be left at the premises overnight. If they have to be left overnight, they must be stored securely under lock.

3.4 Ownership, Safe Custody and Retention of Working Papers and Files

ISA 230 requires the auditor to adopt appropriate procedures for maintaining the confidentiality and safe custody of the working papers and for retaining them for a period to meet the needs of the practice and in accordance with the legal and professional requirements of record retention.

The working papers are *the property of the auditor.* The engagement team should maintain strict confidentiality of the information obtained during the course of the audit. In certain cases, the working papers may have to be availed to third parties when required by law or for quality control reviews. To protect the firm, the instances where the papers may have to be made available to third parties must be notified to the client in the engagement letter.

- Audit working papers relating to an engagement which is the subject of an existing litigation should not be destroyed until the litigation is over and the judgment thereon settled. If the judgment is not settled, the working papers should be maintained for at least 12 years from the date of the judgment or from the date the action required by the judgment becomes due.

- Under other circumstances, the working papers should be retained for at least 8 years after the date of adoption of the financial statements by the owners, to cater for 6 years required by the Limitations Act for actions founded on contracts and an additional 2 years to take into account the possible period of reliance that could be placed on an auditor's report and the initial period for the commencement of legal proceedings.

No files and working papers should be destroyed without a written authority of the board of partners or a partner in charge of such responsibility.

4.0 AGREEING THE TERMS OF AUDIT ENGAGEMENTS

4.1. Client Acceptance

ISQC1 requires that the firm obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding to continue an existing engagement and when considering acceptance of a new engagement with an existing client. The engagement partner should consider:

- The integrity of the principal owners, key management and those charged with governance.
- Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities including time and resources.
- Whether the firm and the engagement team can comply with the ethical requirements which include integrity, objectivity, competence, confidentiality and professional behaviour.
- Significant matters that have arisen during the current and previous audit engagement, and their implications for continuing the relationship.

There must be evidence that the engagement partner has formed a conclusion on compliance with independence requirements including:

- Identifying and evaluating circumstances that create threats to independence.
- Evaluating identified breaches, if any of the firm's independence policies and procedures.
- Taking action to eliminate threats or reduce them to an acceptable level by applying safeguards.

In addition to the above consideration, engagements may need to be declined where:

- An entity is operating in a specialised industry in which the auditor lacks the required expertise and expert assistance is not available.
- An entity operates a significant branch network where the firm is not presented, and there are no alternative audit procedures that can be adopted to cover these branch operations.
- The entity reporting deadlines coincide with existing client pressures.
- A quality control review is required and no suitably qualified and objective reviewer is available.

The information the firm obtains may come from:

- Communication with previous or existing providers of professional accountancy services to the entity and discussions with other third parties.
- Inquiry of other firm personnel or third parties such as bankers, legal counsel and industry peers.
- Background searches of relevant databases.

It is vital that the firm is not exposed to the risk of its reputation or future profitability by accepting new clients without proper vetting procedures. To adhere to the Code of Ethics and in particular, the aspect of client confidentiality, the firm should inform the entity that it will seek information from certain persons as required by ISQC1.

Where issues arise out of any of these considerations, the engagement team should undertake appropriate consultation. This should be completed at the acceptance stage. It should then be completed at least once every five years to ensure that there are no new circumstances that have developed that could affect the continuation of the engagement.

In addition to the ISQC requirements above, the firm should make sure that prior to accepting the appointment:

- It has confirmed that the provisions of the Companies Act relating to appointment of auditors have been complied with by inspecting the appropriate minutes or resolutions.
- Where there is a change of auditors, then in accordance with the Code of Ethics:
  - The entity has communicated with the outgoing auditor giving him the permission to communicate with the incoming auditor. Where necessary, the firm should inform the entity that it cannot accept an engagement until satisfactory communication has been received from the outgoing auditor.
  - The firm writes to the outgoing auditor for professional clearance and requests appropriate information required to enable it to conclude whether to accept the engagement or not. Where no reply is received from the outgoing auditor, the firm should send a reminder within a reasonable period indicating that if they do not hear from the outgoing auditor within a certain time, they will accept the engagement on the assumption that there are no professional reasons as to why they should not accept the engagement.
  - Once the reply is received (or even where one is not received after the reminder), the firm should consider whether it wishes to accept the engagement.
  - Where the entity's permission for the existing auditor to communicate with the proposed auditor is not given, or where the existing auditor has given professional reasons as to why the proposed auditor should not accept the appointment, the proposed auditor needs to evaluate the circumstances and consider declining the appointment.

- The Code of Ethics places an obligation on the existing auditor to inform the proposed auditor on whether there are any professional reasons as to why the proposed auditor should not accept the appointment. Such communication can only be undertaken after receiving the entity's permission to communicate with the proposed auditor. If such permission to communicate with the proposed auditor is not received by the existing auditor from the client, than that fact should be disclosed by the existing auditor to the proposed auditor.

4.2. Terms of Audit Engagement and Changes Thereto

ISA 210 requires that the auditor and the entity to agree on the terms of the engagement, preferably prior to the commencement of the engagement, in an audit engagement letter or other suitable form of contract.

The purpose of the engagement letter is to:

- Help avoid any potential misunderstandings in respect to the engagement.

- Document and confirm the auditor's acceptance of the engagement, the objective and scope of the audit, the extent of the auditor's responsibilities to the entity and the form of any reports.

The form and the contents of the audit engagement letter may vary for each engagement, but would generally include reference to:

- The objective and scope of the audit of the financial statements;
- The responsibilities of the auditor;
- The responsibilities of management;
- Identification of the applicable financial reporting framework for the preparation of the financial statements; and
- Reference to the expected form and content of any reports to be issued by the auditor and a statement that there may be circumstances in which a report may differ from its expected form and content.
- Elaboration of the scope of the audit, including reference to applicable legislation, regulations, ISAs, and ethical and other pronouncements of professional bodies to which the auditor adheres.
- The form of any other communication of results of the audit engagement.
- The fact that because of the inherent limitations of an audit, together with the inherent limitations of internal control, there is an unavoidable risk that some material misstatements may not be detected, even though the audit is properly planned and performed in accordance with ISAs.
- Arrangements regarding the planning and performance of the audit, including the composition of the audit team.
- The expectation that management will provide written representations.
- The agreement of management to make available to the auditor draft financial statements and any accompanying other information in time to allow the auditor to complete the audit in accordance with the proposed timetable.
- The agreement of management to inform the auditor of facts that may affect the financial statements, of which management may become aware during the period from the date of the auditor’s report to the date the financial statements are issued.
- The basis on which fees are computed and any billing arrangements.
- A request for management to acknowledge receipt of the audit engagement letter and to agree to the terms of the engagement outlined therein.
- Arrangements concerning the involvement of other auditors and experts in some aspects of the audit.
- Arrangements concerning the involvement of internal auditors and other staff of the entity.
- Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit.
- Any restriction of the auditor’s liability when such possibility exists.
- A reference to any further agreements between the auditor and the entity.
- Any obligations to provide audit working papers to other parties.

A **Specimen Audit Engagement Letter** is set out in **Appendix 4**.

On recurring audits, the firm does not need to send an engagement letter each year but should consider whether circumstances require the terms of the engagement to be revised and whether there is a need to remind the entity of the existing terms of the engagement. It may be necessary to send a new engagement letter where:

- There is an indication that the entity misunderstands the objective and scope of the audit.
- The terms of engagement have been revised or special terms added.
- There is a change of senior management or those charged with governance or where there is a significant change in ownership or in the nature and size of the business.
- There are specific legal or regulatory requirements.

Where the firm is requested to change the terms of engagement to one which would provide a lower level of assurance, it should consider the appropriateness of doing so including the legal, professional or contractual implications of the change. The firm should not agree to a change of engagement where there is no reasonable justification for doing so. Where the firm agrees to the new terms of engagement, it should confirm the new terms through a new engagement letter and issue a report based on the revised terms of engagement. Where the firm is unable to agree on the change in the scope and is not permitted to continue the original engagement, it should withdraw from the engagement and consider whether there is any obligation, either contractually or otherwise, to report to shareholders, those charged with governance and regulatory bodies on the circumstances necessitating the withdrawal. It would be appropriate to obtain legal counsel on such communication.

4.3 Continuation

The procedures for continuation of client relationship are similar to client acceptance. The risks referred to under client acceptance should be kept under continuous review, particularly in the early years of client relationship as the extent of knowledge a firm will have regarding the integrity of the entity will generally grow within the content of an ongoing relationship. The risks and rewards of continuation must be considered at the planning stage and at the completion stage. Where the terms of engagement have changed, the engagement partner should agree the new terms with the client through a new engagement letter. The engagement partner mayor may not have initiated the client acceptance and continuation process regarding the engagement client. Regardless of this, it is the responsibility of the engagement partner to determine whether the most recent decision remains appropriate.

In deciding whether to continue a client relationship, the firm needs to consider significant matters that may have arisen during the year and their implication on the audit. These could include:

- Changes in the entity's business through expansion into areas where the firm does not possess the necessary knowledge or expertise.
- Additional information on the integrity of the principal owners, key management and those charged with governance, including changes in key management, governance and shareholding, which place a doubt on the integrity.
- Changes in circumstances which reduce the independence of the engagement team.
- Changes in legal, professional and regulatory requirements which the entity is unwilling to comply with.
- Outstanding fees or undue pressure to reduce fees or the scope of work.

An Engagement Continuation Questionnaire should be completed for each year, preferably after conclusion of the last audit, to ensure that significant matters in relation to continuation have been considered prior to the continuation. The Client Acceptance

Questionnaire should however be completed at least once every five years to ensure that there are no new circumstances that have developed that could affect the continuation of engagement
The firm's consideration of client continuance and compliance to the requirements, including independence, often occurs shortly after the completion of the previous audit and is re- assessed throughout the performance of the audit engagement as conditions and changes in circumstances occur.

Where the firm ceases to act for an assurance client, it must carry out the procedures which ensure compliance with the ethical guidelines significant matters that cast a doubt on the continuation of the engagement or where the engagement partner obtains information that would have led to the firm declining the engagement if the information had been available earlier, the engagement partner should undertake appropriate consultations. All such consultations and the conclusions and how these were implemented should be documented. The engagement partner should then evaluate and take an appropriate decision on whether to:

- Resign from a current engagement due to new issues that have come to light that were not available at the engagement acceptance stage or where the entity wants to inappropriately reduce the scope of work or where there are material areas of disagreement with the entity.

- Not seek re- appointment due to significant matters that may have arisen during the year which may have an impact on future audits.

In addition to ceasing to act as the auditor due to resignation from an existing engagement or not seeking re-appointment, the firm could also cease to act by virtue of being removed from office by the shareholders. The firm:

- In cases where it ceases to act due to resignation from an existing engagement or not seeking re-appointment, should inform the management of this decision, and consider whether there is any obligation, either contractually or otherwise, to report to shareholders, those charged with governance and regulatory bodies on the circumstances necessitating the withdrawal from the engagement or resignation. It would be appropriate to obtain legal counsel on such communication.
- In cases where the firm is removed from office by the shareholders, it should consider whether the firm should attend the annual general meeting where it is to be removed and report on circumstances that led to the firm's removal. This may be necessary where the firm is removed from office due to not complying with unreasonable demands of the management, those charged with governance or the shareholders. It would be appropriate in such cases to obtain legal counsel.

In all these instances, the firm is likely to be contacted by the new auditor, who may require professional clearance or release of information or documentation. In all cases, the firm should adopt a professional approach in providing the relevant information. All such information or documentation should only be released to the new auditor after obtaining the relevant written authority from the entity to provide the new auditor with the information and documentation. Where such authority is denied or limited by the entity, the fact should be disclosed to the incoming auditor. Where the firm has professional or other reasons as to why the incoming auditor should not accept the appointment, it should inform the incoming auditor of this. It may be prudent to discuss the reasons with the entity, and where appropriate seek legal counsel.

In providing information and documentation to the new auditor, the firm should consider:

- Whether the information and documentation belongs to the firm or the entity.
- Whether the firm has a lien on the entity's documentation due to outstanding fees.
- The risk to the firm in releasing documentation that belongs to the firm.

However, the fact that fees are owing to the existing auditor is not a professional reason for not providing professional clearance.

4.4 Non-Audit Engagements

The firm could provide other services to the entity provided that this does not compromise the firm's independence. The Code of Ethics provides a safeguard through the use of different partners or teams with separate reporting lines for the provision of non-audit services to assurance clients. However, even when this is used, the firm should consider that relying heavily on a entity for its fee income or letting persons not engaged in the audit work to influence the audit could influence the independence requirements. Where other services are provided it is recommended that separate engagement letters should be issued for each of the services including tax, accounting and management advisory services.

The Code of Ethics requires that where the firm is requested by an entity to undertake additional work which is clearly distinct from the one being carried out by the existing auditor, the firm should inform the entity of the professional obligation to communicate with the existing accountant and should immediately do so advising, in writing, of the approach made by the entity and the general nature of the request as well as seeking all relevant information, if any, necessary to perform the assignment.
Where the entity insists that the existing auditor should not be informed, the accountant should decide whether the entity's reasons are valid enough not to communicate with the existing auditor.

5. PLANNING AN AUDIT OF FINANCIAL STATEMENTS

5.1 Planning

5.1.1 Why Plan?

ISA 300 requires the auditor to plan the audit so that the engagement is performed in an effective manner. Planning also helps the firm perform the engagement efficiently. Planning involves establishing and documenting the overall audit strategy for the engagement and developing and documenting an audit plan, in order to reduce audit risk to an acceptably low level. Effective audit planning ensures:

- That appropriate attention is devoted to key audit areas and significant risks.
- That potential problems are identified and resolved on a timely basis.
- That the engagement is properly organised and managed in order to be performed in an effective and efficient manner.
- The selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
- Proper direction and supervision of the engagement team and review of their work.
- Assists, where applicable, in the coordination of work done by the auditors of components and experts.

Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after the completion of the previous audit and continues until the completion of the current audit engagement. Planning should in any case start before the accounting year-end to take into account year end procedures which need to be carried out e.g. attendance at the annual inventory count or circularisation of receivables. The nature and extent of planning will vary according to the size and complexity of the entity, previous experience with the entity and changes in circumstances that occur during the engagement.

5.2 Planning Activities

There are key tasks involved in the planning process.

5.2.1. Preliminary Engagement Activities - Initial Engagements

The auditor should perform the following activities prior to commencing an initial audit engagement:

- Perform the client acceptance procedures in accordance with ISA 220 and the Code of Ethics.
- Evaluate compliance with ethical requirements.
- Communicate with the previous auditor for professional clearance in compliance with the code of ethics.

5.2.2. Preliminary Engagement Activities - Continuing Audits

Prior to performing any significant activities for the current audit engagement, the engagement partner should perform preliminary engagement activities to help ensure that the firm has considered any events or circumstances that may adversely affect the firm's ability to plan and perform the audit engagement to reduce audit risk to an acceptably low level. Independence may also be impaired if overdue fees, together with fees from the proposed re-appointment will constitute a significant loan. The process often commences shortly after the completion of the previous audit. The key components include:

- Performing procedures regarding the continuation of the client relationship after evaluating compliance with the ethical requirements, including independence, in accordance with ISA 220 and the Code of Ethics.
- Considering significant matters that may have arisen during the previous engagement and thereafter that may adversely affect continuation of the engagement. Such matters could include significant lapses in internal controls, frauds, doubts over the integrity of management etc.
- Understanding the terms of audit engagement in accordance with ISA 210. Consideration should be given to whether the firm has the necessary resource and experience to continue the audit engagement.

5.2.3. Planning - Overall Audit Strategy

The development and documentation of the overall audit strategy sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan. It also helps to ascertain the nature, timing and extent of the resources necessary to perform the engagement. In developing the audit strategy, the engagement team may consider the experience gained on other engagements performed for the entity. The key components of an audit strategy include:

- Review and updating the client background information.
- The expected audit coverage including the number and locations of the components of the entity.
- Financial reporting framework used and industry specific reporting requirements.
- The timing of the audit and reporting deadlines.
- Key dates for communicating with the management and those charges with governance.
- Materiality.
- Identification of areas where there may be higher risk of material misstatement.
- Preliminary identification of material components and account balances.
- Preliminary indication of whether the auditor may plan to obtain evidence regarding the effectiveness of internal controls.
- Identification of recent significant entity-specific, industry, financial reporting or other developments.
- Initial assessment of the overall resource requirements including the use of experts on complex matters.
- Initial assessment of resource allocation to specific audit areas, e.g. the allocation of team members to observe inventory count at material locations, extent of review of the other auditor's work in the case of group audits.

Liaison with client

Discussions with the client will be an essential aid to developing the audit strategy. The discussion would usually take place before the accounting year-end. It would be preferable to have a pre-audit meeting but in some cases a telephone conversation may be adequate. One of the primary aims such discussions are to enable the auditor to update his knowledge of the client's business. An auditor should have sufficient knowledge of the business to enable him to identify and understand the eve and activities that may have a significant effect on the financial statements. Discussions should aim to:

- Obtain the latest financial information to help in setting materiality levels and in performing preliminary analytical review work.
- Agree a timetable (including inventory counts and visits) and any specific deadlines.
- Agree schedules requirements and on any other accounting work to be produced by the client.
- Find out the actions taken on the points raised in last year's management letter.
- Agree settlement of any outstanding fees.
- Identify any specific areas of concern to the client and their impact on the audit scope.

It may be appropriate to document the above in writing.

Review of last year's file

The last year's audit file should be reviewed for:

- Points brought forward to be considered during the engagement.
- Any areas where time or cost savings could be made, any unnecessary audit work and any other ways in which the effectiveness of the audit could be improved.
- Any previously unidentified areas of audit risk.

Initial Engagements

In case of initial engagements, while the planning elements remain the same as for recurring engagements, the auditor may need to expand the planning activities as the auditor does necessarily have the previous experience with the entity that is considered when planning recur engagements. Additional matters that may be considered in planning initial engagements include:

- Where possible and where not prohibited by law, consider arrangements with the previous auditor to review the working papers.
- Review any major issues, including the application of accounting principles or auditing reporting standards, discussed with management or those charged with governance connection with the initial selection as auditors, and how these affect the audit strategy and audit plan.
- Obtaining sufficient appropriate audit evidence regarding opening balances.
- Involvement of another partner or a senior individual to review the overall audit strategy prior to commencing significant audit procedures or to review reports prior to their issuance.

Once the overall audit strategy has been established the auditor can commence the development a more detailed audit plan to address the various matters identified in the strategy. Although auditor establishes the overall audit strategy before developing the audit plan, the two activities not necessarily sequential processes but closely inter-related since changes in one may result in changes to the other.

In case of audits of smaller entities where the audit is conducted by a very small audit team, the development of an audit strategy need not be a complex process and a brief memorandum prepared at the completion of the previous audit, based on a review of the working papers and highlighting the issues identified, updated and changed in the current period based on discussions with the management, can serve as the basis for planning the current audit engagement.

Appendix 5: Matters That an Auditor May Consider in Developing an Audit Strategy provides examples of the matters that an auditor may consider in establishing an audit strategy.

5.2.4. Planning - Audit Plan

The audit plan includes the nature, timing and extent of the audit procedures to be performed by the engagement team in order to obtain sufficient appropriate audit evidence to reduce the audit risk to an acceptably low level. Audit planning is evidenced in two ways by the:

- Overall audit plan.
- Audit programme.

The Overall Audit Plan

The overall audit plan documents the assessment of risk and the response to assessed risk by setting out the nature, timing and extent of the overall audit procedures to be performed by the engagement team in order to obtain sufficient appropriate audit evidence to reduce the audit risk to an acceptably low level. The plan also reflects the auditor's decision on whether to test the operating effectiveness of controls and the extent of planned substantive procedures.

The audit plan will often be prepared by the manager, although preparation of parts or all of it may be delegated to the audit senior. In case of high risk audits the partner may also be involved in preparing the plan, particularly in the areas of materiality, risk assessment and approach to assessed risk and sample sizes. The overall plan together with the tailored audit programmes setting out the nature, timing and extent of the audit procedures to be adopted during the engagement should be completed and approved by the partner prior to commencement of the engagement. In case of a sole proprietorships or small audit firms, the partner may be actively involved in developing the audit plan and programmes.

Appendix 6: Contents of the Audit Plan provides a summary of the contents of an audit plan**.**

Audit Programme

The audit programme documents the nature, timing and extent of audit procedures to be performed at the assertion level for each material class of transactions, account balance and disclosure. The programme sets out the nature, timing and extent of the audit procedures required to implement the overall plan and serves as a set of instructions to the engagement team and as a means to control and record the proper execution of the audit.

The audit programme will often be drafted by the senior and reviewed by the manager and approved by the engagement partner. However, the extent of the manager's role will depend on the senior's previous experience and knowledge of the entity.

In preparing the audit programme, consideration should be given to the specific assessment of risk and the level of assurance to be provided by substantive procedures.

5.2.5. Communication with Those Charged with Governance

The engagement partner or the manager may discuss elements of planning with those charged with governance and the management as part of the overall communication required to be made or to improve the effectiveness and efficiency of the audit. The overall audit strategy and the audit plan, however, remain the auditor's responsibility and the engagement team should exercise care not to compromise the audit by making the audit procedures too predictable by discussing the nature, timing and the extent of the audit tests. The matters normally communicated would include the overall audit strategy, the timing of the audit, any limitations on the scope of the audit and the audit requirements.

5.2.6. Changes to Planning Decisions during the Course of the Audit

The engagement team may be required to change the audit strategy and the audit plan thereby resulting in the planned nature, timing and extent of further audit procedures as a result of:

- Unexpected events;
- Changes in condition e.g. a material business combination; or
- Evidence obtained from the result of audit procedures which contradict the information available at the planning stages or the result of substantive tests which contradict the results obtained from testing the effectiveness of internal controls.

As the assessed risk of material misstatement increases, one would ordinarily increase the extent and timeliness of direction and supervision of the engagement team and perform a more detailed review of their work.

Any changes to the audit strategy and plan needs to be documented giving reasons for significant changes and the auditor's response to the events, conditions or results of audit procedures that resulted in such changes. The changes need to be discussed and approved by the partner.

In case of smaller entities where the audit is carried out entirely by the engagement partner, the partner needs to ensure that the audit has been conducted in accordance with ISAs. In such cases the partner needs to ensure that he takes an objective view on the appropriateness of the judgements made in the course of the audit, and where desirable, on complex or unusual issues, the partner undertakes appropriate consultations.

5.3. Time Costing

The auditor's service to a client is based on the level of staffing involved on the engagement and the time spent by each staff on the engagement. It is therefore important that the firm adequately costs its time to ensure that it is running a commercially viable practice and keeps an adequate record of time spent on each engagement. ISQC 1 requires that an auditor develops policies and procedures on compensation of human resources. Such polices can only be sustained on a long term basis by ensuring that staff cost and operating overheads are recovered from the engagements undertaken.

5.4. Time Budgeting

Time budgets are an essential tool for monitoring the progress of an engagement, in determining actual performance against the budget and to assist in future planning of audits.

The aim of preparing budgets is:

- To aid in planning, so that the engagement team may use their time efficiently.
- To monitor the actual costs of the engagement.
- To estimate and negotiate the fees.

When preparing budgets, the following factors should be considered:

- The level of detail i.e. whether the budget is to be broken down into individual audit areas or prepared for the assignment as a whole.
- The time to be spent in planning, review and completion procedures.
- Any additions in the scope of the engagement.
- Contingency factors such as future staff salary increases.
- A comparison of last year's time spent with this year's budget. Any significant differences should be explained.

When conducting the audit, the auditor should aim to keep within the budget in so far as is possible, but the auditor should **never** compromise the standard of his audit work, to keep within budget. If it appears that there will be significant discrepancies between the budgeted time and the actual time, the senior/ manager should inform the manager/ partner as soon as possible, particularly where additional time arises due to the client's shortcomings.

Time summaries should be prepared for all engagements and the total time spent should be compared with the budgeted time and reasons given for significant variances. A record should be kept of work which the engagement team have had to complete as a result of client shortcomings, as a basis for additional charges if necessary.

6. AUDITORS RESPONSIBILITY RELATING TO FRAUD IN AUDIT OF FINANCIAL STATEMENTS

6.1. Introduction

The auditor, in the conduct of an audit, is required to:

a. To identify and assess the risks of material misstatement of the financial statements due to fraud;
b. To obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses; and
c. To respond appropriately to fraud or suspected fraud identified during the audit.

Misstatements in the financial statement could arise as a result of fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement is intentional (fraud) or unintentional (error).

Error refers to an unintentional misstatement in the financial statements, including the omission of an amount or a disclosure, which could include:

- A mistake in gathering or processing data from which financial statements are prepared.
- An incorrect accounting estimate arising from oversight or misinterpretation of facts.
- A mistake in the application of accounting polices relating to measurement, recognition, classification, presentation or disclosure.

Fraud refers to an intentional act by one or more individuals among management, those charged with governance, employees or third parties, involving the use of deception to obtain an unjust or illegal advantage. Though fraud is a broad legal concept, the auditor is just concerned with fraud that causes a material misstatement in the financial statements. In carrying out an audit, we are not required to make legal determination of whether the fraud has actually occurred. The two types of fraud relevant to in the conduct of an audit are:

- Misstatements resulting from fraudulent financial activities.
- Misstatements resulting from misappropriation of assets.

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

While the general audit procedures that the engagement team is required to follow to detect misstatements are covered in the other sections of the manual, this chapter provides additional considerations that the team should take into account in designing the audit procedures to enable them to have reasonable expectations to detecting misstatements arising from fraud. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the ISA's. An audit does not guarantee all material misstatements will be detected because of such factors as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature. For these reasons, one can only obtain reasonable assurance that material misstatements in the financial statements will be detected. The fact that an audit is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error.

6.2. Characteristics of Fraud

Fraudulent financial reporting involving intentional misstatements, including omissions of amounts or disclosures in financial statements, to deceive financial statement users. Fraudulent financial reporting may be accomplished by:

- Manipulation, falsification (including forgery), or alteration of accounting records or supporting documents from which the financial statements are prepared.
- Misrepresentation in or intentional omission from, the financial statements of events, transactions or other significant information.
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively using such techniques as:

- Recording fictitious journal entries, particularly close to the end of an accounting period, to manipulate operating results or achieve other objectives.
- In appropriately adjusting assumptions and changing judgements used to estimate account balances.
- Omitting, advancing or delaying recognition in the financial statements of events and transactions that have occurred during the reporting period. .
- Concealing, or not disclosing, facts that could affect the amounts recorded in the financial statements.
- Engaging in complex transactions that are structures to misrepresent the financial position or financial performance of the entity.
- Altering records and terms related to significant and unusual transactions.

Misappropriation of assets involving the theft of an entity's assets. Misappropriation of assets can be accomplished in a variety of ways including embezzling receipts, stealing physical assets or intellectual property, using an entity’s assets for personal use or causing an entity to pay for goods and services not received. It is often accomplished by false or misleading records or documents in order to conceal the fact that the assets are missing.

Fraud is usually concealed making it difficult to detect. Nevertheless, by obtaining an understanding of the entity and its environment, including internal controls, the engagement team may identify events or conditions that indicate an incentive or pressures to commit fraud or to provide an opportunity to commit fraud. Such events and conditions are referred to as "fraud risk factors". While fraud risk factors may not necessarily indicate the existence of fraud, they are often present circumstances where fraud has occurred, and would therefore affect the engagement team's assessment of the risks of material misstatements. Such factors could include:

- The need to meet expectations of third parties to obtain additional equity financing.
- The granting of significant bonuses if unrealistic profit targets are met.
- An ineffective control environment.

Appendix 7 & 8 - Examples of Fraud Risk Factors provides examples of such factors that may be faced by auditors in a broad range of situations**.** It should be noted that not all the situations identified may be relevant in all entities and some may be of greater significance in entities of different sizes, ownership structures or circumstances.

6.3 Professional Scepticism

The primary responsibility for the prevention and detection of fraud rests with those charged with the governance of the entity and with the management.

- **Governance:** It is the responsibility of those charged with governance of an entity to ensure, through oversight of management, that the entity establishes and maintains internal control to provide reasonable assurance with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

- **Management:** It is the responsibility of management to place a strong control on fraud prevention, which may reduce opportunities from fraud to take place, and fraud deterrence, which could persuade individuals to persuade individuals not to commit fraud because of the likelihood of detection or punishment. This involves creating a culture of honesty and ethical behaviour. It is also the responsibility of the management to establish a control environment and maintain policies and procedures to assist in achieving the objective of ensuring, as far as possible, the orderly and efficient conduct of the entity's business.

- **Professional scepticism** is an attitude of that includes a questioning mind and a critical assessment of audit evidence. Professional scepticism requires an ongoing questioning of whether the information and audit evidence obtained suggests that a material misstatement due to fraud may exist.

The engagement team is required to obtain reasonable assurance that the financial statements taken as a whole are free from material misstatement whether caused by fraud or error. When obtaining reasonable assurance, the team maintains an attitude of professional scepticism throughout the audit, considers the potential for management override of controls and recognises the fact that the audit procedures that are effective for detecting errors may not be appropriate in the context of an identified risk of material misstatement due to fraud. The engagement team should maintain professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud may exist, notwithstanding the firm's past experience with the entity about the honesty and integrity of the management and those charged with governance.

Although the engagement team cannot fully disregard past experience of the entity with respect to the honesty and the integrity of management and those charged with governance, the maintenance of an attitude of professional scepticism becomes important as there may have been changes in circumstances. When carrying out other audit procedures, the engagement team should not be satisfied with less-than-persuasive evidence that the management and those charged with governance are honest and have integrity. In respect to those charged with governance, the engagement team should carefully consider the reasonableness of responses to inquiries and other information obtained from them in light of all other evidence obtained during the audit.

An audit rarely involves the authentication of documents, nor is an auditor trained as or expected to be an expert in such authentication. Unless the auditor has reason to believe to the contrary, the auditor ordinarily accepts records and documents as genuine. Where conditions exist causing the engagement team to believe that the documents may not be authenticated or have been modified, the engagement team should undertake further investigation e.g. by direct third party confirmation or by using the work of an expert.

6.4. Audit Procedures in Relation to Fraud

6.4.1. Preliminary Engagement Activates

Engagement letter

The audit engagement letter should clearly spell out that the responsibility for the prevention and detection of fraud rests with the management. It should also state that while the audit will be planned to have a reasonable expectation to detect material misstatements arsing from fraud, due to the inherent nature of the audit, an audit should not be relied upon to detect all misstatements that may exist. If a special examination of potential misstatements arising from fraud is required by the client, this should be specified and agreed in the engagement letter, quite separately from the audit scope.

6.4.2. Audit Planning

6.4.2.1 Discussion among the Engagement Team

ISA 315 requires a discussion among the engagement team members and a determination by the engagement partner of which matters are to be communicated to those team members not involved in the discussion. This discussion shall place particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur. The discussion shall occur setting aside beliefs that the engagement team members may have that management and those charged with governance are honest and have integrity.

The discussion would include:

- Identification of areas where the entity's financial statements would be susceptible to material misstatement due to fraud, how the management could perpetrate and conceal fraudulent financial reporting and how the assets of the entity could be misappropriated.
- Circumstances indicative of earnings management and practices followed by management to manage earnings that could lead to fraudulent financial reporting.
- External and internal factors that may create an incentive or pressure for management and others to commit fraud.
- Management's involvement in overseeing employees with access to cash and assets susceptible to misappropriation.
- Unusual or unexplained changes in behaviour or lifestyle of management or employees.
- An emphasis on maintaining a proper state of mind throughout the audit regarding the potential material misstatement due to fraud and consideration of types of circumstances that, if encountered, might indicate the possibility of fraud.
- Considerations of the audit procedures to be adopted in response to the susceptibility of the entity's financial statements to material misstatements due to

fraud and how an element of unpredictability will be incorporated into the nature, timing and extent of the audit procedures to be performed.
- To determine how any allegations of fraud that comes to the attention of the engagement team will be dealt with.
- Consideration of the risk of management's override of controls.

6.4.2.2 Risk Assessment Procedures

When obtaining a general understanding of the entity and its control environment, the engagement team should ascertain the following:

- How those charged with governance exercise oversight of the management's process for identifying and responding to the risks of fraud and the internal controls that management has established to prevent and detect risks.
- Management's process for identifying and responding to the risks of fraud in the entity, including any specific risks of fraud that management has identified or that have been brought to its attention.
- Management's process of identifying and responding to the risks of fraud including and specific risk that the management has identified or account balances, classes of transactions or disclosures for which a risk of fraud is likely to exist.
- Management's communications if any, to those charged with governance regarding the processes for identifying and responding to the risks of fraud.
- Management's communication, if any, to employees regarding its view on business practices and ethical behaviour.
- Whether there have been any actual, suspected or alleged frauds by making inquiries of management, internal audit and any other appropriate person within the entity. It should be noted that while such inquiries may provide useful information concerning material misstatements in the financial statements resulting from employee fraud, they will not provide useful information regarding the risk of material misstatements arising from management fraud.
- The attitude of the internal audit, where it exists, towards the risk of fraud, and whether during the year, internal audit has performed audits to detect fraud and whether the management has satisfactorily responded to the findings arising from such audits.

While the management's approach to risk assessment will vary between entities, the fact that the management has not made an assessment of the risk of fraud may in some circumstances be indicative of the lack of importance that the management places on internal controls. In owner managed entities, the management may have a more effective oversight than in larger entities, thereby compensating for the generally more limited opportunities for segregation of duties. On the other hand, the owner-manager may be more able to override controls. This needs to be considered by the engagement team at the risk assessment stage.

Based on the above the engagement team should:

- Consider whether one or more fraud risk factors are present.
- Consider any unusual or unexpected relationships that have been identified when performing the preliminary analytical review.
- Document the fraud risk factors identified as being present during the engagement team's assessment process and document the response to any such factors.

6.4.3 Execution

As the assessed risks due to fraud are significant risks, the engagement team should, to the extent not done so, evaluate the design of the entity's related controls, including relevant control activates, and determine whether they have been implemented. The team uses professional judgement to:

- Identify classes of transactions, account balances and disclosures in the financial statements that may be susceptible to fraud.
- Relate the identified risks of fraud to what can go wrong at the assertion level.
- Consider the likely magnitude of the potential misstatement including the possibility that the risk might give rise to multiple misstatements and the likelihood of the risk occurring.

Based on this, the team should determine the overall response to address the assessed risk of material misstatement at the financial statement level, and design substantive procedures whose nature, timing and extent, reduce to an acceptably low level, the risk from misstatements resulting from fraud. The engagement team also incorporates an element of unpredictability in the selection of the nature, extent and timing of audit procedures to be performed. This can be achieved by:

- Performing substantive procedures on selected account balances and assertions not otherwise tested due to materiality or risk.
- Adjusting the timing of audit procedures from that otherwise expected.
- Using different sampling methods.
- Performing audit procedures at different locations or at locations on an unannounced basis.

If during the performance of the audit, fraud risk factors are identified that cause the engagement team to believe that additional audit procedures are necessary, the team should document the presence of such risk factors and the response to them.

The knowledge, skill, and ability of the individuals assigned significant engagement responsibilities should be commensurate with the engagement partner's assessment of the risk. This could include assigning additional individuals with specialised skill and knowledge or by assigning more experienced individuals to the engagement.

6.4.3.1 Audit Procedures Responsive to Risks of Material Misstatements Due to Fraud

The audit procedures at the assertion level may include changing the nature, timing and the extent of audit procedures to obtain audit evidence that is more corroborative more corroborative information. This can be achieved by:

- Physical observation or inspection of certain assets.
- Use of computer assisted audit techniques to gather more evidence about data contained significant accounts or electronic transaction files.
- Obtaining additional corroborative evidence e.g. between high earnings and cut-off errors in the recording of sales.
- Extended use of external confirmation to also confirm the terms of trade.
- Modifying the timing of substantive procedures e.g. applying substantive procedures at or near the period end where cut-off errors are more likely, or applying them to transactions occurring earlier in or throughout the reporting period.

- Increasing the sample size or performing analytical procedures to at a more detailed level.

Appendix 9: Audit Procedures to Address the Risk of Material Misstatement Due to Fraud provides examples of responses to the auditor's assessment of the risk of material misstatement resulting from both fraudulent financial reporting and misappropriation of assets.

6.4.3.2 Audit Procedures Responsive to Management Override of Controls

The engagement team should design and perform audit procedures to:

- Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of financial statements.
- Review accounting estimates for biases that could result in material misstatements due to fraud.
- Obtain an understanding of the business rationale of significant transactions that the engagement team becomes aware of that are outside of the normal course of business for the entity, or tha1 otherwise appear to be unusual given the team's understanding of the entity and its environment.

6.5 Evaluation of Audit Evidence

The engagement team, based on the audit procedures performed and the audit evidence obtained should evaluate whether the assessment of the risks of material misstatements at the assertion level remains appropriate. This evaluation is primarily a qualitative matter based on judgement. Such an evaluation may provide further insight about the risks of material misstatements due to fraud and whether there is a need to perform additional or different audit procedures. The engagement partner should also considers if there has been appropriate communication with other engagement team members throughout the audit regarding information or conditions indicative of material misstatement due to fraud.

6.5.1 Circumstances That Indicate Possibility of Fraud gives situations that may indicate the possibility of fraud.

In forming an opinion on the financial statements, the engagement partner should consider:

- Whether analytical procedures that are performed at or near the end of the audit when forming an overall conclusion as to whether the financial statements as a whole are consistent with the firm's knowledge of the business indicate a previously unrecognised risk of material misstatement due to fraud.
- Whether misstatements identified may be indicative of fraud, and if there is such an indication, the engagement team should consider the implications of the misstatement in relation to other aspects of the audit, particularly the reliability of management representations.

Appendix 10 provides further indicators of the possibility of fraud**.**

6.5.2 Management Representations

Written representations should obtain from the management that:

- It acknowledges its responsibility for the design and implementation of internal control to prevent and detect fraud.
- It has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.
- It has disclosed to the auditor its knowledge of fraud or suspected fraud affecting the entity and involving management, employees who have significant roles in internal control or others where the fraud could have a material effect on the financial statements.
- It has disclosed to the auditor of its knowledge of any allegations of fraud or suspected fraud affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.

6.6. Reporting

Where the engagement team confirms that, is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the engagement partner should consider the implications on the audit report.

6.6.1 Communicating with Management and Those Charged with Governance

Where the engagement team identifies a fraud or has obtained information that indicates that a fraud may exist, this should be communicated as soon as practicable to the appropriate level of management, even if the matter might be considered inconsequential. The determination of the level of management on which the communication is to take place is a matter of professional judgement and would ordinarily involve at least one level above the person who appears to be involved with the suspected fraud.

Where the fraud involves the management, employees who have significant role in internal control or others where the fraud has resulted in a material misstatement, the reporting should be done to those charged with governance.

The engagement partner should also communicate at the appropriate level of responsibility, material weaknesses in the design or implementation of internal controls to prevent and detect fraud which may have come to the engagement team's attention and also consider whether any other matters related to fraud need to be discussed with governance of the entity including:

- Concerns about the nature, extent and frequency of management's assessment of the controls in place to prevent and detect fraud and of the risk that the financial statements may be misstated.
- A failure by management to appropriately address identified material weaknesses in internal control.
- A failure by management to appropriately respond to an identified fraud.
- The auditor's evaluation of the entity's environment including questions regarding the competence and integrity of management.
- Actions by management that may be indicative of fraudulent financial reporting.
- Concerns about the adequacy and completeness of the authorisation of transactions that appear to be outside the normal course of business.

6.6.2 Communications with Regulatory and Enforcement Authorities

The auditor's professional duty to maintain confidentiality of client information generally precludes reporting of fraud to a party outside the entity. However, where such requirements are enshrined in law, the engagement partner should consider obtaining legal advice on the appropriate course of action.

6.6.3 Withdrawal from the Engagement

If as a result of a misstatement resulting from fraud or suspected fraud the engagement team encounters exceptional circumstances that bring into question the firm's ability to continue performing the audit, the engagement partner should:

- Consider the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the firm to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;
- Consider the possibility of withdrawing from the engagement; and
- If the firm withdraws:
    - Discuss with the appropriate level of management and those charged with governance the firm's withdrawal from the engagement and the reasons for the withdrawal; and
    - Consider whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the withdrawal from the engagement and the reasons for the withdrawal.

7.0 IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISTATEMENT

7.1 Risk Assessment

The engagement team should to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

The extent of the understanding required is a matter of professional judgement, and is based on the primary consideration on whether it is sufficient to assess the risk of material misstatement of the financial statements and to design and perform further audit procedures. The level of understanding required is however less than that required by the management in managing the entity.

7.2 Audit Risk

In conducting an audit, the engagement team obtains reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether due to fraud or error. In the conduct of an audit, one cannot obtain absolute assurance because of inherent limitations in the audit process due to the following factors:

- The use of testing.
- The inherent limitations of internal controls due to the possibility of management override or collusion.
- The fact that most audit evidence is persuasive rather than conclusive.

Based on the above, an audit is not a guarantee that the financial statements are free from material misstatement, because absolute assurance is not attainable. In addition, an audit opinion does not assure the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk. The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit. The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

The engagement team reduces audit risk by designing and performing audit procedures to obtain sufficient appropriate audit evidence to draw reasonable conclusion on which to base the audit opinion. Reasonable assurance is obtained when the audit risk is reduced to an acceptably low level.

7.3 Risks of Material Misstatement

The risks of material misstatement may exist at two levels:

- The overall financial statement level; and
- The assertion level for classes of transactions, account balances, and disclosures.

Risks of material misstatement at the overall financial statement level refer to risks of material misstatement that relate pervasively to the financial statements as a whole and potentially affect many assertions.

Risks of material misstatement at the assertion level are assessed in order to determine the nature, timing, and extent of further audit procedures necessary to obtain sufficient appropriate audit evidence. This evidence enables the auditor to express an opinion on the financial statements at an acceptably low level of audit risk.

The risks of material misstatement at the assertion level consist of two components: inherent risk and control risk. Inherent risk and control risk are the entity's risks; they exist independently of the audit of the financial statements.

7.3.1 Inherent risk

Inherent risk is the susceptibility of an assertion about a class of transactions, account balances or disclosure to a misstatement that could be material either individually or when aggregated with other misstatements, before consideration of any related controls. The assessment of inherent risk is a judgemental process.

Appendix 11: Inherent Risk Considerations provide a list of factors that the engagement team may consider when assessing inherent risk.

7.3.2 Control risk

Control risk is the risk that a material misstatement that could occur about a class of transactions, account balances or disclosure that could be material either individually or when aggregated with other misstatements, will not be prevented or detected and corrected, on a timely basis by the entity's internal control. Control risk can only be assessed as low if the controls have been tested.

7.3.3 Detection risk

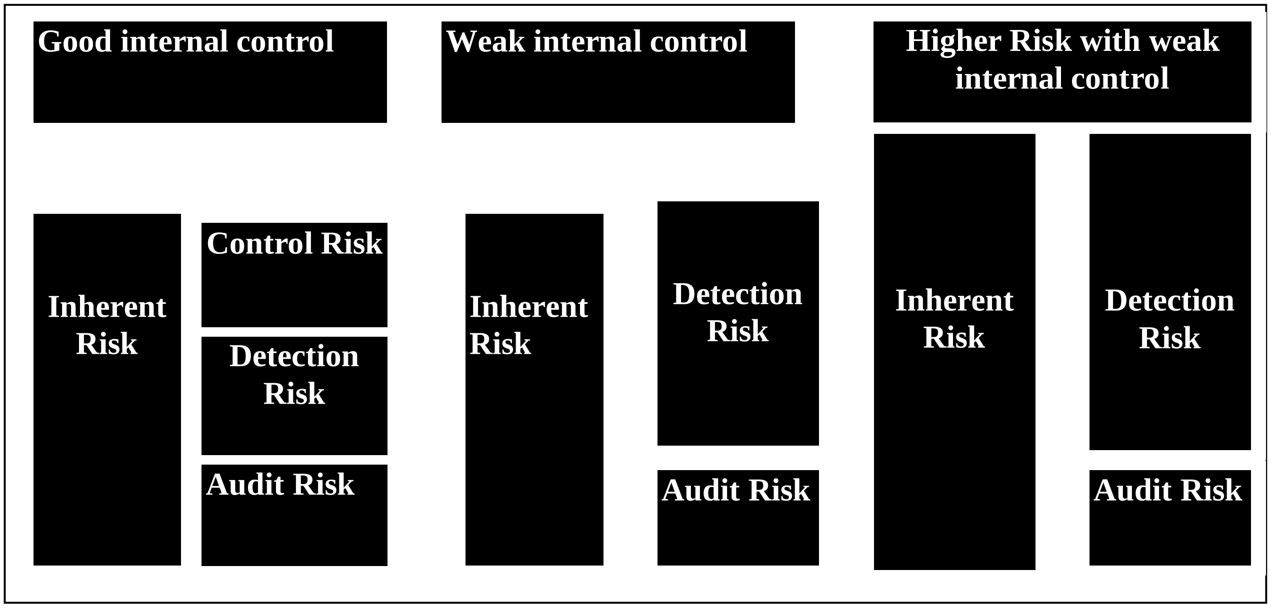
Detection risk is the risk that the procedures performed by the auditor to reduce audit risk to an acceptable low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

7.3.4 Risk Levels

Whether the risk assessment is quantified or not, the engagement team has to assess how the estimation of the levels of risk affects the testing to be carried out:

- A low inherent risk assessment will mean that less assurance needs to be gained from detailed audit tests than a high risk assessment.
- Low control risk will mean more emphasis can be placed on tests of control, and substantive tests of detail would be of less importance.
- Low analytical risk will mean more emphasis can be put on analytical review as substantive procedures, and detailed substantive tests of detail would be of less importance.
- The higher the inherent risk, the higher level the level of assurance that is required for the test of control and from substantive procedures (including analytical procedures used as substantive procedures) and therefore the higher the sample size required.

The inverse relationship between inherent risk on the one hand and control and detection risks (including analytical risk as a component of detection risk) on the other, in order to achieve an acceptably low level of audit risk, is shown in below.



To enable the engagement team to identify and assess the risks of material misstatement and to provide a basis for designing and performing further audit procedures, the auditor:

a. Identify risks throughout the process of obtaining an understanding of the entity and its environment, including relevant controls that relate to the risks, and by considering the classes of transactions, account balances, and disclosures in the financial statements.

b. Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions;

c. Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test; and

d. Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

7.4 Risk Assessment Procedures at the Planning Stage

ISA 315 requires the engagement team to identify and assess the risk of misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances, and disclosures. Obtaining an understanding of the entity and its environment establishes a frame of reference within which the engagement team plans the audit and exercises professional judgement about assessing risks of material misstatement and responding to those risks throughout the audit. The engagement team is also required to assess the risks of material misstatement due to fraud. The engagement team at the planning stage should summarise the key risks attaching to the entity and factors that may minimise or eliminate those risks.

The engagement team usually obtains an understanding of the entity and its environment, including internal control through:

- Information obtained while performing the client acceptance and continuation procedures.
- Inquiries of management and others within the entity including employees, internal audit and those charged with governance;
- Analytical procedures;
- Observation of the entity's activities and operations including visits to premises and plant facilities;
- Inspection of documents such as business plans, internal control manuals, management and board and management minutes, management reports and interim financial statements;
- Tracing transactions through the information systems relevant to financial reporting; and
- External sources e.g. bank or rating agency reports, legal counsel, valuation experts, trade journals and regulatory and financial publications.

Level of inquiry	Types of information that could be obtained
Governance	• Understanding of the environment in which the financial statements are prepared.
Management (usually the main source of information)	• Assessment of the control environment • The entity's performance including an overall understanding of the entity and its internal control.
Internal audit	• Design and effectiveness of internal control • Whether management has responded satisfactorily to finding from the internal audit function.
Employees	• From those involved in initiating, processing or recording complex or unusual transactions; evaluation of the appropriateness of the selection and application of certain accounting policies. • Marketing or sales personnel: changes in marketing strategies, sales trend and contractual arrangements with customers
Legal counsel (both in house and external	• Litigation • Compliance with laws and regulations • Knowledge of fraud or suspected fraud • Warranties and post – sales obligations • Arrangements with business partners including special arrangements joint ventures, shareholders' agreements and any special commitments to buy or sell.

7.4.1 Information Obtained in Prior Periods

Where the engagement team intends to use information obtained in prior periods, the team should determine whether changes have occurred that may affect the relevance of such information in the current audit e.g. changes in the entity or its environment may render such information irrelevant. They should also make inquiry or perform other audit procedures such as walk through tests to determine whether changes have occurred that may affect the relevance of such information.

7.4.2 Discussions amongst the Engagement Team

The engagement team should discuss the susceptibility of the entity's financial statements to material misstatement to gain a better understanding of the potential misstatements arising form fraud or error in the specific area assigned to them, and to understand how the results of the audit procedures they perform may affect other aspects of the audit including the decisions about the nature, timing and extent of further audit procedures.

Ordinarily only the key members of the engagement team are involved in the discussion. In certain cases it may be necessary to involve experts including professionals possessing specialist information technology or other skills required by the engagement team. The extent of the discussion is influenced by the roles, experience and the information needs of the engagement team. In case of very small partner led audits, such discussions may not be necessary, as the partner will usually lead the team on the field.

7.4.3 Understanding the Entity and its Environment, including its Internal Control

The engagement team should obtain an understanding of the following:

a. Relevant industry, regulatory, and other external factors, including the applicable financial reporting framework: The industry in which the entity operates gives rise to specific risks of material misstatement arising from the nature of the industry or the degree of regulation e.g. long term contracts may involve significant estimates of revenues and costs.

b. Nature of the entity, including its operations, ownership and governance structures: The types of investments that the entity is making and plans to make, including investments in special-purpose entities and the way the entity is structured and how it is financed.

   This enables the auditor to understand the classes of transactions, account balances and disclosures expected in the financial statements, including the impact of significant and unusual transactions.

c. The entity's selection and application of accounting policies including the changes thereto: The auditor shall evaluate whether the entity’s accounting policies are appropriate for its business and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

d. Objectives and strategies, and the related business risks that may result in material misstatement of the financial statements: In response to the industry, regulatory requirements and other internal and external factors, the management and those charged with governance define objectives, which are the overall plans for the entity, and the strategies, which are the operational approaches, by which the management intends to achieve its objectives. Business risks result from significant conditions, events, circumstances and actions or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies. The engagement team needs to identify the business risks associated with the business as this increases the likelihood of identifying risks of material misstatements. In case of smaller entities, where plans and the risk management process may not usually be documented, the understanding is normally obtained through inquiries of management and observations of how the entity responds to such matters.

e. Measurement and review of the entity's financial performance: This understanding enables the engagement team to consider whether financial performance pressures can increase the chance of material misstatements.

f. Entity’s Internal control: The engagement team uses the understanding of internal controls to identify types of potential misstatements, consider factors that affect the risks of material misstatement, and design the nature, timing and extent of further audit procedures.

Appendix 12: Factors to Consider in Understanding the Entity and its Environment, provides overall guidance on matters that the one may consider in understanding the nature of the entity, the industry and the regulatory environment in which the entity operates, the objectives and strategies and related business risks of the entity, and the measurement and review of the entity's financial performance.

Appendix 13: Condition and Events that may indicate Risk of Material Misstatement, provides guidance on potential indicators of material risk.

7.5 Significant Risks

As part of the risk assessment, the engagement team should determine which of the risks identified and assessed require special audit consideration. Such risks are defined as "significant risks".

An understanding of the entity's controls related to significant risks is required to provide the team with adequate information to develop an effective audit approach. Significant risks often relate to non-routine transactions and judgemental matters. Non-routine transactions are transactions that are unusual, either due to their size or nature, and therefore occur infrequently.

In considering the nature of the risks, the engagement team considers a number of matters, including the following:

- Whether the risk is a risk of fraud.
- Whether the risk is related to recent significant economic, accounting or other development s and, therefore, requires specific attention.
- The complexity of transactions.
- Whether the risk involves significant transactions with related parties.
- The degree of subjectivity in the measurement of financial information related to the risk especially those involving a wide range of measurement uncertainty.

- Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual.

If the auditor has determined that a significant risk exists, the auditor should obtain an understanding of the entity's controls, including control activities relevant to that risk. Although, risks relating to significant non-routine or judgemental matters are often less likely to be subject to routine controls, management may have other responses intended to deal with such risks. Therefore, the team understands whether the entity has designed and implemented compensating controls for such significant risks.

7.6 Revision of Risk Assessment

The engagement team's assessment of the risks of material misstatement may change during the course of the audit as additional audit evidence is obtained. In particular, the risk assessment may be based on an expectation that controls are operating effectively. In performing tests of controls to obtain audit evidence about their operating effectiveness, the team may obtain audit evidence that controls are not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures the team may detect misstatements in amounts or frequency greater than is consistent with their risk assessments. In circumstances where the engagement team obtains audit evidence from performing further audit procedures that tends to contradict the audit evidence on which the team originally based the assessment, the team should revise the assessment and modify the further planned audit procedures accordingly.

7.7 Internal Control

Internal control is the process designed and affected by those charged with governance, management and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability, of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. Internal control consists of the following components:

a. The control environment;
b. The entity's risk assessment process;
c. The information systems, including the related business processes, relevant to financial reporting, and communication;
d. Control activities; and
e. Monitoring of controls.

The division of internal control into five components provides a useful framework for the engagement team to consider how different aspects of the entity's internal control may affect the audit. The engagement team's primary concern is whether, and how, a specific control prevents, or detects and corrects material misstatements in classes of transactions, account balances, or disclosures, and their related assertions. It also enables an engagement team to:

- Determine whether it is likely to produce a reliable system of accounting.
- Consider management's ability to make the necessary judgements and estimates.
- Assess whether the entity has fulfilled the legal requirement to keep proper accounting records. Identify the incentives and opportunities for misrepresentation or distortion by management.
- Assess whether management has sufficient reliable information for the effective control of the business.

- Identify the key indicators and controls.

Appendix 14: Internal Control Components sets out detailed discussions of the internal control components as they relate to an audit of the financial statements.

7.7.1 The Depth of Understanding

Obtaining an understanding of an entity's controls is not sufficient to serve as testing the operating effectiveness of controls, unless there is some automation that provides for the consistent application of the operation of the control. For example, obtaining audit evidence about the implementation of a manually operated control at a point in time does not provide audit evidence of the operating effectiveness of the control at other times during the period under audit. However, IT enables an entity to process large volumes of data consistently and enhances the entity's ability to monitor the performance of control activities and to achieve effective segregation of ties by implementing security controls in applications, databases, and operating systems.
Therefore, because of the inherent consistency of IT processing, performing audit procedures to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness, depending on the engagement team's assessment and testing of controls such as those over program changes.

7.7.2. Manual Verses Automated Controls

The extent and nature of the risks of internal control vary depending on the nature and characteristics of the entity's information system. Therefore in understanding internal control, the engagement team considers whether the entity has responded adequately to the risks arising from the use of IT or manual systems by establishing effective controls. An entity may use a combination of manual or automated controls.

The use of manual or automated elements in internal control affects the manner in which transactions are initiated, recorded, processed, and reported.

Controls in a manual system may include such procedures as approvals and reviews of activities, and reconciliations and follow-up of reconciling items. Alternatively an entity may make use of automated procedures to initiate, record, process, and report transactions, in which case records in electronic format which replace such paper documents as purchase orders, invoices, shipping documents, and related accounting records.

Controls in IT systems consist of a combination of automated controls i.e. those controls embedded in computer programs) and manual controls. Further, manual controls may be independent of IT, may use information produced by IT, or may be limited to monitoring the effective functioning of IT and of automated controls, and to handling exceptions. When IT is used to initiate, record, process or report transactions, or other financial data for inclusion in financial statements, the systems and programs may include controls related to the corresponding assertions for material accounts or may be critical to the effective functioning of manual controls that depend on IT. An entity's mix of manual and automated controls varies with the nature and complexity of the entity's use of IT.

Automated controls provide potential benefits of effectiveness and efficiency for an entity's internal control because it enables an entity to:

- Consistently apply predefined business rules and perform complex calculations in processing large volumes of transactions or data;
- Enhance the timeliness, availability, and accuracy of information;
- Facilitate the additional analysis of information
- Enhance the ability to monitor the performance of the entity's activities and its policies and procedures.
- Reduce the risk that controls will be circumvented; and
- Enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases, and operating systems.

Automated controls however pose specific risks to an entity's internal control, which including the following:

- Reliance on systems or programs that are inaccurately processing data, processing inaccurate data, or both.
- Unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- The possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- Unauthorised changes to data in master files.
- Unauthorised changes to systems or programs.
- Failure to make necessary changes to systems or programs.
- Inappropriate manual intervention.
- Potential loss of data or inability to access data as required.

Manual controls are performed by people, and therefore pose specific risks to the entity's internal control. Manual controls may be less reliable than automated controls because they can be more easily bypassed, ignored, or overridden and they are also more prone to simple errors and mistakes. Consistency of application of a manual control element cannot therefore be assumed.

Manual aspects of systems may be more suitable where judgement and discretion are required such as for the following circumstances:

- Large, unusual or non-recurring transactions.
- Circumstances where errors are difficult to define, anticipate or predict.
- In changing circumstances that require a control response outside the scope of an existing automated control.
- In monitoring the effectiveness of automated controls.

Manual controls may be less suitable for the following:

- High volume or recurring transactions, or in situations where errors that can be anticipated or predicted can be prevented or detected by control parameters that are automated.
- Control activities where the specific ways to perform the control can be adequately designed and automated.

7.7.3. Limitations of Internal Control

Internal control, no matter how well designed and operated, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of achievement is affected by limitations inherent to internal control due to human failures, simple errors or mistakes. Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control.

Small entities often have fewer employees which may limit the extent to which segregation of duties is practicable. However, for key areas, even in a very small entity, it can be practicable to implement some degree of segregation of duties or other form of unsophisticated but effective controls. The potential for override of controls by the owner-manager depends to a great extent on the control environment and in particular, the owner-manager's attitudes about the importance of internal control.

7.7.4. Control Environment

ISA 315 requires the engagement team to obtain an understanding of the control environment. The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity.

The control environment is the foundation for effective internal control, providing discipline and structure by setting the tone at the top influencing the control consciousness of the entity's personnel. The engagement team is required to understand how management and those charged with governance have created and maintained a culture of honesty and ethical behaviour, and established appropriate controls to prevent and detect fraud within the entity. The engagement team also considers matters such as the independence of the directors and their ability to evaluate the actions of management. The engagement team also considers whether there is an audit committee which understands the entity's business transactions and evaluates whether the financial statements give a true and fair view.

The control environment in itself does not prevent, or detect and correct, a material misstatement in classes of transaction, account balances, and disclosures and related assertions and the engagement team should consider the control environment along with the effects of other internal control components when assessing the risk of material misstatement.

Appendix 16: Controls Relevant to an Audit provides examples of controls relevant to an audit.

7.7.5. The Entity's Risk Assessment Process

ISA 315 requires the engagement team to obtain an understanding of the entity's process for identifying the business risks relevant to financial reporting objectives, and deciding about actions to address those risks and the results thereof. In evaluating the design and implementation of the entity's risk assessment process, the engagement team determines how management identifies the business risks relevant to financial reporting, estimates the significance of the risks, assesses the likelihood of their occurrence and decides upon action to manage them.

7.7.6. Information System, Including the Related Business Processes, Relevant to Financial Reporting, and Communication

The information system relevant to financial objectives, which includes the accounting system, consists of the procedures and records established to initiate, record, process, and report entity transactions and to maintain accountability for the related assets, liabilities, and equity.

ISA 315 requires the engagement team to obtain an understanding of the information system, including the related processes, relevant to financial reporting, including the following areas:

- The classes of transactions in the entity's operations that are significant to the financial statements.
- The procedures, within both IT and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements.
- The related accounting records, whether electronic or manual, supporting information, and specific accounts in the financial statements, in respect of initiating, recording, processing and reporting transactions.
- How the information system captures events and conditions, other than classes of transactions that are significant to the financial statements.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.
- The controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

The auditor should also understand how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting.

7.7.6.1 Information transfer

In obtaining this understanding, the engagement team considers the procedures used to transfer information from transaction processing systems to general ledger or financial reporting systems. The engagement team also understands the entity's procedures to capture information relevant to financial reporting for events and conditions other than transactions, such as the depreciation and amortisation of assets and changes in the recoverability of accounts receivables. When IT is used to transfer information automatically, there may be little or no visible evidence of such intervention in the information systems.

7.7.6.2 Processing of transactions

The engagement team also understands how incorrect processing of transactions is resolved e.g. whether there is an automated suspense file and how it is used by the entity to ensure that suspense items are cleared out on a timely basis, and how system overrides or bypasses to controls are processed and accounted for. The engagement team also obtains an understanding of the entity's information system relevant to financial reporting in a manner that is appropriate to the entity's circumstances. This includes an understanding of how transactions originate within the entity's business processes.

An entity's business processes are the activities designed to develop, purchase, produce, sell and distribute an entity's products and services, ensuring compliance with laws and regulations; and record information, including accounting and financial reporting information.

7.7.6.3 Journal entries

An entity's information system typically includes the use of standard journal entries that are required on a recurring basis to record transactions such as sales, purchases, and cash disbursement~ the general ledger, or to record accounting estimates that are periodically made by management such as changes in the estimate of uncollectible accounts receivable.

An entity's financial reporting process also includes the use of non-standard journal entries to record non-recurring, unusual transactions or adjustments e.g. such entries include consolidation adjustments and entries for a business combination or disposal or non-recurring estimates such an asset impairment. In manual, paper-based general ledger systems, non-standard journal entries may be identified through inspection of ledgers, journals, and supporting documentation. Howe' when automated procedures are used to maintain the general ledger and prepare financial statements, such entries may exist only in electronic form and may be more easily identified through the use of computer-assisted audit techniques.

In obtaining the understanding of the journal entries, the engagement team considers risks material misstatement associated with inappropriate override of controls over journal entries and controls surrounding non-standard journal entries. For example, automated processes and cont may reduce the risk of inadvertent error but do not overcome the risk that individuals r inappropriately override such automated processes, for example, by changing the amounts be automatically passed to the general ledger or financial reporting system.

7.7.7 Control Activities

ISA 315 requires the engagement team to obtain a sufficient understanding of control activities, assess the risks of material misstatements at the assertion level and to design audit procedure assessed risk.

In obtaining an understanding of control activities, the engagement team's primary consideration whether, and how, a specific control activity, individually or in combination with others, prevents detects and corrects, material misstatements in classes of transactions, account balances, disclosures.

Control activities relevant to the audit are those for which the engagement team consider necessary to obtain an understanding in order to assess risks of material misstatement at the assertion level and to design and perform further audit procedures responsive to the assessed risks. An audit does not require an understanding of all the control activities related to each significant class of transactions, account balance, and disclosure in the financial statements or to every assertion relevant to them. The engagement team's emphasis is on identifying and obtaining understanding of control activities that address the areas where the engagement team considers that material misstatements are more likely to occur.

When multiple control activities achieve the same objective, it is unnecessary to obtain understanding of each of the control activities related to such objective.

The engagement team should obtain an understanding of how the entity has responded to risks arising from IT. The use of IT affects the way that control activities are implemented. The engagement team considers whether the entity has responded adequately to the risks arising from IT by establishing effective general IT-controls and application controls. From the engagement team's perspective, controls over IT systems are effective when they maintain the integrity of information and the security of the data such systems process. General IT-controls are policies and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. General IT controls that maintain the integrity of information and security of data commonly include controls over the following:

- Data centre and network operations.
- System software acquisition, change and maintenance.
- Access security.
- Application system acquisition, development, and maintenance.

7.7.8. Monitoring of Controls

Monitoring of controls is a process to assess the effectiveness of internal control over time, and involves assessing the design and operations of controls on a timely basis and taking necessary corrective action modified for changes in conditions. ISA 315 requires the engagement team to obtain an understanding of the major types of activities that the entity uses to monitor internal control over financial reporting, including those related to those controls activities relevant to the audit, and how the entity initiates corrective actions to its controls.

Appendix 14: Part E provides consideration that the engagement team may use in obtaining an understanding of how the entity monitors internal control.

7.8. Recording and Assessment of the Accounting and Information Systems

Entities which are subject to statute are usually required by their governing law to keep proper accounting records which reflect all the business transactions. Entities which are subject to taxes on profits need to keep accounting records sufficient to enable periodic financial statements to be prepared. Engagement teams of such entities are required to report to the members if, in their opinion, governing legislation has been complied with, and on whether proper accounting records have been kept.

The recording of the accounting system should identify the major transaction cycles, significant accounting records, the in-built controls and the financial reporting process.

An understanding of the accounting system, together with internal control in-built into the system, provides answers to the following questions:

- Whether proper and reliable accounting records have been kept.
- Whether there is a need to rely on management assurances.
- Whether a recognisable control system is in operation.

Appendix 17: Guidance on Documenting the Accounting Systems provides guidance on documentation of the accounting systems.

Information Obtained in Prior Periods

Where the engagement team intends to use information obtained in prior periods, the engagement team should determine whether changes have occurred through inquiry and by carrying other audit procedures such as walk through tests and determine the relevance of such changes.

7.9. Inadequate Records or Systems

If the initial assessment indicates that the accounting records may be inadequate or the accounting systems may not be reliable, further audit assurance will be required from substantive procedures to support the audit opinion, e.g. if a business has no proper system for recording sales on a cash register, the record of cash sales is quite likely to be unreliable, unless there is alternative evidence, such as the aggregate selling value of goods purchased.

If the audit opinion has to be qualified on the basis of inadequacies in the accounting system and records, the qualification will need to be as specific as possible, giving details of where there are deficiencies.

ISA 315 requires that the engagement team should make those charged with governance or management aware, as soon as practicable, and at an appropriate level of responsibility, of material weaknesses in the design or implementation of internal controls which have come to the engagement team's attention. One of the avenues of communication is through a management letter.

7.10. Engagement team's Response to Assessed Risk

ISA 330 requires that in order to reduce audit risk to an acceptably low level, the engagement team should determine the overall responses to assessed risks, including the risk of material misstatement due to fraud or error, at the financial statement level, and should design and perform further audit procedures whose nature, timing and extent are responsive to the assessed risk at the assertion level. In designing the audit approach, the engagement team should develop a clear linkage between the nature, timing and extent of further audit procedures and the risk assessment, taking onto consideration:

- The significance of the risk.
- The likelihood that a material misstatement will occur.
- The characteristics of the class of transactions, account balance or disclosure involved.
- The nature of the specific control used by the entity and in particular whether they are manual or automated.
- Whether the engagement team expects to obtain audit evidence to determine if the entity's controls are effective in preventing or detecting and correcting material misstatements.

The nature, timing and extent of the audit procedures are a matter of the engagement team's professional judgement. In some cases,' the engagement team may determine that only by performing tests of controls may the engagement team achieve an effective response to the assessed risk of material misstatement for a particular assertion. In other cases, the engagement team may determine that performing only substantive procedures is appropriate for specift1 assertions and, therefore, the engagement team excludes the effect of controls from the relevant risk assessment. This may be because the engagement team's risk assessment procedures have not identified any effective controls relevant to the assertion, or because testing the operating effectiveness of controls would be inefficient. However, the engagement team needs to be satisfied that performing only substantive procedures for the relevant assertion would be effective in reducing the risk of material misstatement to an acceptably low level. Often the engagement team may determine that a combined approach using both tests of the operating effectiveness of controls and substantive' procedures is an effective approach. Irrespective of the approach selected the engagement team designs and performs substantive procedures for each material class of transactions, account balance and disclosure.

In the case of very small entities, there may not be many control activities that could be identified by the engagement team, the engagement team's further audit procedures are likely to be primarily substantive procedures. In such cases, the engagement team also considers whether in the absence of controls it is possible to obtain sufficient appropriate audit evidence.

7.10.1 Nature

The nature of further audit procedures refers to their purpose (tests of controls or substantive procedures) and their type, that is, inspection, observation, inquiry, confirmation, recalculation, re performance, or analytical procedures. Certain audit procedures may be more appropriate for some assertions than others. The following are some examples of the audit procedures the engagement team may adopt in response to the assessed risk.

- In relation to revenue, tests of controls may be most responsive to the assessed risk of misstatement of the completeness assertion, whereas substantive procedures may be most responsive to the assessed risk of misstatement of the occurrence assertion.
- If the engagement team considers that there is a lower risk that a material misstatement may occur because of the particular characteristics of a class of transactions without consideration 0 the related controls, the engagement team may determine that substantive analytical procedure alone may provide sufficient appropriate audit evidence.
- If the engagement team expects that there is a lower risk that a material misstatement may arise because an entity has effective controls and the engagement team intends to design substantive procedures based on the effective operation of those controls, then the engagement team performs tests of controls to obtain audit evidence about their operating effectiveness. This may be the case, for example, for a class of transactions of reasonably uniform, non-com pie: characteristics that are routinely processed and controlled by the entity's information system.
- If the engagement team uses non-financial information or budget data produced by the entity'! information system in performing audit procedures, such as substantive analytical procedures and tests of controls, the engagement team obtains audit evidence about the accuracy am completeness of such information.

7.10.2 Timing

Timing refers to when audit procedures are performed or the period or date to which the audit evidence applies. The engagement team may perform tests of controls or substantive procedures at an interim date or at period end. The higher the risk of material misstatement, the more likely it is that the engagement team may decide it is more effective to perform substantive procedures nearer to, or at, the period end rather than at an earlier date, or to perform audit procedures unannounced or at unpredictable times.

Performing audit procedures before the period end may assist the engagement team in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters. If the engagement team performs tests of controls or substantive procedures prior to period end, the engagement team should consider the additional evidence required for the remaining period.
In considering when to perform audit procedures, the engagement team also considers such matters as:

- The control environment.
- When relevant information is available (for example, electronic files may subsequently be overwritten, or procedures to be observed may occur only at certain times).
- The nature of the risk (for example, if there is a risk of inflated revenues to meet earnings expectations by subsequent creation of false sales agreements, the engagement team may wish to examine contracts available on the date of the period end).
- The period or date to which the audit evidence relates.

7.10.3 Extent

Extent includes the quantity of a specific audit procedure to be performed, for example, a sample size or the number of observations of a control activity. The extent of an audit procedure is determined by the judgement of the engagement team after considering the materiality, the assessed risk, and the degree of assurance the engagement team plans to obtain. In particular, the engagement team ordinarily increases the extent of audit procedures as the risk of material misstatement increases. However, increasing the extent of an audit procedure is effective only if the audit procedure itself is relevant to the specific risk; therefore, the nature of the audit procedure is the most important consideration. The use of computer-assisted audit techniques (CM Ts) may enable more extensive testing of electronic transactions and account files.

Valid conclusions may ordinarily be drawn using sampling approaches (This is covered in Section 16 of the manual). However, if the quantity of selections made from a population is too small, the sampling approach selected may not be appropriate to achieve the specific audit objective, or if exceptions are not appropriately followed up, there will be an unacceptable risk that the engagement team's conclusion based on a sample may be different from the conclusion reached if the entire population was subjected to the same audit procedure.

7.11. Tests of Controls

ISA 330 requires the engagement team to perform tests of controls when the engagement team's risk assessment includes an expectation of the operating effectiveness of controls or when substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level. The engagement team is required to obtain sufficient and reliable audit evidence that the controls were operating effectively at all relevant times during the audit. Testing the operating effectiveness of controls is performed only on those controls that the engagement team has determined are suitably designed to prevent, or detect and correct, a material misstatement in an assertion. In making the decision, the engagement team considers the following factors:

- Key controls.
- The degree of reliance required.
- Which controls address similar assertions to substantive procedures.
- How easily controls can be tested.
- The evidence gained from previous years and the impact of any changes.
- The IT environment.
- Cost effectiveness and staff requirements.
- Any specific legal or regulatory requirements.

In practice, most small and medium sized entities will not have any reliable system of internal control and therefore the engagement team may have to obtain audit evidence primarily from substantive procedures. Even where apparently reliable systems do exist, it will often not be cost effective for the engagement team to carry out tests on internal control, in the small to medium sized entities.

Where the engagement team has determined that it is not possible or practicable to reduce the risks of material misstatement at the assertion level to an acceptably low level with audit evidence obtained only from substantive procedures, the engagement team should perform tests of relevant controls to obtain audit evidence about their operating effectiveness. This may be the case where the engagement team finds it impossible to design effective substantive procedures that by themselves provide sufficient appropriate audit evidence at the assertion level e.g. where an entity conducts its business using IT and no documentation of transactions is produced or maintained, other than through the IT system.

Testing the operating effectiveness of controls is different from obtaining audit evidence that controls have been implemented. When obtaining audit evidence of implementation by performing risk assessment procedures, the engagement team determines that the relevant controls exist and that the entity is using them. When performing tests of the operating effectiveness of controls, the engagement team obtains audit evidence that controls operate effectively. This includes obtaining audit evidence about how controls were applied at relevant times during the period under audit, the consistency with which they were applied, and by whom or by what means they were applied. If substantially different controls were used at different times during the period under audit, the engagement team considers each separately. The engagement team may determine that testing the operating effectiveness of controls at the same time as evaluating their design and obtaining audit evidence of their implementation is efficient.

Appendix 15: Framework for Assessing Controls provides a framework for assessing controls.

7.12 Drawing Conclusions

If audit tests disclose no exceptions, reliance can be placed on the controls that have been tested. If audit tests reveal that the control was not operating properly, the reasons for not operating and the impact must be ascertained. Was the exception an isolated departure, or was it representative of other problems? If it is believed to be an isolated departure, the validity of the explanation should be confirmed by carrying out further tests. If these further tests fail, the control cannot be relied on and substantive tests may not be restricted unless alternative controls, that give sufficient comfort, can be identified.

On completion of the tests relating to each key question, a conclusion should be drawn on whether the controls are reliable. The reliability of controls relating to each key question should be taken, together with any relevant overall controls, for the purpose of assessing whether control risk is high, medium or low in relation to substantive tests linked with that key question. If the controls are working, control risk will be low, and hence the amount of substantive testing can be limited. Before the conclusion of the audit, based on the results of substantive procedures and other audit evidence obtained by the engagement team, the engagement team should consider whether the assessment of control risk is confirmed.

7.13 Audit Considerations Relating to Entities Using Service Organisations

ISA 402 requires the engagement team to consider how a service organisation affects the entity's accounting and internal control systems, so as to plan the audit and develop an effective audit approach accordingly. The entity may use a service organisation to process its accounting data, and certain records, procedures and policies maintained by the organisation, may be relevant to the audit. If the services provided are limited to recording and processing data and the entity retains authorisation and maintenance of accountability, the entity could implement effective control procedures.

If the service organisation maintains accountability, the entity may rely on control procedures in place at the service organisation. The engagement team therefore needs to assess the significance of the service organisation's activities and its relevance to the audit, for example, by assessing the services provided, the terms of reference, the controls exercised over processing and the extent to which the client's systems interact with those at the services organisation. The engagement team may conclude that the risk attaching to this area is low and does not present any audit problem.

If the services provided are significant to the entity and relevant to the audit, the engagement team needs to obtain sufficient" information to understand the systems at the service organisation, to properly assess the control risk involved. The team may ask the service organisation's engagement teams for assistance, for example, requesting a report on the operating effectiveness of the organisation's accounting and internal control systems for processing data relevant to the audit. The engagement team will have to consider the nature and content of any such report and make enquiries as to the professional competence of the service organisation's engagement team, before deciding whether to rely on it.

If the engagement team uses a report from the engagement team of a service organisation, no reference should be made to that report in the auditor's report.

8. CONSIDERATION OF LAWS AND REGULATIONS IN AN AUDIT OF FINANCIAL STATEMENTS

8.1 Introduction

ISA 250 requires that the auditor:

a. To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements;
b. 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; and
c. To respond appropriately to non-compliance or suspected noncompliance with laws and regulations identified during the audit.

The term **non-compliance** refers to acts of omission or commission by the entity, either intentional or unintentional, which are contrary; to the prevailing laws and regulations. Such acts include transactions entered into by, or in the name of, the entity, or on its behalf, by those charged with governance, management or employees. Non-compliance does not include personal misconduct (unrelated, to the business activities of the entity) by those charged with governance, management or employees of the entity.

It is the management's responsibility to ensure that the entity's operations are conducted in accordance with laws and regulations, and the responsibility for the prevention and detection c: non-compliance rests with the management. The auditor is not responsible for preventing non-compliance nor can the auditor be expected to detect all non-compliance with laws and regulations.

However, the engagement team should perform the audit with an attitude of professional scepticism recognising that the audit may reveal conditions or events that would lead to questioning whether the entity is complying with laws and regulations. Detection of non-compliance, regardless of the materiality, requires consideration of the implications for the integrity of management or employees and the possible effect on other aspects of the audit.

Laws and regulations vary considerably in their relation to the financial statements. The level of the relationship depends on:

- Whether the laws or regulation determine the form or contents of financial statements or the disclosures to be made in the financial statements e.g. the Uganda Companies Act.
- Whether the laws or regulations are to be complied with by the management the provisions under which the entity is allowed to conduct its business e.g. the Ugandan Companies Act or the Financial Institutions Act or the Insurance Act.
- Whether the laws and regulations govern the general operating aspects of the entity e.g. laws governing human resource, health and safety and environmental matters.

Generally the further removed the non-compliance is from the events and transactions ordinary reflected in the financial statements, the less likely the auditor will become aware of it or recognise its possible non-compliance.

8.2 Considering Compliance with Laws and Regulations at the Planning Stage

The engagement team should obtain a general understanding of the *legal and regulatory framework* applicable to the entity and how the entity is complying with the framework. In obtaining this understanding, the engagement team should particularly recognise that some laws and regulations may give rise to business risks that have a fundamental effect on the operations of the entity such as causing the entity to cease operations or call into question the entity's continuation as a going concern. At the planning stage one should:

- ♦ Use the existing understanding of the entity's industry, regulatory and other external factors.
- ♦ Hold discussion with the management to obtain an understanding of the:
  - Laws and regulations governing the entity and in particular those that may have a fundamental effect on its operations.
  - Entity's policies and procedures adopted by the entity for identifying and monitoring compliance with the laws and regulations.
  - Policies and procedures for identifying, evaluating and accounting for litigation claims, assessments and potential fines for non-compliance.
- ♦ Discuss the legal and regulatory framework with auditors of components in other countries.
- ♦ Develop sufficient understanding of these laws and regulations in order to consider them in the design of audit procedures.

In carrying out preliminary assessment on compliance with the laws and regulations, one should note that there is a higher risk with regards to material misstatements resulting form non-compliance due to the following factors:

- ♦ There are many laws and regulations relating principally to the operating aspects of the entity that do not have a material effect on the financial statements and are not captured by the entity's information systems relevant to financial reporting. Such factors could, however, have a significant impact on the entity e.g. the non-compliance with licensing regulations may impact the going concern assumption.
- ♦ Non-compliance may involve conduct designed to conceal it e.g. collusion, forgery, deliberate failure to record transactions, senior management override of controls or intentional misrepresentation being made to the auditor. This is compounded by the fact that the effectiveness of audit procedures is affected by the inherent limitations of internal controls and by the use of testing.

Where such issues are identified, the engagement team then needs to plan audit procedures to ascertain the extent of such non-compliance and assess the impact of this on the financial statements and on the audit opinion.

8.3 Audit Procedures

The audit procedures that could be adopted to help identify instances of non-compliance with laws and regulations which have an effect on the amounts and disclosures in the financial statements and on the audit assertions related to determination of the amounts to be recorded or disclosed in the financial statements could include:

a. Inquiry with management as to whether the management has complied with all applicable laws and regulations.
b. Inspection of correspondence with the relevant licensing or regulatory authorities, minutes of directors and management meeting and reports from regulatory authorities and auditors of components.
c. Independent confirmations from the entity's legal counsel concerning litigation, claims and assessment.
d. Substantive tests of the details of classes of transactions, account balances or disclosures e.g. on the form and contents of the financial statements, industry or regulatory specific requirements, accounting for transactions under government contracts or the accrual or recognition of expenses for income taxes or pension costs.

The following may indicate that non-compliance may have occurred:

- Investigation by government departments or payment of fines and penalties.
- Payments for unspecified services or loans to consultants, related parties, employees or government employees.
- Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually rendered.
- Purchasing at prices significantly above or below market price.
- Unusual payments in cash, purchases in the form of cashiers' cheques payable to bearer or transfers to numbered bank accounts.
- Unusual transactions with companies registered in tax havens.
- Payments for goods or services made other than to the country from which the goods or services originated.
- Payments without proper exchange control documentation.
- Existence of an information system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- Unauthorised transactions or improperly recorded transactions.
- Adverse media comment.

Apart from the above, the engagement team is not required to perform other audit procedures on the entity's compliance with the laws and regulations as this would be outside the scope of audit of financial statements.

Written representations should be obtained from the management stating that the management has disclosed to the auditor all known actual or possible non-compliance with laws and regulations whose effects should be considered when preparing financial statements.

8.4 Reporting

In absence of any audit evidence to the contrary, the auditor is entitled to assume that the entity is in compliance with the laws and regulations.

When the engagement team becomes aware of information concerning a possible instance of non-compliance, it should obtain an understanding of the nature of the act and the circumstances in which it has occurred, and sufficient other information to evaluate the possible effects on the financial statements including:

- The potential financial consequences such as fines, penalties, damages, threats of expropriation of assets, enforced discontinuation of operations and litigation.
- Whether the financial consequences require disclosure.
- Whether the potential consequences are so serious so as to call into question the true and fair view given by the financial statements.

The engagement team should document findings of non-compliance and discuss them with management. Documentation of finding would include obtaining copies of records and documents and making minutes of conversations. Where the management does not provide sufficient information, the engagement partner should consider consulting the entity's lawyer or the firm's own lawyer about the application of the laws and regulations to the circumstances and the possible effects on the financial statements. Appropriate steps should be taken to ensure client confidentiality, while at the same time not compromising the audit.

Reporting of non-compliance will usually be at three levels depending on the nature on the non-compliance, the legal and regulatory requirements and the impact on the financial statements. Reporting need not take place for inconsequential or trivial matters.

8.4.1 To Management

As soon as practicable, the engagement partner should communicate with those charged with governance, or obtain audit evidence that they are appropriately informed regarding the non-compliance.

8.4.2 To Users of the Financial Statements

- ♦ If the engagement partner concludes that the non-compliance has a material effect on the financial statements and has not been properly reflected, then the partner should consider expressing a qualified or an adverse opinion.
- ♦ If the engagement team is precluded from obtaining sufficient appropriate audit evidence to evaluate whether the non-compliance may have a material effect on the financial statements, the engagement partner should express a qualified opinion or a disclaimer of opinion on the basis of limitation on the scope of the audit.
- ♦ If the engagement team is unable to determine whether non-compliance has occurred because of limitations imposed by circumstances rather than by the entity, the engagement partner should consider the effect on the auditor's report.

8.4.3 To Regulatory Authorities

In certain cases the auditor is required by statue or by court of law to report to the regulatory authorities or to the court on non-compliance. In such cases the firm may need to seek legal advice on the requirement to report taking into consideration the duty of confidentiality to the entity and the firm's responsibility to the public interest.

8.5 Withdrawal from the Engagement

The firm should consider withdrawal from the engagement in instances where the entity does not take remedial action. This may even be in instances where the non-compliance is not material to the financial statements. Such instances may include the involvement of the highest authority within the entity which may affect the reliability of management representations and the effects on the firm's continuing association with the entity. In reaching such conclusion the firm may ordinarily seek legal advice.

The Code of Ethics also imposes an obligation on the existing auditor to advise the proposed auditor on whether there are any professional reasons as to why the proposed auditor should not accept the appointment.

8.6 Reporting on Compliance with IFRSs (IAPS 1014)

The objective of an audit of financial statements in accordance with ISA 200 is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified reporting framework. ISA 700 requires that the auditor's report should clearly indicate the financial reporting framework used to prepare the financial statements.

8.6.1 Audit Process

International Financial Reporting Standard (IFRS) require that financial statements should not be described as complying with IFRS unless they comply with all the requirements of IFRS. An unqualified opinion may be expressed only when the auditor is able to conclude that the financial statements give a true and fair view of the financial position of the entity in accordance with IFRS, and any departures do not have a material effect on the financial statements. In all other circumstances the auditor is required to disclaim an opinion or issue a qualified or adverse opinion depending on the nature of the circumstances.

At the **planning stage** the engagement team needs to ascertain the entity complies with IFRS and the accounting polices adopted by the entity comply with IFRS and are consistently followed, and appropriate disclosures are made for any changes.

At the **execution stage**, the engagement team needs to plan the audit procedures for each area to ensure that:

- The accounting polices determined by the entity are compliant with IFRS, have been consistently followed and any changes thereto are adequately disclosed.
- Adequate disclosures have been made for each class of transactions and account balances in accordance with the IFRS.
- Any departures are quantified and taken to the schedule of unadjusted errors to determine the materiality of the non-compliance.

It should be noted that not all departures can be quantified but non-compliance may have a significant impact on the financial statements e.g. the nature of a related party relationship or a non adjusting post balance sheet event or a contingent liability that is not disclosed. If the engagement team determines that the non-compliances are material, the engagement team should discuss with the management to adjust the financial statements. If the management refuses to adjust the financial statements, consideration should be given to issuing a modified report.

The following are indications that the financial statements do not comply with IFRS:

- The financial statements indicate that they have been prepared in accordance with IFRS, then go on to specify certain departures e.g. a note describing the accounting polices used states that the financial statements are prepared in accordance with IFRSs except for the non-disclosure of sales for geographical segments.

- The financial statements identify only specific IFRS requirements used to prepare the statements, but these do not include all the requirements that are applicable to an entity fully complying with the IFRS.
- Financial statements indicate a partial compliance without reference to specific departures e.g. a note indicating significant compliance with IFRS.

9. MATERIALITY IN PLANNING AND PERFORMING AN AUDIT

9.1 Introduction

The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework.

The assessment of materiality assists:

- As an aid, together with risk assessment, to establishing the nature, timing and extent of audit procedures to reduce the audit risk to an acceptably low level.
- To decide what items to examine and whether to use sampling and substantive analytical procedures in relation to classes of transactions, account balances, and disclosures.
- In deciding which transactions are to be tested.
- In evaluating potential and actual quantitative misstatements.

Performance materiality means the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.

9.2 General Considerations in Setting Materiality Levels

In designing the audit plan, the engagement team needs to establish an acceptable materiality level so as to detect quantitative (based on the amount) material misstatements. However, the engagement team should be mindful that qualitative misstatements (based on the nature) need also to be considered. The following should be considered in setting materiality levels:

- The possibility of quantitative misstatements of relatively small amounts that, cumulatively, could have a material effect on the financial statements e.g. errors in month end procedures could be material if that error is repeated each month.
- In addition to quantitative misstatements, qualitative misstatements may materially affect the financial statements. Such misstatements and the audit approach are covered in other chapters of the manual. Examples of qualitative misstatements include:

    - Inadequate or improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description.
    - Failure to disclose the breach of regulatory requirements when it is likely that the consequent imposition of regulatory restrictions will significantly impair operating capability.

- Some areas, principally those where "sensitive" disclosures are required in the financial statements e.g. related party transactions should always be regarded as material at the planning stage.

- Materiality may be influenced by classes of transactions, account balances, and disclosures and their relationships, resulting in different materiality levels depending on the aspect of the financial statements being considered.
- The assessment of materiality and risk may be different at the planning level from that at the completion stage either due to changes in circumstances or because of change in the auditor's knowledge as a result of performing audit procedures. In some cases, during planning, materiality may intentionally be set to a lower level than is intended to be used to evaluate the results. This is done to reduce the likelihood of uncovered mistakes and also provides the engagement team with a margin of safety when evaluating the effects of misstatements discovered during the audit.
- The assessment of what is material is a matter of professional judgment, and the engagement team needs to consider materiality at both the overall financial statement level and in relation to classes of transactions, account balances, and disclosures. The engagement team should also consider materiality and its relationship with audit risk when conducting an audit.

9.3 Relationship between Materiality and Risk

There is an inverse relationship between materiality and the level of audit risk, that is, the higher the materiality level, the lower the audit risk and vice versa. This should be taken into account when determining the nature, timing and extent of audit procedures. If after planning for specific audit procedures, it is determined that the acceptable materiality is lower and the audit risk is increased, the engagement team would compensate for this by either:

- Reducing the assessed risk of material misstatement, where this is possible, and supporting the reduced level by carrying out extended or additional tests of control; or
- Reducing detection risk by modifying the nature, timing and extent of planned substantive procedures.

Further discussion on risk is presented in Section 7 of this Manual.

9.4 Overall and Individual Materiality

The setting of the materiality level may be regarded as a two-stage process:

- Setting the materiality level for the financial statements as a whole; and
- Setting a materiality level for individual audit areas, where considered necessary.

9.4.1 Overall Materiality Level

The overall materiality level will be used at the opinion stage to determine whether the aggregate of all misstatements do not exceed the materiality level set for the engagement. The overall materiality level is set initially at the planning stage. This has the following benefits:

- It ensures that the audit is focused to significant areas and therefore less attention will be given to insignificant items.
- The nature and extent of audit procedures will be more effective.

Details of the level chosen and the reasons for choosing it should be documented as part of the audit strategy and the overall audit plan.

In the absence of any specific recommendations in ISA 320 on the methods to be used in calculating materiality, this section of the manual provides some guidance on the setting of materiality levels using various formulae. However the manual does not dictate the methods to be adopted as there are other suitably acceptable methods of calculating materiality. Whatever method is used, the planning documentation should state the factors that have influenced the choice of materiality selected.

Appendix 18: Guidance on Setting Materiality provides illustration on how to set the materiality level.

Materiality at the planning stage should be set using the most recent management accounts. If these are not available then the current period budget or then the last year's audited financial statements should be used. If reliable information is available at the planning stage, the overall materiality level set at the planning and opinion stages will be the same. As more up-to-date financial information becomes available, the level set may need to be modified. If, exceptionally, modification results in a significant reduction in the materiality level, it may be necessary to extend audit tests already completed.

Once the draft financial statements become available, an opinion materiality level should be determined. This level should be used as a factor in considering whether areas of uncertainty or disagreement in the financial statements are sufficiently material to require an audit qualification [if the uncertainty is not adequately disclosed, or the disagreement cannot be resolved]. Consideration should also be given to the effect of the opinion materiality level on the level set for individual audit areas.

9.4.2 Materiality Level for Individual Areas

As well as the overall materiality level, particular items may be of such significance that the user of the financial statements may apply a different materiality level to them. This may be connected with the nature of the item (for example, any misstatement will be considered significant) or the effect of the item changing (for example, the effect any misstatement will have on key ratios or indicators in the financial statements).

Note: When using statistical sampling, the materiality level chosen for the individual area is adjusted by the risk factor chosen, to arrive at an adjusted materiality level used for sampling purposes, or which can be used as the tolerable error rate.

9.5 Influences and Other Considerations Including Fraud on Setting Materiality

9.5.1 General Influences

General factors to consider when deciding both the overall materiality level and the level used for individual items include:

a. Users of financial statements

- Who are the users are and what they need to know (for example, the financial statements of a private owner-managed entity will have a different readership than those of a listed entity).
- Which figures or information in the financial statements are they particularly interested in.
- What level of error in these figures will affect the users.

b. The Nature of Reporting Based on the Type of Entity

Different sectors produce very different financial statements based on the nature of their activity. For a business generating profits from a relatively low total asset base, a materiality level based on the profit and loss account is likely to be more meaningful; by contrast for a business with high total assets but low profits, a materiality level based on total assets is likely to be more relevant. If the business has high turnover but low profits in an individual year, it may be more appropriate to base materiality on turnover or on an average of profits for previous years.

c. Losses and Net Liabilities

In general, the magnitude of losses should be ignored when setting materiality if the business has a strong net assets position. If the business is close to a break-even point, or has net liabilities, the formulae given in the appendices should not be used. Instead, consideration should be given to how the business is to be funded, and what level of liabilities or profits would cause the sources of finance to be withdrawn.

9.5.2 Influences on Materiality of Individual Items

Factors which may influence the judgement on setting the materiality of an item may include:

- **Sensitive items:** These would include transactions with related parties, illegalities and irregularities.
- **Infrequent or unusual occurrences:** These would include areas where there has been a change in accounting policy, or a departure from a treatment normally required.
- **Special circumstances:**
  - If the business is being reviewed for a potential takeover or sale.
  - Where the going concern basis may be inappropriate.
  - Whether immaterial items (such as illegal payments) may lead to discoveries of material errors.

The specific terms of the engagement may impose additional responsibilities, for example, looking for fraud. Such procedures may be strictly outside the scope of the audit, but can be taken to affect materiality levels if they are carried out at the same time.

9.5.3 The Effect of the Item in the Financial Statements

The effect on the financial statements of the item being misstated will depend on the absolute amount of the item itself. The following factors should also be considered:

The amount relative to the other figures in the financial statements e.g. how large the item is relative to other current assets or liabilities, total assets or liabilities, shareholders funds, profits or income. A small error may have the effect of turning a small profit into a small loss, or a positive net current assets figure into a negative.

- **Measures of liquidity** or solvency for instance, whether a small error will significantly affect debt to equity or working capital ratios, or cause ratios or limits in relation to borrowings to be exceeded.
- **Other key ratios and trends i.e**. whether an error will effect asset turnover, profit margin or return on capital ratios or effect profitability, current asset and other liquidity ratios.
- **Tax Charge i.e.** whether an error would have a significant tax effect, for example, on capita expenditure and disallowable items.
- **Subsequent financial statements i.e.** whether a small difference will impact greatly on the financial statements in future years.
- **Directional testing considerations.** When setting a materiality level for a particular item considers whether a different materiality level applies to the corresponding item which is the subject of the directional test.

9.5.4 Accounts Preparation Materiality

If the firm is preparing the financial statements for the entity, the setting of an accounts materiality level i.e. The amount that would cause us to amend the financial statements is quite a separate decision from setting the materiality level for audit purposes. A number of the factors that will influence our choice of audit materiality level will also influence the choice of accounts materiality level. In such cases the entity may require their draft figures to be adjusted for any errors, even if the errors are immaterial in auditing terms.

9.5.5 Materiality and Groups

If the firm audits a group and reports on the subsidiary's financial statements, then in auditing the subsidiaries, the firm's assessment of materiality should be as described above. In particular, the engagement team should consider the likely users of the subsidiary's financial statements and the importance the users will attach to the subsidiary's financial statements compared to the consolidated financial statements. Each component in the group should be regarded as a separate entity for the purposes of audit planning, setting materiality levels and reporting.

If the firm does not report on the subsidiary's financial statements, materiality levels should normally be determined by reference to the group. The engagement team should discuss with group management the implications of the restricted examination of the subsidiary. Group management may wish to make a more detailed assessment of the subsidiary than is implied by choosing its materiality level by reference to its importance to the group. Group-based materiality levels should be used when considering any consolidation adjustments, and to evaluate the total unadjusted errors of all the components and the parent company.

9.5.6 Entities with Several Branches or Divisions

Larger entities may have several different branches, divisions or locations with autonomous or semiautonomous accounting systems. In these circumstances, the engagement team should normally determine materiality in relation to the key components of the financial statements, irrespective of ~e number of branches, divisions or locations. However the engagement team should confirm with management whether they want to consider each branch or division as a separate entity. If so, separate materiality levels should be set for each branch.

9.6 Evaluating the Effects of Misstatements

The engagement partner should assess whether the aggregate of uncorrected misstatements that have been identified during the audit are material taking into account the overall materiality level. The aggregate of uncorrected misstatements comprise the:

- Specific misstatements identified by the engagement team including the net effects of uncorrected misstatements identified during the audit of previous periods; and
- The engagement team's best estimate of other misstatements which cannot be specifically identified e.g. projected errors.

On the other hand, the engagement team may identify that the aggregate of the uncorrected misstatements approaches the materiality level. In such a case, the engagement partner should consider whether it is likely that undetected misstatements, when taken with aggregate uncorrected misstatements could exceed the materiality level.

If the engagement partner concludes, in both the above scenarios, that the misstatements may be material the partner may either:

1) Consider reducing the audit risk by extending the audit procedures; or
2) Requesting the management to adjust the financial statements.

If the management refuses to adjust the financial statements or the engagement partner is not able to conclude that the aggregate of the uncorrected misstatements is not material, then consideration should be given to modifying the auditor's report. The engagement partner may also consider communicating the misstatements with those charged with governance.

10. AUDIT EVIDENCE

10.1 Definition

Audit evidence refers to the information used by the auditor in arriving at the conclusions on which the audit opinion is based, and includes the information contained in the accounting records, underlying the financial statements and other information.

In the conduct of an engagement, the engagement team should obtain sufficient appropriate audit evidence to enable it to draw reasonable conclusions on which to base the audit opinion. The engagement team is not expected to address all information that may exist as they may use sampling approaches and other means of selecting items for testing. The team may find it necessary to rely on evidence that is persuasive rather than conclusive.

Audit evidence should be evaluated by its characteristics which include:
- Sufficiency.
- Appropriateness.

The appropriateness of the audit evidence is determined by its quality and relates to:
- Relevance.
- Reliability.
- Consistency.

10.2 Sufficient and Appropriate Evidence

Sufficiency is the measure of the quantity of audit evidence needed to form the audit opinion. The judgement on what is sufficient will be influenced by:

- The risk of misstatement (the greater the risk, the more evidence is likely to be required).
- The assessment of the accounting and internal control procedures.
- The materiality of the item being examined.
- The experience gained during past audits.
- The source and nature of the evidence available.

Appropriateness is the measure of the quality of audit evidence and relates to:

10.2.1 Relevance

The relevance of audit evidence has to be considered, in relation to the objective of forming an opinion and reporting on the financial statements.

When assessing the relevance of audit evidence relating to tests of controls to support the assessed level of control risk, the engagement team should consider the following aspects:

- **Design:** Whether the accounting and internal control system is capable of preventing or detecting material misstatements.

- **Operation:** Whether the controls exist and have operated effectively throughout the relevant accounting period.

When assessing the relevance of audit evidence obtained from substantive procedures, the engagement team should assess certain assertions which are embodied in the financial statements. Audit evidence, in relation to an item, is usually obtained regarding each financial statement assertion e.g. evidence regarding one assertion (for example, existence of inventory) will not compensate for the failure to obtain audit evidence regarding another assertion (for example, valuation of inventory).

10.2.2 Reliability

The reliability of audit evidence is influenced by its source and by its nature and is dependent on the individual circumstances under which it is obtained.

When assessing the reliability of audit evidence the engagement team should consider the following factors:

- External evidence (e.g. independent third party confirmations or from an examination of external documents) is more reliable than internal evidence.
- Internally generated information is more reliable when related controls imposed by the entity are effective.
- Documentary evidence whether paper, electronic or other medium, is more reliable than oral evidence.
- Evidence obtained directly by the firm (such as observation of the application of a control or physical inspection) is more reliable than audit evidence obtained indirectly or by inference.
- Internal evidence may be more reliable if it is obtained:
  - From a reliable senior official;
  - From an employee with no financial interest in the entity; or
  - From a number of different personnel.
- Original documents are more reliable than copies.

10.2.3 Consistency

The engagement team would ordinarily obtain more assurance from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually.

The engagement team should therefore consider whether the conclusions from different types of audit tests are consistent with one another. When different sources of audit evidence appear to contradict each other, the reliability of each remains in doubt until further work has been done to resolve the inconsistency. However, when the individual sources of evidence relating to a particular matter are all consistent, then the cumulative degree of assurance obtained is higher than that obtained from individual sources.

The engagement team may take into account the relationship between the cost of obtaining evidence and the usefulness of the information obtained, but the cost and degree of difficulty in obtaining evidence is not in itself a valid basis for omitting a necessary audit procedure.

10.3 Audit Techniques

10.3.1 Inspection of Records or Documents - This consists of examining records or documents Inspection of records and documents provides audit evidence of varying degrees of reliability depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. Examples of where this audit technique can apply are: when verifying expenditure, inspection of documents for evidence of authorisation, in verification of documents of ownership such as title deeds for land, logbooks for motor vehicles etc.

Inspection of such documents may not necessarily provide evidence about ownership or valuation. In addition, inspection of an executed contract may provide audit evidence relevant to the entity's application of accounting policies such as revenue recognition.

10.3.2 Inspection of Tangible Assets - This consists of physical inspection of assets, which may provide reliable audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or valuation of the assets. Inspection is usually done when observing inventory counting.

10.3.3 Observation - Consists of examining at a process or procedure being done by others, for example observation of the counting of inventories and observation of the performance of control activities. Although observation provides audit evidence about the performance of a process or procedure, it is limited to the point in time at which it takes place and by the fact that the act of being observed may affect how the process or procedure is performed.

10.3.4 Inquiry - This consists of seeking information of knowledgeable persons, both financial and non-financial, throughout the entity or outside the entity. Inquiry is an audit procedure that is used extensively throughout the audit and often is complementary to performing other audit procedures. Inquiry alone ordinarily does not provide sufficient audit evidence to detect a material misstatement at the assertion level. Moreover, inquiry alone is not sufficient to test the operating effectiveness of controls. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures.

Although corroboration of evidence obtained through inquiry is often of particular importance, in the case of inquiries about management intent, the information available to support management's intent may be limited. In these cases, understanding management's past history of carrying out its stated intentions with respect to assets or liabilities, management's stated reasons for choosing a particular course of action, and management's ability to pursue a specific course of action may provide relevant information about management's intent.

In respect of some matters, the auditor obtains written representations from management to confirm responses to oral inquiries. For example, the auditor ordinarily obtains written representations from management on material matters when other sufficient appropriate audit evidence cannot reasonably be expected to exist.

10.3.6 External Confirmation - This is a specific type of inquiry, and is the process of obtaining a representation of information or of an existing condition directly from a third party. For example, confirmation of receivables by communication with debtors. Confirmations are frequently used in relation to account balances and their components, but need not be restricted to these items. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties; the confirmation request is designed to ask if any modifications have been made to the agreement and, if so, what the relevant details are. Confirmations also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a "side agreement" that may influence revenue recognition.

10.3.7 Recalculation - Consists of checking the mathematical accuracy of documents or records and can be performed through the use of information technology, for example, through the use of CAATs to check accuracy or summarization of an entity's electronic files.

10.3.8 Reperformance - This is the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control, for example, reperforming the bank reconciliations, or using CAATs for reperforming the ageing of accounts receivable.

10.3.9 Analytical Procedures - Consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also include the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

10.4 Designing Audit Procedures for Obtaining Evidence

Audit evidence is obtained to enable the auditor draw reasonable conclusions on which to base the audit opinion. The following are the audit procedures that can be used to obtain audit evidence:

i. Risk assessment procedures - These are used to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and assertion levels.
ii. Tests of controls - Test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.
iii. Substantive procedures - Detect material misstatements at the assertion level and include tests of details of classes of transactions, account balances, and disclosures and substantive analytical procedures.

The engagement team uses a combination of the above audit procedures to obtain audit evidence.

Risk assessment procedures are performed to provide a satisfactory basis for the assessment of risks at the financial statement and assertion levels. However, as risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion, they need to be supplemented by further audit procedures in the form of tests of controls, and substantive procedures themselves.

Tests of controls are necessary when the engagement team's risk assessment includes an expectation of the operating effectiveness of controls, or when substantive procedures alone do not provide sufficient appropriate audit evidence.

Substantive procedures are performed by the engagement team in response to the related assessment of risks of material misstatement, which includes the results of tests of controls, if any. However, as the auditor's risk assessment is judgmental, it may not identify all risks of material misstatement. In addition, there are inherent limitations to internal control such as the risk of management override, the possibility of human error and the effect of systems changes. Therefore, substantive procedures for material classes of transactions, account balances, and disclosures are always required to obtain sufficient appropriate audit evidence.

10.5 Attendance at Physical Inventory Counting

If inventory is material to the financial statements, the engagement team should obtain sufficient appropriate audit evidence regarding its existence and condition, by attendance at the physical inventory counting, unless impracticable to do so. The team's attendance serves as a test of controls or substantive procedure over inventory depending on the engagement team's risk assessment and planned approach. Such attendance enables the engagement team to inspect the inventory, to observe compliance with management procedures for recording and controlling the results of the count and to provide evidence as to the reliability of management's procedures.

In planning to attend, the engagement team will need to consider the systems of controlling inventory, the risks involved, the adequacy of the counting instructions (including arrangements relating to the control of count sheets / work-in-progress and obsolete items and the movement of inventory), timing and the locations of inventory and whether an expert is needed.

The engagement team should take test counts or assess the reasonableness of procedures for estimating quantities not subject to counts (such as fluids). If weighing machines are being used, the calibration of such machines should always be tested. The engagement team would also need assurances as to adequate cut-off procedures, including details of the movement of inventory just prior to, during and after the count so that the accounting for such movements can be checked at a later date.

When the entity operates a perpetual inventory system, which is used to determine the period end balance, the engagement team would evaluate whether, through the performance of additional procedures, the reasons for any significant differences between the physical count and the perpetual inventory records are understood and the records are properly adjusted.

The engagement team should perform audit procedures over the final inventory listing to determine whether it accurately reflects actual inventory counts.

When inventory is situated in several locations, the engagement team will need to determine which locations are appropriate to attend, considering the materiality and risk of misstatement of inventory at different locations.

When third parties hold inventory on behalf of the entity, the engagement team should consider the need to obtain a direct confirmation from the third party, taking into account the materiality of this inventory. The team would consider the following:

- The integrity and independence of the third party.
- Observing, or arranging for another auditor to observe, the physical inventory count.
- Obtaining another auditor's report on the adequacy of the third party's internal control for ensuring that inventory is correctly counted and adequately safeguarded.
- Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts, or obtaining confirmation from other parties when such inventory has been pledged as collateral.

If the engagement team is unable to attend the physical inventory count, a physical count should be taken or observed on an alternative date and procedures on intervening transactions, where necessary, should be performed.

If it is impracticable for the engagement team to attend the physical inventory count, consideration should be given to whether alternative procedures, such as documentation of subsequent sale of specific inventory items acquired prior to the period end, provide sufficient appropriate audit evidence.

10.6 External Confirmations

The engagement team should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence to support certain financial statement assertions. In making this determination, the engagement team should consider the assessed risk of material misstatement at the assertion level and how the evidence from other planned audit procedures will reduce this risk to an acceptably low level for the applicable financial statement assertions.

External confirmation is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item affecting assertions made by management in the financial statements. In deciding to what extent to use external confirmations the engagement team considers the characteristics of the environment in which the entity being audited operates and the practice of potential respondents in dealing with requests for direct confirmation.

External confirmations are frequently used in relation to obtaining evidence regarding account balances and their components, but may also be used as a request of external confirmation of the terms of agreements or transactions an entity has with third parties. The confirmation request is designed to ask if any modifications have been made to the agreement, and if so what the relevant details are.

10.6.1 Examples of situations where external confirmations may be used include:

When inventory is situated in several locations, the engagement team will need to determine which locations are appropriate to attend, considering the materiality and risk of misstatement of inventory at different locations.

When third parties hold inventory on behalf of the entity, the engagement team should consider the need to obtain a direct confirmation from the third party, taking into account the materiality of this inventory. The team would consider the following:

- The integrity and independence of the third party.
- Observing, or arranging for another auditor to observe, the physical inventory count.
- Obtaining another auditor's report on the adequacy of the third party's internal control for ensuring that inventory is correctly counted and adequately safeguarded.
- Inspecting documentation regarding inventory held by third parties, for example, warehouse receipts, or obtaining confirmation from other parties when such inventory has been pledged as collateral.

If the engagement team is unable to attend the physical inventory count, a physical count should be taken or observed on an alternative date and procedures on intervening transactions, where necessary, should be performed.

If it is impracticable for the engagement team to attend the physical inventory count, consideration should be given to whether alternative procedures, such as documentation of subsequent sale of specific inventory items acquired prior to the period end, provide sufficient appropriate audit evidence.

10.6.2 Other Examples of situations where external confirmations may be used include:

- Bank balances and other information from bankers.
- Accounts receivable balances.
- Stocks held by third parties at bonded warehouses for processing or on consignment.
- Property title deeds held by lawyers or financiers for safe custody or as security.
- Investments purchased from stockbrokers but not delivered at the balance, sheet date.
- Loans and other borrowings.
- Contingent liabilities including off-balance sheet items and legal cases.
- Accounts payable balances.

The reliability of the audit evidence obtained by external confirmations depends, among other factors, upon the engagement team applying appropriate audit procedures in designing the external confirmation request, performing the external confirmation procedures, and evaluating the results *or* the external confirmation procedures. Factors affecting the reliability of confirmations include the control the engagement team exercises over confirmation requests and responses, the characteristics of the respondents, and any restrictions included in the response or imposed by management.

10.6.3 Design of the External Confirmation Request

The engagement team should tailor external confirmation requests to the specific audit objective. Factors to consider when designing confirmation requests include:

- The assertions being addressed.
- Specific identified risks of material misstatement, including fraud risks.
- The layout and presentation of the confirmation request.
- Prior experience on the audit or similar engagements.

- The method of communication (for example, in paper form, or by electronic or other medium).
- Management's authorization or encouragement to the confirming parties to respond to the auditor. Confirming parties may only be willing to respond to a confirmation request containing management's authorization.
- The ability of the intended confirming party to confirm or provide the requested information (for example, individual invoice amount versus total balance).

10.6.3.1 Positive and negative confirmations

The engagement team may use positive or negative external confirmation requests or a combination of both. A positive external confirmation request asks the respondent to reply to the auditor in all cases, whether in agreement with the information or not. There is a risk, however, that a respondent may reply to the confirmation request without verifying that the information is correct. The engagement team may reduce this risk, however, by using positive confirmation requests that do not state the amount (or other information) on the confirmation request, but ask the respondent to fill in the amount or furnish other information. On the other hand, use of this type of "blank" confirmation request may result in lower response rates because additional effort is required of the respondents.

A negative external confirmation request asks the respondent to reply only in the event of disagreement with the information provided in the request. However, when no response is received, the engagement team will have no way of ascertaining whether the intended third parties have received the confirmation requests. Accordingly, the use of negative confirmation requests ordinarily provides less reliable audit evidence than the use of positive confirmation requests, and the engagement team should consider performing other substantive procedures to supplement the use of negative confirmations.

A combination of positive and negative external confirmations may be used. For example, where the total accounts receivable balance comprises a small number of large balances and a large number of small balances, the auditor may decide that it is appropriate to confirm all or a sample of the large balances with positive confirmation requests and a sample of the small balances using negative confirmation requests.

10.6.3.2 Management Requests

When the engagement team seeks to confirm certain balances or other information, and management requests them not to do so, the team should consider whether there are valid grounds for such a request and obtain evidence to support the validity of management's requests. If the engagement team agrees to management's request not to seek external confirmation regarding a particular matter, they should apply alternative procedures to obtain sufficient appropriate evidence regarding that matter.

If the engagement team does not accept the validity of management's request and is prevented from carrying out the confirmations, there has been a limitation on the scope of the auditor's work and the engagement team should consider the possible impact on the auditor's report.

When considering the reasons provided by management, the engagement team should apply an attitude of professional scepticism and consider whether the request has any implications regarding management's integrity. The engagement team should also consider whether management's request might indicate the possible existence of fraud or error. The engagement team should also consider whether the alternative procedures will provide sufficient appropriate evidence regarding that matter.

When performing confirmation procedures, the engagement team should maintain control over the process of selecting those to whom a request will be sent, the preparation and sending of confirmation requests, and the responses to those requests.

Control is maintained over communications between the intended recipients and the engagement team to minimize the possibility that the results of the confirmation process will be biased because of the interception and alteration of confirmation requests or responses. The engagement team should ensure that it is them who send out the confirmation requests, that the requests are properly addressed, and that it is requested that all replies are sent directly to the firm. The engagement team should consider whether replies have come from the purported senders.

The engagement team should perform alternative procedures where no response is received to a positive external confirmation request. The alternative audit procedures should be such as to provide the evidence about the financial statement assertions that the confirmation request was intended to provide.

When the engagement team forms a conclusion that the confirmation process and alternative procedures have not provided sufficient appropriate audit evidence regarding an assertion, they should undertake additional procedures to obtain sufficient appropriate audit evidence.

The engagement team should evaluate whether the results of the external confirmation process together with the results from any other procedures performed, provide sufficient appropriate audit evidence regarding the financial statement assertion being audited.

10.7 Procedures Regarding Litigation and Claims

The engagement team would need to carry out procedures to identify any litigation and claims which may have a material effect on the financial statements. These could include obtaining management representations, reviewing Board Minutes and correspondence with the entity's legal counsel, examination of legal expense accounts, and use of any information obtained regarding the entity's business including information obtained from discussions with any in-house legal department.

When the engagement team assesses a risk of material misstatement regarding litigation or claims that have been identified or when the team believes they may exist, they should seek direct communication with the entity's legal counsel. This will assist in obtaining sufficient appropriate audit evidence as to whether potentially material litigation and claims are known and management's estimates of the financial implications, including costs, are reliable. When the engagement team determines that the risk of material misstatement is a significant risk, they should evaluate the design of the entity's related controls and determines whether they have been implemented.

The letter, which should be prepared by management and sent by the engagement team, should request the entity's legal counsel to communicate directly with the firm. When it is considered unlikely that the entity's legal counsel will respond to a general inquiry, the letter would ordinarily specify the following:

- A list of litigation and claims.
- Management's assessment of the outcome of the litigation or claim and its estimate of the financial implications, including costs involved.
- A request that the entity's legal counsel confirm the reasonableness of management's assessments and provide the auditor with further information if the list is considered by the entity's legal counsel to be incomplete or incorrect.

The engagement team should consider the status of legal matters up to the date of the audit report. In some instances, the team may need to obtain updated information from entity's legal counsel.

In certain circumstances, for example, where the engagement team determines that the matter is a significant risk, complex or there is disagreement between management and the entity's legal counsel, it may be necessary for the engagement team to meet with the entity's legal counsel to discuss the likely outcome of litigation and claims. Such meetings would take place with management's permission and, preferably, with a representative of management in attendance.

If management refuses to give the engagement team permission to communicate with the entity's legal counsel, this would be a scope limitation and should ordinarily lead to a qualified opinion or a disclaimer of opinion. Where the entity's legal counsel refuses to respond in an appropriate manner and the engagement team is unable to obtain sufficient appropriate audit evidence by applying alternative audit procedures, the team should consider whether there is a scope limitation which may lead to a qualified opinion or a disclaimer of opinion.

11. OTHER AUDIT AREAS

This chapter contains a summary of the audit requirements contained in the ISAs that have not been specifically addressed elsewhere, including:

ISA 510 - 'Initial Engagements – Opening Balances'.
ISA 540 - 'Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures'.
ISA 710 -'Comparative Information-Corresponding Figures and Comparative Financial Statements'.

11.1 Audit of Opening Balances on Continuing Audits

'Opening balances', are defined as those account balances which exist at the beginning of the period. Opening balances are based upon the closing balances of the prior period and reflect the effects of:

(a) Transactions and events of prior periods; and
(b) Accounting policies applied in the prior period.

The engagement team should obtain sufficient appropriate evidence that the opening balances and comparatives are free from material misstatement and have been properly included in the current year's financial statements.

The team should check that the prior period's closing balances have been correctly brought forward and that accounting policies have been applied consistently, or any changes fully disclosed and prior year balances restated.

Where comparatives have been adjusted, as required by legislation or by accounting standards, it should be confirmed that appropriate disclosures have been made in the financial statements.

11.1.1 Audit of Opening Balances Where Prior Years not Audited

In an initial audit engagement, the firm will not have previously obtained audit evidence supporting the opening balances. Under ISA 510, for initial audit engagements, the engagement team should obtain sufficient appropriate evidence that:

(a) The opening balances do not contain misstatements that materially affect the current year's financial statements;
(b) The previous period's closing balances have been correctly brought forward to the current period or, when appropriate, have been properly restated; and
(c) Appropriate accounting policies are consistently applied or changes in the accounting policies have been properly accounted for and adequately disclosed.

The engagement team should also perform other appropriate audit procedures in order to obtain assurance that the opening balances are not materially misstated. Examples of audit procedures that may be performed include:

- The testing of subsequent receipts and payments during the current period on opening receivables and payables respectively as this may provide audit evidence as to their existence, rights and obligations, completeness and valuation at the beginning of the period.

- In case of inventory, where it may be more difficult for the engagement team to be satisfied as to inventory on hand at the beginning of the period, the team may be able to observe a current physical inventory count, and reconcile that count back to the opening inventory quantities, testing valuation of the opening inventory items and testing gross profit and cut-offs.
- Obtaining external confirmations for certain classes of assets and liabilities e.g. bank balances, borrowings, assets held by third parties and investments.
- For non current assets and liabilities, such property, plant and equipment, investments and long-term debt, some evidence may be obtained by examining the accounting records and other information underlying the opening balances.

If, after performing the procedures available, the engagement team is unable to obtain sufficient appropriate audit evidence concerning opening balances, the audit report should be qualified due to the limitation on the scope of the work.

If the opening balances contain misstatements which could materially affect the current period's financial statements and the effect of the misstatement is not properly accounted for and adequately disclosed, one should express a qualified opinion. In addition, if the current period's accounting policies have not been consistently applied in relation to the opening balances and if the changes are not properly accounted for or disclosed then consideration should be given to express a qualified or an adverse opinion as appropriate.

11.1.2 Audit of Opening Balances Where Previous Year Audited by Another Firm

If another auditor audited the prior period's financial statements, one may be able to obtain sufficient appropriate audit evidence regarding the opening balances by discussions with, or confirmations from, the previous auditors or by reviewing their working papers. In these circumstances, consideration should be given to the professional competence and independence of the previous auditor. Prior to any communication with the previous auditor, the firm should obtain clearance from the client to communicate with the previous auditor.

The engagement team should review the prior year's audit report and must take appropriate action if that report was qualified. If the matter giving rise to the qualification remains unresolved or could have a material impact on the current year's figures, then the current year's audit report should be qualified or an emphasis of matter paragraph included, as appropriate.

11.2. Comparatives

ISA 710 requires the auditor to determine whether the comparatives comply in all material respects with the particular financial reporting framework relevant to the financial statements being audited.

The ISA provides two frameworks for the presentation of comparatives in the financial statements as follows:

- Corresponding figures: where amounts and other disclosures for the preceding periods are included as part of the current period financial statements, to be read in relation to the amounts and other disclosures relating to the current period.
- Comparative financial statements: where amounts and disclosures for the preceding periods are included for comparison with the current period financial statements, but do not form part of the current period financial statements.

In Uganda the framework used for the presentation of comparatives is that of corresponding figures. In carrying out the engagement, the engagement team should obtain sufficient appropriate audit evidence that the corresponding figures meet the requirements of the relevant financial reporting framework (IFRS in the context of Uganda). Audit procedures should ensure that corresponding figures have been correctly reported and are appropriately classified and will involve assessing whether:

- Accounting policies used for corresponding figures are consistent with those the current period or whether appropriate adjustments and / or disclosures have been made; and
- Corresponding figures agree with the amounts and other disclosures presented in the prior period or whether appropriate adjustments and / or disclosures have been made.

If the engagement team becomes aware of a possible material misstatement in the corresponding figures when performing the current period audit, they should perform such additional audit procedures as are appropriate in the circumstances.

11.3 Reporting

When comparatives are presented as corresponding figures, the audit report issued is one in which the comparatives are not specifically identified, and the opinion is on the current period's financial statements as a whole, including the corresponding figures.

11.3.1 Prior Period Audited by another Auditor

If the auditor's report on the prior period included a qualified opinion, disclaimer of opinion, or adverse opinion and the matter which gave rise to the modification:

- Is unresolved, and results in modification of the auditor's report regarding current period figures the current audit report should also be modified regarding the corresponding figures.
- Is unresolved, but does not result in the modification of the auditor's report regarding the current period figures, the auditor's report should be modified regarding the corresponding figures.

When the auditor's report on the prior period, as previously issued, included a qualified opinion disclaimer of opinion, or adverse opinion and the matter which gave rise to the modification s resolved and properly dealt with in the financial statements, the current report does not ordinarily refer to the previous modification. However, if the matter is material to the current period, then a~ emphasis of matter paragraph dealing with the situation should be included.

During the audit of the current period, if the engagement team becomes aware of a material misstatement affecting the prior period financial statements on which an unmodified report has previously been given, they should consider the guidance in ISA 560, 'Subsequent Events' and:

a) If the prior period financial statements have been revised and reissued with a new auditor's report, the engagement team should obtain sufficient audit evidence that the correspond;'"; figures agree with the revised financial statements; or
b) If the prior period financial statements have not been revised and reissued, and to the corresponding figures have not been properly restated and / or appropriate disclosures made the auditor should qualify his current period report with respect to the corresponding figures However, if the corresponding figures have been properly restated and / or appropriate disclosures given in these circumstances, the engagement team should include an emphasis c: matter paragraph in the audit report.

If, in the circumstances described above, the prior period financial statements have not been revised and an auditor's report has not been reissued, but the corresponding figures have been properly restated and / or appropriate disclosures have been made in the current period financial statements, the an emphasis of matter paragraph describing the circumstances and referencing to the appropriate disclosures may be included. Consider guidance in ISA 560.

If another auditor audited the prior period, and if the engagement team decides to refer to the predecessor's audit report, the firm's auditor report should indicate:

- That the prior period financial statements were audited by another auditor;
- The type of report issued, and if modified, the reasons for the modification; and
- The date of that audit report.

11.3.2 Prior Period Not Audited

If the prior period was not audited, the engagement team should state, in the audit report, that the corresponding figures are unaudited. Where the team identifies that the corresponding figures are materially misstated, management should be requested to revise the corresponding figures. If management refuses to revise the corresponding figures, the audit report should be modified appropriately.

11.4 Audit of Accounting Estimates

11.4.1 Accounting Estimates

Accounting estimates are defined by ISA 540 as "an approximation of a monetary amount in the absence of a precise means of measurement". This term is used for an amount measured at fair value where there is estimation uncertainty, as well as for other amounts that require estimation.

ISA 540 also provides the following as examples of accounting estimates:

- Allowances to reduce inventory and accounts receivable to their estimated realisable value.
- Depreciation on property, plant and equipment.
- Accrued revenue.
- Deferred tax.

- Provision for a loss from a lawsuit.
- Losses on construction contracts in progress.
- Provision to meet warranty claims.

The responsibility of making provisions for accounting estimates in the financial statements lies with the management of an entity. The risk of material misstatement is normally greater when accounting estimates are involved and these are made in conditions of uncertainty regarding the outcome of events that have occurred or are likely to occur and involve the use of judgment. In some cases the engagement team may determine that the risk of material misstatement related to an accounting estimate is a significant risk that requires special audit consideration.

11.4.2 Audit Procedures to be adopted on Testing of Accounting Estimates

The engagement team should design and perform further audit procedures to obtain sufficient appropriate audit evidence as to whether the entity's accounting estimates are reasonable in the circumstances and, when required, appropriately disclosed. The audit evidence available to detect a material misstatement in an accounting estimates is usually more difficult to obtain and less persuasive than audit evidence available to detect a material misstatement in other items in the financial statements.

An understanding of the procedures and methods, including relevant control activities, used by management in making the accounting estimates is important for the engagement team to identify and assess risks of material misstatement in order to design the nature, timing and extent of the further audit procedures.

The engagement team can adopt anyone or a combination of the following approaches in the audit of an accounting estimate:

11.4.2.1 Review and Testing of Processes Used by Management to Develop the Estimate

This involves:

- **Evaluation of Data and Consideration of Assumptions** - The data on which the estimate is based should accurate, complete and relevant. Where information produced by the entity is used, it will need to be consistent with the data processed through the information system relevant to financial reporting. For example, in substantiating a warranty provision, the ~ engagement team would obtain audit evidence that the data relating to products still within the warranty period at period end agree with the sales information within the information system relevant to financial reporting.

The engagement team may also seek audit evidence from sources outside the entity. For example, when examining a provision for inventory obsolescence calculated by reference to anticipated future sales, the team may, in addition to examining internal data such as past levels of sales, orders on hand and marketing trends, seek audit evidence from industry-produced sales projections and market analyses. Similarly, when examining management's estimates of the financial implications of litigation and claims, the engagement team would seek direct communication with the entity's lawyers.

The data collected should also be appropriately analysed and projected to form a reasonable basis for determining the accounting estimate. Examples are the analysis of the ageing of accounts receivable and the projection of the number of months of supply on hand of an item of inventory based on past and forecast usage.

The entity's basis for the principal assumptions used in the accounting estimate should be appropriate. In some cases, the assumptions will be based on industry or government statistics, such as future inflation rates, interest rates, employment rates and anticipated market growth. In other cases, the assumptions will be specific to the entity and will be based on internally generated data. Factors to consider when evaluating assumptions on which accounting estimates are based include:

- Reasonableness of the assumptions in light of results of past periods;
- Consistency with assumptions of other accounting estimates; and
- Consistency with appropriate management plans.

In the case of complex estimating processes that involve specialised techniques, for example, determining stage of completion of construction contracts, the engagement team should consider need to obtain expert advise, such as that of an architect or quantity surveyor.

The engagement team would review the continuing appropriateness of formulae used by management in the preparation of accounting estimates, based on knowledge of the financial results of the entity in prior periods, practices used by other entities in the industry and the future ~ plans of management as disclosed to the engagement team.

- **Testing of Calculations** - Appropriate audit procedures on management's calculation procedures relating to accounting estimates would need to be performed. The nature, timing and extent of audit procedures will depend on the assessed risk of material misstatement, which in turn is determined by factors such as the complexity involved in calculating the accounting estimate, the engagement team's understanding and evaluation of the procedures and methods, including relevant control activities used by the entity in producing the estimate and the materiality of the estimate in the context of the financial statements.

- **Comparison of Previous Estimates with Actual Results** - This will assist the engagement team in:

  - Obtaining audit evidence about the general reliability of the entity's estimating procedures and methods, including relevant control activities;
  - Considering whether adjustments to estimating formulae may be required; and
  - Evaluating whether differences between actual results and previous estimates have been quantified and that, where necessary, appropriate adjustments or disclosures have been made.

- **Consideration of Management's Approval Procedures** - the engagement team will need to evaluate whether review and approval procedures over accounting estimates are in place and whether the approval is done by the appropriate level of management and that there exists appropriate documentary evidence of review and approval.

11.4.2.2 Using an Independent Estimate

The engagement team can use and independent estimate and compare it with that of management. The auditor will need to evaluate the data, consider the assumptions and perform adequate audit procedures on the calculation procedures used in the development of the estimate.

11.4.2.3 Review of subsequent events

Events occurring after the year-end but prior to completion of the audit may provide the engagement team with evidence regarding accounting estimates. The auditor's review of such subsequent events may reduce, or even remove, the need for the auditor to review and perform audit procedures on the process used by management to develop the accounting estimate or to use an independent estimate in assessing the reasonableness of the accounting estimate.

11.4.3 Evaluation of Results

The engagement team should make a final assessment of the reasonableness of the entity's accounting estimates based on the understanding of the entity and its environment and whether the estimates are consistent with other audit evidence obtained during the audit.

The engagement team should consider whether there are any significant subsequent transactions or events which affect the data and the assumptions used in determining the accounting estimates.

Because of the uncertainties inherent in accounting estimates, evaluating differences can be more difficult than in other areas of the audit. When there is a difference between the engagement team's estimate of the amount best supported by the available audit evidence and the estimated amount included in the financial statements, the team should determine whether such a difference requires adjustment. If the difference is reasonable, it may not require adjustment. However, if the engagement team believes the difference is unreasonable, management would be requested to revise the estimate. If management refuses to revise the estimate, the difference would be considered a misstatement and would be considered with all other misstatements in assess-whether the effect on the financial statements is material.

The engagement team should also consider whether individual differences, which have bee accepted as reasonable, are biased in one direction, so that, on a cumulative basis, they may have a material effect on the financial statements. In such circumstances, the engagement team would evaluate the accounting estimates taken as a whole.

11.5 Auditing Fair Value Measurements and Disclosures

11.5.1 Introduction

ISA 545 states that “The auditor should obtain sufficient appropriate audit evidence that fair value measurements and disclosures are in accordance with the entity's applicable financial reporting framework”.

Management is responsible for making the fair value measurements and disclosures included in the financial statements. Therefore, it is important that management should establish an accounting and

- financial reporting process for determining the fair value measurements and disclosures, select appropriate valuation methods, identify and adequately support any significant assumptions used, prepare the valuation and ensure that the presentation and disclosure of the fair value measurements are in accordance with the entity's applicable financial reporting framework.

Fair value measurements for certain assets, for example quoted securities, can be measured easily and reliably, as information on the prices is readily available. However, where an asset does not have an active market (for example unquoted securities, or investment property), measurement of fair value may be more complex. In such cases, fair value may be estimated by management through the use of valuation models such as discounting of future cash flows, or through the use of an expert, such as an independent valuer.

11.5.2 Understanding the Entity's Approach for Determining Fair Value

As part of the understanding of the entity and its environment, including its internal control, the engagement team should obtain an understanding of the entity's process for determining fair value measurements and disclosures and of the relevant control activities sufficient to identify and assess the risks of material misstatement at the assertion level and to design and perform further audit procedures.

When obtaining an understanding of the entity's process for determining fair value measurements and disclosures, the engagement team according to IAS 545 considers, for example:

- The relevant control procedures over the process used to determine fair value measurements, including, for example, controls over data and the segregation of duties between those committing the entity to the underlying transactions and those responsible for undertaking the valuations.
- The expertise and experience of those persons determining the fair value measurements.
- The role of information technology in the process.
- The types of accounts or transactions requiring fair value measurements or disclosures (for example, whether the accounts arise from the recording of routine and recurring transactions or whether they arise from non-routine or unusual transactions).
- The extent to which the entity's process relies on a service organisation to provide fair value measurements or the data that supports the measurement.
- The extent to which the entity uses the work of experts in determining fair value measurements I and disclosures.
- The significant management assumptions used in determining fair value.
- The documentation supporting management's assumptions.
- The methods used to develop and apply management assumptions and to monitor changes in those assumptions.
- The integrity of change controls and security procedures for valuation models and relevant information systems, including approval processes.
- The controls over the consistency, timeliness and reliability of the data used in valuation models.

After obtaining an understanding of the entity's process for determining fair value measurements and disclosures, the engagement team should assess the risks of material misstatement at the assertion level related to the fair value measurements and disclosures in the financial statements to -L. determine the nature, timing and extent of further audit procedures.

The nature, timing and extent of the further audit procedures will depend upon the fair value measurement's susceptibility to misstatement and whether the process for determining fair value measurements is relatively simple or complex. The susceptibility to misstatement of fair value measurements may also increase due to the complexity of the accounting and financial reporting requirements. The engagement team considers the inherent limitations of controls in such circumstances in assessing the risk of material misstatement.

11.5.3 Audit Approach and Review of Assumptions

The engagement team's understanding of the requirements of the financial reporting framework and knowledge of the business and industry, together with the results of other audit procedures, are used to assess whether the accounting for assets or liabilities requiring fair value measurements is appropriate, and whether the disclosures about the fair value measurements and significant uncertainties related thereto are appropriate under the entity's financial reporting framework.

The engagement team should obtain audit evidence about management's intent to carry out specific courses of action, and consider its ability to do so, where relevant to the fair value measurements and disclosures under the entity's applicable financial reporting framework.

Management often documents plans and intentions relevant to specific assets or liabilities. While the extent of audit evidence to be obtained about management's intent is a matter of professional judgment, the audit procedures ordinarily include inquiries of management, with appropriate corroboration of responses, for example, by:

- Considering management's past history of carrying out its stated intentions with respect to assets or liabilities.
- Reviewing written plans and other documentation, including, where applicable, budgets, minutes, etc.
- Considering management's stated reasons for choosing a particular course of action.
- Considering management's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its contractual commitments.

Evaluating whether the method of measurement of fair value is appropriate in the circumstances requires the use of professional judgment. Where management selects one particular valuation method from alternative methods, the engagement team should obtain an understanding of management's reasons for doing so. The team should consider whether:

- Management has sufficiently evaluated and appropriately applied the criteria provided in the applicable financial reporting framework to support the selected method;
- The valuation method is appropriate in the circumstances given the nature of the asset or liability being valued and applicable financial reporting framework; and
- The valuation method is appropriate in relation to the business, industry and environment in which the entity operates.

In certain cases, management may determine that different valuation methods result in a range of significantly different fair value measurements. The engagement team should evaluate how the entity has investigated the reasons for these differences in establishing its fair value measurements.

The team should evaluate whether the entity's method for its fair value measurements is applied consistently, considering possible changes in the environment or circumstances affecting the entity, or changes in the applicable financial reporting framework.

Where management changes the valuation method, the auditor will need to consider whether management can adequately demonstrate that the valuation method to which it has changed provides a more appropriate basis of measurement, or whether the change is supported by a change in the requirements of the entity's applicable financial reporting framework or a change in circumstances.

The engagement team would also need to obtain sufficient and appropriate audit evidence relating to assumptions used by management in establishing fair value measurements. The team would evaluate whether assumptions used by management are reasonable, and information underlying the assumptions was relevant and reasonably available at the time. Estimation techniques and assumptions and the team's consideration and comparison of fair value measurements determined in prior periods, if any, to results obtained in the current period may provide audit evidence of the reliability of management's processes. However, the engagement team also considers whether variances in fair value measurements between the current and prior period arise as a result from changes in economic circumstances.

In certain cases, management will employ the services of an expert for valuation of specialised assets and liabilities of the entity (for example, valuation of investment property). As such, management will rely on the assumptions made by the expert to develop fair value measurements. The engagement team will need to pay particular attention to significant assumptions underlying a valuation method and evaluate whether such assumptions are reasonable. In order for assumptions to be relied upon to provide a reasonable basis for fair value measurements, they need to be relevant, reliable, neutral, understandable and complete.

The engagement team considers the sensitivity of the valuation to changes in significant assumptions, including market conditions that may affect the value. Where applicable, the team encourages management to use such techniques as sensitivity analysis to help identify particularly sensitive assumptions. In the absence of such management analysis, the engagement team considers whether to employ such techniques. The team also considers whether the uncertainty associated with a fair value measurement, or the lack of objective data may make it incapable of -reasonable estimation under the entity's applicable financial reporting framework in which case the auditor considers whether the auditor's report needs modification.

In determining whether the assumptions provide a reasonable basis for the fair value measurements, the engagement team will need to consider all the assumptions as a whole as well as each one individually. This is because an assumption when considered individually may appear -reasonable, which may not be the case when considered in conjunction with other assumptions.
The engagement team considers whether management has identified the significant assumptions and factors influencing the measurement of fair value.

The assumptions on which the fair value measurements are based ordinarily will reflect what management expects will be the outcome of specific objectives and strategies. To be reasonable, -such assumptions, individually and taken as a whole, also need to be realistic and consistent with:

a) The general economic environment and the entity's economic circumstances;
b) The plans of the entity;
c) Assumptions made in prior periods, if appropriate;
d) Past experience of, or previous conditions experienced by, the entity to the extent currently applicable;
e) Other matters relating to the financial statements, for example assumptions used by management in accounting estimates for financial statement accounts other than those relating to fair value measurements and disclosures; and
f) If applicable, the risk associated with cash flows, including the potential variability of the cash flows and the related effect on the discounted rate.

If management relies on historical financial information in the development of assumptions, the auditor considers the extent to which such reliance is justified. However, historical information might not be representative of future conditions or events, for example, if management intends to engage in new activities or circumstances change.

For items valued by the entity using a valuation model, the engagement team is not expected to substitute his or her judgment for that of the entity's management. Rather, the team reviews the model, and evaluates whether the model is appropriate and the assumptions used are reasonable.

The engagement team should perform audit procedures on the data used to develop the fair value measurements and disclosures and evaluate whether the fair value measurements have been properly determined from such data and management's assumptions.

The engagement team should also evaluate whether the disclosures about fair values made by the entity are in accordance with the entity's financial reporting framework (International Financial Reporting Standards, in the context of Uganda).

11.5.4 Evaluating Results

In making a final assessment of whether the fair value measurements and disclosures in the financial statements are in accordance with the entity's applicable financial reporting framework, the engagement team should evaluate the sufficiency and appropriateness of the audit evidence obtained as well as the consistency of that evidence with other audit evidence obtained and evaluated during the audit.

Where disclosure of fair value information is omitted because of the inability to determine fair value with sufficient reliability, the engagement team evaluates whether the financial statements are materially misstated as a result of the departure from the applicable financial reporting framework.

Depending on the nature, materiality and complexity of fair values, one should consider obtaining written representations from management regarding the reasonableness of significant assumptions, and whether they appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity where relevant to the fair value measurements or disclosures.

12. ANALYTICAL PROCEDURES

12.1 Nature and Purpose of Analytical Procedures

ISA 520 defines analytical procedures as evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount.

Examples of analytical procedures are:

- Comparisons of the entity's financial information with:
    - Prior years.
    - Other companies in its industry (such as comparing sales to accounts receivables with industry averages).
    - Budgets or forecasts.
    - Predictive estimates of the auditor (such as an estimation of depreciation charges).

- Analysis of relationships between elements of financial information that are expected to conform to a predictable pattern (such as gross margin percentages).
- Comparisons between financial and non-financial information (such as payroll costs to the number of employees).
- Comparisons between different branches or locations.

Various methods can be used in performing the above procedures, ranging from simple comparisons to complex analyses using advanced statistical techniques. Analytical procedures can be applied to consolidated financial statements, the financial statements of single entity's or individual divisions or elements of financial information. The engagement team's choice of procedures, methods and level of application is a matter of professional judgement.

Analytical procedures are used for the following purposes:

(a) At the planning stage as a risk assessment procedure to obtain an understanding of the entity and its environment;
(b) As substantive procedures during the execution phases, when their use can be more effective or efficient than tests of details in reducing the risk of material misstatement at the assertion level to an acceptably low level; and
(c) As an overall review of the financial statements at the completion stage to confirm that the financial statements as a whole are consistent with our understanding of the entity.

Benefits of analytical review:

i. Preliminary risk assessment: Assists in gaining an understanding of the business and helps direct audit work to key audit areas.
ii. Substantive procedures: May be an efficient way of obtaining substantive assurance thereby providing audit evidence to support the audit opinion.
iii. Completion: Assists in the overall review of the financial statements.

iv. Other benefits: Conclusions reached provide a source of recommendations to the client.

Possible sources of information for analytical review purposes include:

- Published industry information from newspapers or industry journals.
- Prior year financial statements.
- Management information (management accounts, budgets, cash flows and forecasts).
- Purchase and sales day book summaries and general ledgers.
- Tax returns and correspondence.
- Non-financial data (for example, number of employees).

12.2 Types of Analytical Techniques

Analytical techniques can be classified under three broad headings:

Trend analysis

This is the analysis of changes in a given item over time.

Trend analysis procedures could include:

- Period by period comparisons.
- Graphs of recent and historic results.
- Weighted averages of recent and historical results.
- More complicated statistical techniques such as regression analysis.

One danger of trend analysis is that trends may be explained by general explanations without further investigation being undertaken.

Ratio analysis

Ratio analysis procedures compare relationships between items in the accounts over time, or between different entities. Ratio analysis may involve comparison of financial ratios, or items compared with other items (for example, cost of sales as a percentage of sales).

In order for ratio analysis to be helpful, the ratios compared must have been calculated on a consistent basis and the relationship between the factors in the ratio should be stable.

Reasonableness tests

Reasonableness procedures aim to develop an estimate of an item, based on the auditor's understanding of relationships involving relevant financial and operating data. Examples of reasonableness tests include overall verification procedures (such as average hotel occupancy numbers, multiplied by average room charges, should approximate to total revenue) and proof in total tests (such as opening inventory, plus inventory produced, less inventory sold, equals closing inventory, which should equal inventory counted at the accounting year-end). For reasonableness tests to work, all relevant factors have to be considered.

12.3 Analytical Procedures as Risk Assessment Procedures

ISA 520 requires that analytical procedures should be applied as risk assessment procedures at the planning stage. The aims of doing so are to: Assist in understanding the entity's business:

- Identify areas of potential risk (such as problems with going concern, liquidity, problems with divisions, locations and other unexpected features); and
- Help determine the "nature, timing and extent of other auditing procedures.

Analytical procedures at the planning stage can identify potential operating and control problems, and indicate the extent to which analytical review will be used in substantive testing.

Procedures at the planning stage will normally be of a general nature reviewing key business ratios.

12.4 Analytical Procedures as Substantive Procedures

The engagement team may design and perform substantive procedures to be responsive to the related assessment of the risk of material misstatement at the assertion level. The use of substantive procedures at the assertion level may comprise fests of details or substantive analytical procedures or a combination of both. The decision about which audit procedures to use to achieve a particular audit objective is based on the engagement team's judgment about the expected effectiveness and efficiency of the available audit procedures in reducing the assessed risk of material misstatement to an acceptably low level. The use of analytical procedures as substantive procedure requires the design of procedures and comparing the outcomes with expectations that the engagement team has developed against which to compare the outcomes.

When relying on analytical procedures as a substantive procedure, the engagement team will ordinarily inquire of management as to the availability and reliability of information needed to apply substantive analytical procedures and the results of any such procedures performed by the entity. It may be efficient to use analytical data prepared by the entity, provided the team is satisfied that such data is properly prepared.

When designing and performing analytical procedures as substantive procedures, the engagement team will need to consider a number of factors such as the following:

- Suitability of using substantive analytical procedures given the assertions.
- The reliability of the data.
- Whether the expectation is sufficiently precise.

12.4.1 Suitability of Using Substantive Analytical Procedures Given the Assertions

Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time. The application of substantive analytical procedures is based on the expectation that relationships among data exist and continue in the absence of known conditions to the contrary. The presence of these relationships provides audit evidence as to the completeness, accuracy and occurrence of transactions captured in the information produced by the entity's information system. However, reliance on the results of substantive analytical procedures will depend on the engagement team's assessment of the risk that the analytical procedures may identify relationships as expected when, in fact, a material misstatement exists.

In determining the suitability of substantive analytical procedures given the assertions, consideration should be given to the following:

a. The assessment of the risk of material misstatement - The engagement team considers the understanding of the entity and its internal control, the materiality and likelihood of misstatement of the items involved, and the nature of the assertion in determining whether substantive analytical procedures are suitable. For example, if controls over sales order processing are weak, the team may place more reliance on tests of details rather than substantive analytical procedures for assertions related to receivables. As another example, when inventory balances are material, one does not ordinarily rely only on substantive analytical procedures when performing audit procedures on the existence assertion.
b. Any tests of details directed toward the same assertion - Substantive analytical procedures may also be considered appropriate when tests of details are performed on the same assertion. For example, when auditing the collectability of accounts receivable, one may apply substantive analytical procedures to an ageing of customers' accounts in addition to tests of details on subsequent cash receipts.

12.4.2. The Reliability of the Data

The reliability of data is influenced by its source and by its nature and is dependent on the: circumstances under which it is obtained. In determining whether data is reliable for purposes of designing substantive analytical procedures, consideration should be given to the following:

a. Source of the information available - For example, information is ordinarily more reliable when it s obtained from independent sources outside the entity:
b. Comparability of the information available - For example, broad industry data may need to be supplemented to be comparable to that of an entity that produces and sells specialised products.
c. Nature and relevance of the information available - For example, whether budgets have been established as results to be expected rather than as goals to be achieved.
d. Controls over the preparation of the information. For example, controls over the preparation, review and maintenance of budgets.

12.4.3. Whether the Expectation is Sufficiently Precise

When testing the reliability to data, the engagement team should consider testing the controls if any, over the entity's preparation of information which is to be used by the engagement team in applying substantive analytical procedures. When such controls are effective, the team develops greater confidence in the reliability of the information and, therefore, in the results of substantive analytical procedures.
In assessing whether the expectation can be developed sufficiently precise to identify a material misstatement at the desired level of assurance, consideration should be given to the following:

- The accuracy with which the expected results of substantive analytical procedures can be predicted. For example, the engagement team should ordinarily expect greater consistency comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising.

- The degree to which information can be disaggregated. For example, substantive analytical procedures may be more effective when applied to financial information on individual sections of an operation or to financial statements of components of a diversified entity, than when applied to the financial statements of the entity as a whole.

- The availability of the information, both financial and non-financial. For example the engagement team should consider whether financial information, such as budgets or forecasts and non-financial information, such as the number of units produced or sold, is available design substantive analytical procedures. If the information is available, the team should also consider the reliability of this information.

12.2.4. Amount of Difference of Recorded Amounts from Expected Values that is Acceptable.

In designing and performing substantive analytical procedures, the engagement team considers the amount of difference from expectation that can be accepted without further investigation consideration is influenced primarily by materiality and the consistency with the desired level of assurance. Determination of this amount involves considering the possibility that a combination of misstatements in the specific account balance, class of transactions, or disclosure could aggregate to an unacceptable amount. Any increase in the desired level of assurance as the risk of material misstatement increases is compensated by reducing the amount of difference from the expectation that can be accepted without further investigation.

When the engagement team performs substantive procedures at an interim date and plans to perform substantive analytical procedures with respect to the intervening period, the team considers the results affect the ability to obtain sufficient appropriate audit evidence for the remaining period. This includes considering whether the period end balances of the particular classes of transactions or account balances are reasonably predictable with respect to amount, relative significance, and composition.

12.5. Approach to using Analytical Review as Substantive Procedures

If it is decided to use analytical procedures as substantive procedures, a methodical approach is essential. The process can be summarised as a series of stages:

a. *Define the item or relationship* to *be used*

Consider first of all:

- The relevance and reliability of the relationship being considered for testing.
- The complexity of the relationship.
- The level of detail available and required.
- Any shortcomings, such as the possibility of over-simplification or circular proofs of relationships.

b. Define the objectives of the review process

For example, it may be desired to use analytical review techniques to decide on the completeness or accuracy of sales.

c. Consider any factors that could lead to deviations from expected results

For sales, these could include year-end cut-off procedures or changes in the price or product mix.

d. Determine the examination methods

This could include the type of procedure to be used, whether complex techniques are to be used, and also whether the use of computerised comparisons is likely.

e. Define a significant deviation from expected results

Factors to consider would include:

- The materiality level chosen.
- The level of confidence chosen.
- The direction of the test (testing for over or understatement).
- The expected sizes of deviation.

f. Specify the reliance desired (i.e. the assurance required from analytical review procedures*)*

Factors to consider would include:

- The nature of the assertions being audited.
- The extent to which assurance will be gained from analytical procedures and other tests.
- The risks of error in the population.
- The precision of the procedure to be adopted.

12.5.1. Utilising the Techniques

a. Ensure Control - members of the engagement team performing the techniques should be we briefed, and any analytical data generated by the entity should be reviewed.
b. Ensure the procedures are fully documented.

12.5.2. Examine any Deviations from Expected Results

Identify deviations
Deviations may be of a number of different types:

- Normal deviations (business trends, seasonal changes, trading cycles).
- Isolated deviations (those caused by changes in accounting policies or unusual items).
- Abnormal deviations (those caused by accounting policies applied incorrectly, inadequate accounting or irregularities).

Significant movements in the major figures in the financial statements will need to be explained for each audit area.

Investigate significant deviations

If comparisons between the amounts predicted and the amounts recorded reveal unexpected deviations (such as unexpected variations between prior year and current year recorded figures, based on our knowledge of activities which have occurred during the year), these should be discussed with the management of the entity.
Management explanations should not be accepted in isolation. It may be that they are supported by audit evidence already available.

Further procedures may, however, be necessary. These may include:

- Extending the analytical procedure: The original procedure may need to be adjusted, following additional factors identified in testing. The reliability of such factors will need to be corroborated I in the same way as the factors used originally. In some cases a detailed analysis of individual accounts may be necessary, to determine whether the explanations received are acceptable.
- Examining documentation: This may be necessary where the difference is caused by a small number of unusual or infrequently occurring transactions.
- Making enquiries of others, if possible: Explanations from management in one sector may be confirmed by management in a different one.
- Conducting additional substantive tests, if the explanations received appear inadequate.

12.5.3. Evaluating the Results and Forming Conclusions

The degree of reliance to be placed on analytical tests needs to be considered. Reliance may range from total reliance (such as proving an account balance in total) to no reliance.
Factors to consider when assessing how much reliance can be placed on the results could include:

- Any analytical procedures that show similar results.
- The extent variations have been corroborated by explanations or other audit procedures directed towards the same objectives.
- The materiality of the items involved (for example, when inventory balances are material, the auditor does not rely only on analytical procedures in forming his conclusions).

In order to be able to place high reliance on analytical review (and therefore assess analytical risk as low), the engagement team must be satisfied that the results represent relevant and reliable evidence, corroborated by explanations and other evidence. If high reliance is being placed on analytical review, it may be possible to confine substantive tests of detail to high value and key items only. However, if the item is particularly material, the engagement team should consider undertaking some testing of representative items (i.e. audit sampling).

The engagement team should also consider whether the conclusions drawn impact on other audit areas (for example, assessment of the management or whether the going concern basis is appropriate).

12.6. Recording of Analytical Review

Analytical procedures must be documented in order to provide valid support for the audit opinion.

Any working papers which detail analytical procedures used as substantive tests should include:

- The objectives of the tests.
- The sources of the information used.
- Details of the procedures performed (such as trends, ratios, or reasonableness tests).
- The basis of calculations and the documentation of the expectations against which to compare the outcome
- All assumptions used.
- Other factors affecting the procedures used.
- Any predictions made and tolerable ranges or results accepted.
- The extent and nature of variations, highlighting significant fluctuations.
- Explanations obtained for variations, including their origin.
- Tests carried out to verify explanations received.
- Any re-calculations and other procedures considered necessary.
- The extent of any effect on the audit plan, in other areas.
- The conclusions reached, including an estimate of the amount of misstatements.

12.7. Analytical Risk

Analytical risk is the risk that analytical procedures, used as substantive procedures, may fail to detect a material error. In order ensure that analytical risk is low, key relationships need to be' predicted with confidence, using available data. If the procedures used by the engagement team are of limited reliability, the team should assume a high analytical risk and rely on alternative audit procedures in obtaining sufficient and reliable audit evidence. High risk means that substantive tests will become more important elements in the audit process, and therefore more assurance will be required from them resulting in higher sample sizes.

The assessment of analytical risk serves two purposes, that is, they:

- Help assess whether analytical procedures will be worthwhile as substantive tests. High analytical risk indicates that analytical procedures will not be useful as substantive tests, as they will only provide a low level of assurance.
- If analytical procedures are performed, the assessment helps to determine the level of reliance that can be placed on the results of those procedures, and how much the auditor has to rely on detailed tests of balances and transactions.

In conclusion, while analytical procedures may be used as substantive procedures, consideration should be given to the cost-benefit analysis of using them compared to other substantive compliance procedures that may be more cost effective. Even when analytical procedures are used the procedures adopted, the reliability of the data used in the procedures, the expectations developed and the conclusions should be recorded as part of the audit work. In the case of small and medium entities which may not have a complex management information system, the use c: analytical procedures as substantive procedure may in most cases not provide sufficient and reliable audit evidence.

12.8. Analytical Procedures at Conclusion

ISA 520 requires the auditor to apply analytical procedures at or near the end of the audit, when forming an overall conclusion as to whether the financial statements, as a whole, are consistent with the auditor's understanding of the entity. The conclusions drawn from the results of such audit procedures are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements and assist in arriving at the overall conclusion as to the reasonableness of the financial statements. However, they may also identify a previously unrecognised risk of material misstatement. In such circumstances, the engagement team may need to re-evaluate the planned audit procedures, based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and relate: - assertions.

When analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts, the engagement team should investigate and obtain adequate explanations and appropriate corroborative audit evidence. The investigation of unusual fluctuations and relationships ordinarily begins with inquiries of management, followed by:

- Corroboration of management's responses, for example, by comparing them with the engagement team's understanding of the entity and other audit evidence obtained during the course of the audit; and
- Consideration of the need to apply other audit procedures based on the results of such inquiries, if management is unable to provide an explanation or if the explanation is not considered adequate.

Appendix 19: **Guide to Drawing Conclusions from Analytical Procedures** provides some consideration that may be considered in drawing conclusions from the use of analytical procedures at the conclusion stage.

13. SUBSTANTIVE TESTING OF TRANSACTIONS AND ACCOUNT BALANCES

13.1 Definition

Substantive tests are tests of detail of transactions, balances and disclosures which seek to substantiate the completeness, accuracy and validity of the information contained in the accounting records or financial statements. They include inspection of records, documents or assets and external confirmations. The objective of these tests, together with other procedures such as analytical review, is to verify the substance of the income, expenditure, assets and liabilities, which have *been* incorporated in the accounting records. Tests are also necessary to verify that no material omissions have occurred in compiling the records. Substantive tests must be performed for each material class of transactions, balances and disclosures even if all risks have been assessed as low.

Substantive procedures also include:

- Agreeing the financial statements to the underlying records.
- Examining the journal entries passed while preparing the financial statements.
- Evaluation of whether the overall presentation of the financial statements, including disclosures, is in accordance with International Financial Reporting Standards (IFRS).

13.2. Directional Testing

In order to design an efficient programme of substantive tests, the primary aim of each test needs to be defined. Consideration also needs to be given as to what extra assurance can be gained from the tests contemplated, as well as the assertions being sought. Use of directional testing enables this to be done.

The principle of directional testing is that the objective of an audit test is usually to detect either understatement or overstatement (and in rare cases, both). Accordingly, an audit test should only be expected to find errors consistent with its objective (i.e. a test for overstatement of receivables should only be relied upon to find errors in relation to overstatement of receivables and should not be relied upon to find errors of understatement of the same). However, due to the features of double-entry bookkeeping, an error of overstatement results in *either* an understatement or an overstatement of another item in the accounts, depending on whether the items concerned are assets or liabilities. For example, if an asset is overstated, there is a possibility that either:

(i) another asset is understated - e.g. a posting error between two classes of asset;
(ii) a liability has been overstated - e.g. an invalid liability has been established to finance an invalid asset;
(iii) an item of expenditure has been understated - e.g. an asset has been incorrectly capitalised; or
(iv) an item of income has been overstated - e.g. an incorrect amount of investment income has been accrued.

Therefore if assets and expenditure are tested for overstatement, and income and liabilities are tested for understatement, all possible misstatements should be capable of being addressed.

The Effect of Directional Testing on Test Design

a. Tests for overstatement

Expenditure

Tests should start at the latest convenient point for summarising expenditure (the nominal ledger, cash book or purchases daybook). The items are traced backwards to supporting documentation (invoices or purchase orders).

Assets

The assets recorded in the accounting records should be verified with evidence of their existence, ownership and valuation, to supporting documentation.

b. Tests for understatement

Income

Tests should start at the earliest point at which a transaction for goods or services is recorded (e.g. goods despatched note). This record is then traced forward to an invoice - sales daybook, and cashbook, or other record summarising income, for processing to the nominal ledger.

Liabilities

Tests include:

- Cut off testing;
- A review of the following year's expenditure to verify that liabilities are not understated in the current year; and
- Determining the possible types of liabilities that an entity may have incurred and then communicating directly with the relevant third parties to ascertain their view of the liabilities.

It should be noted that tests of understatement would often be tests of overstatement of reciprocal populations and classes of transactions (for example, examining the following period's accounting "records for overstated liabilities, to verify that the current period liabilities have not been understated. Also, testing trade receivables for overstatement automatically tests sales for overstatement and vice-versa).

13.3. Other Considerations in the Design of Substantive Tests

Irrespective of the assessed risk of material misstatement, the engagement team should design and perform substantive procedures for each material class of transactions, account balance, and disclosures. ISA 313 requires the auditor to perform substantive procedures that are specifically responsive to any significant risk of material misstatement at the assertion level.

Substantive testing may be omitted where the aggregate value of transactions is less than the materiality level when testing for overstatement and the accounting system appears to be reliable.

The entity may decide to carry out year-end procedures, such as inventory counting, before the year-end. Audit tests will need to be carried out on such procedures. In addition, other audit work may be conducted (such as confirmation of debtor balances). In these circumstances, testing of the accounting systems should be designed to ensure that the system will identify any adjustments required in the remaining period, up to the year-end. Certainty will be required over the entity's cut off procedures.

It will also be necessary to obtain sufficient audit evidence in relation to the period from the date of the pre-year end audit tests to the year-end. This evidence may be obtained by controls testing during that period, substantive transaction tests during that period, through analysis, or through repeating substantive tests at the year-end.

13.4. Selection of Substantive Tests

The following factors need to be considered when selecting the type of substantive tests to be used.

- ***Audit objective*** - The aim of the test needs to be established, including whether the test is for overstatement or understatement. The tests selected may also help achieve other audit objectives, such as gaining an understanding of the entity or gathering information for financial statement purposes.

- ***Understanding the entity and its environment*** - The evaluation of risks of material misstatement is important. The evidence, which can be obtained, and how easy it is to obtain it, should also be considered.

- ***The level* of *assurance required*** - The individual tests, and how the tests will combine to give greater audit assurance, will be important here.

- ***The diversity* of *items*** - The diversity of items, which comprise an account balance or class of transactions, may require different types of tests to be performed (in some cases, it may be difficult to obtain sufficient audit evidence from a single test).

- ***The cost and time involved*** - It is not acceptable to allow cost considerations to prevent the performance of sufficient and necessary audit work. However, the most cost effective way to obtain the required audit evidence should always be looked for.

13.5. Types of Substantive Tests

- **Proofs in total**
  "Proofs in total" are where the theoretical total of the account balance or class of transactions can be determined or computed from independent information, and then compared with the actual results (for example, sales and production figures could be supported by reference to the consumption of key raw materials).

- **100% testing**
  It may be most appropriate to examine the entire population of items that make up a class of transactions or account balance (or a stratum within that population). 100%

examination is unlikely in the case of tests of controls; however, it is more common for tests of details. For example, 100% examination may be appropriate when the population constitutes a small number of large value items, when there is a significant risk and other means do not provide sufficient appropriate audit evidence, or when the repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective, for example, through the use *or* computer-assisted audit techniques (CAATs).

- **Selective testing procedures**

This is where one selects specific items from a population based on such factors as the auditor's understanding of the entity, the assessed risk of material misstatement, and the characteristics of the population being tested. Since all items are not examined, there is a risk that the audit opinion will be incorrect. A rational basis is therefore needed in selecting items for examination.

The basis for selection may consist of:

(a) ***High value items*** - The selection of high value items is where all items over a certain value 'are selected for testing. This method is normally used where an error in one high value item could have a material effect on the financial statements, or where it is an efficient way of forming an opinion on a large proportion of a population being tested.
(b) ***Key items* -** Key items selection is where items are selected, because they are believed to be more susceptible to risks of material misstatement. These may include suspicious or unusual items, items with a history of error in previous years or any apparent inconsistencies ~ identified (it could also include high-value items).
(c) ***Items* to *obtain informatio****n* - Items may be examined to obtain information about matters such as the nature of the entity, the nature of transactions, and internal control.
(d) ***Items* to *test control activities*** - Judgement may be used to select and examine specific items to determine whether or not a particular control activity is being performed.

The decision as to which approach to use will depend on the circumstances, and the application of anyone or combination of the above means may be appropriate in particular circumstances. While the decision as to which means, or combination of means, to use is made on the basis of the risk of material misstatement related to the assertion being tested and audit efficiency, the engagement team needs to be satisfied that methods used are effective in providing sufficient appropriate audit evidence to meet the objectives of the audit procedure.

- **Scrutiny and review**

Scrutiny tests can be performed to in relation to review of documents and certain other accounting record like ledger accounts and cash books. These are usually performed to enable the auditor to determine large or unusual transactions which warrant special attention or to verify underlying supporting documentation.

- **Analytical review**

Covered in Section 12.

14. SAMPLING

14.1. Definition

Audit Sampling (sampling) is the application of audit procedures to less than 100% of items within a population of audit relevance such that all sampling units have a chance of selection in order to provide the auditor with a reasonable basis on which to draw conclusions about the entire population.

Audit sampling can use either a statistical or a non- statistical approach.

Other key definitions as per ISA 530 are:

- **Anomaly –** A misstatement or deviation that is demonstrably not representative of misstatements or deviations in a population.
- **Population** - The entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions. For example, all of the items in a class of transactions or account balance constitute a population. A population may be divided into strata, or sub-populations, with each stratum being examined separately. The term population is used to include the term stratum.
- **Sampling risk -** Arises from the possibility that the auditor's conclusion, based on a sample may be different from the conclusion reached if the entire population were subjected to the same audit procedure. There are two types of sampling risk:

  - The risk the auditor will conclude, in the case of a test of controls, that controls are more effective than they actually are, or in the case of a test of details, that a material error does not exist when in fact it does. This type of risk affects audit effectiveness and is more likely to lead to an inappropriate audit opinion; and
  - The risk the auditor will conclude, in the case of a test of controls, that controls are less effective than they actually are, or in the case of a test of details, that a material error exists when in fact it does not. This type of risk affects audit efficiency, as it would usually lead to additional work to establish that initial conclusions were incorrect.
    The mathematical complements of these risks are termed confidence levels.

- **Non-sampling risk -** Arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the size of the sample. For example, ordinarily the auditor finds it necessary to rely on audit evidence that is persuasive rather than conclusive, the auditor might use inappropriate audit procedures, or the auditor might misinterpret audit evidence and fail to recognize an error.

- **Sampling unit** - Means the individual items constituting a population, for example checks listed on deposit slips, credit entries on bank statements, sales invoices or debtors' balances, or a monetary unit.

- **Statistical sampling** - Any approach to sampling that has the following characteristics:

  - Random selection of a sample; and
  - Use of probability theory to evaluate sample results, including measurement of sampling risk.

A sampling approach that does not have characteristics (a) and (b) is considered non statistical sampling.

- **Stratification** - The process of dividing a population into subpopulations, each of which is a group of sampling units, which have similar characteristics (often monetary value).
- **Tolerable error** - The maximum error in a population that the auditor is willing to accept.
- **Tolerable misstatement** – A monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.
- **Tolerable rate of deviation** – A rate of deviation from prescribed internal control procedures set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the rate of deviation set by the auditor is not exceeded by the actual rate of deviation in the population.

14.2. Sample Design, Size and Selection of Items for Testing.

In designing an audit sample, the auditor should consider:

- The purpose of the audit procedure and the characteristics of the population from which the sample will be drawn.
- The sample size sufficient to reduce sampling risk to an acceptably low level.
- Select items for the sample in such a way that each sampling unit in the population has a chance of selection.

Audit sampling enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can be applied using either non-statistical or statistical sampling approaches.

In considering the characteristics of the population from which the sample will be drawn, the auditor may determine that stratification or value weighted selection is appropriate.

The decision whether to use a statistical or non-statistical sampling approach is a matter for the auditor's judgment; however, sample size is not a valid criterion to distinguish between statistical and non-statistical approaches.

14.3. Overview of the Sampling Process

When designing an audit sample, the engagement team should consider the objectives of the audit procedure and the attributes of the population from which the sample will be drawn.

Objectives

When designing an audit sample, the auditor's consideration includes the specific purpose to be achieved and the combination of audit procedures that is likely to best achieve that purpose. Consideration of the nature of the audit evidence sought and possible deviation or misstatement conditions or other characteristics relating to that audit evidence will assist the auditor in defining what constitutes a deviation or misstatement and what population to use for sampling. In fulfilling the requirements of ISA 500, when performing audit sampling, the auditor performs audit procedures to obtain evidence that the population from which the audit sample is drawn is complete.

The auditor's consideration of the purpose of the audit procedure, includes a clear understanding of what constitutes a deviation or misstatement so that all, and only, those conditions that are relevant to the purpose of the audit procedure are included in the evaluation of deviations or projection of misstatements. For example, in a test of details relating to the existence of accounts receivable, such as confirmation, payments made by the customer before the confirmation date but received shortly after that date by the client, are not considered a misstatement. Also, a misposting between customer accounts does not affect the total accounts receivable balance. Therefore, it may not be appropriate to consider this a misstatement in evaluating the sample results of this particular audit procedure, even though it may have an important effect on other areas of the audit, such as the assessment of the risk of fraud or the adequacy of the allowance for doubtful accounts.

In considering the characteristics of a population, for tests of controls, the auditor makes an assessment of the expected rate of deviation based on the auditor's understanding of the relevant controls or on the examination of a small number of items from the population. This assessment is made in order to design an audit sample and to determine sample size. For example, if the expected rate of deviation is unacceptably high, the auditor will normally decide not to perform tests of controls. Similarly, for tests of details, the auditor makes an assessment of the expected misstatement in the population. If the expected misstatement is high, 100% examination or use of a large sample size may be appropriate when performing tests of details.

Population

It is important for the engagement team to ensure that the population is:

(a) ***Appropriate*** to the objective of the audit procedure, which will include consideration of the direction of testing. For example, if the engagement team's objective is to test for overstatement of accounts payable, the population could be defined as the accounts payable listing. On the other hand, when testing for understatement of accounts payable, the population is not the accounts payable listing but rather subsequent disbursements, unpaid invoices, suppliers' statements, unmatched receiving reports or other populations that provide audit evidence of understatement of accounts payable; and

(b) ***Complete.*** For example, if one intends to select payment vouchers from a file, conclusions cannot be drawn about all vouchers for the period unless one is satisfied that all vouchers have in fact been filed. Similarly, if the engagement team intends to use the sample to draw conclusions about whether a control activity operated effectively during the financial reporting period, the population needs to include all relevant items from throughout the entire period.

Audit efficiency may be further improved if the population is stratified by dividing it into discrete subpopulations which have an identifying characteristic. Stratification reduces the variability of items within each stratum, thereby allowing sample size to be reduced without a proportional increase in sampling risk. Sub-populations need to be carefully defined such that any sampling unit can only belong to one stratum.

When performing tests of details, a class of transaction or account balance is often stratified by monetary value. This allows greater audit effort to be directed to the larger value items which may contain the greatest potential monetary error in terms of overstatement. Similarly, a population may be stratified according to a particular characteristic that indicates a higher risk of error, for example, when testing the valuation of accounts receivable, balances may be stratified by age.

The results of audit procedures applied to a sample of items within a stratum can only be projected to the items that make up that stratum. To draw a conclusion on the entire population, the engagement team will need to consider the risk of material misstatement in relation to whatever other strata make up the entire population. For example, 20% of the items in a population may --make up 90% of the value of an account balance. The engagement team may decide to examine a
sample of these items, and evaluate the results of this sample to reach a conclusion on the 90% of the value separately from the remaining 10% (on which a further sample or other means of gathering --audit evidence will be used, or which may be considered immaterial).

14.4. Statistical Versus Non-Statistical Sampling

The decision whether to use a statistical or non-statistical sampling approach is a matter for the engagement team's judgment regarding the most efficient manner to obtain sufficient appropriate audit evidence in the particular circumstances. The method of sample selection will affect not only the sample sizes used but also the method by which errors will be evaluated.

When applying statistical sampling, the sample size can be determined using either probability theory or professional judgement. Non-statistical sampling relies on one's professional judgement.
The advantages of statistical sampling are:

- It imposes a more formal discipline towards planning the audit of a population
- The required sample size is determined objectively
- The evaluation of test results is made more precisely and the sampling risk is quantified.

The disadvantages of statistical sampling are:

- Lack of judgement *(however, note that judgement is used to set the objectives for the sample and to evaluate the results* of *tests).*
- Statistical sampling produces one sample size (which may be inappropriate).
- Statistical procedures can take time to set up and to implement. However in practice, little extra time is incurred in planning a statistical sampling approach and statistical procedures are particularly cost effective if:
    - o there is a large population; and
    - o a large number of small items are being examined, rather than a small number of larger items.
- Statistical sampling procedures impact on sample sizes. It is possible that statistical sample sizes could be higher than those derived at using judgmental methods (this however, depends on the judgement of the person carrying out the test).

NOTE: if the engagement team considers that the statistical sample size derived is higher than required, the sample size can be reduced based on the engagement team's professional judgement, and provided that reasons for doing so are fully justified and documented.

For different populations to be audited different sampling procedures should be considered; key factors in deciding whether or not to use statistical sampling are the extent of reliance on substantive tests of detail, and the desire to quantify risk and obtain assurance.

For audit of medium and small sized entities non-statistical sampling may be the preferred method and statistical procedures may not be cost-effective. When using non-statistical sampling, the number of transactions chosen would be dependent on the assessment of risk, the higher the audit risk, the higher the number of transactions selected. What is however important that the working papers clearly state the method chosen and the sample selected.

14.5. Documenting the Sampling Process

The following should be stated whatever sampling procedures are used:

- The objectives of the procedure and the definitions of error.
- The definition of the population (and the population value if relevant).
- How it was ensured that selection was made from a complete population.
- The definition of the sampling unit.
- The risk of incorrectly accepting a test result.
- The tolerable error level or rate.
- The size of the sample and the sampling interval.
- The method of sample selection.
- The nature, causes and follow-up of errors found.
- Sample evaluation procedures.
- The overall audit conclusions.

NOTE: All errors found above the tolerable error level should be included in the overall summary of unadjusted errors schedule.

14.6. Methods of Selecting the Sample

As per ISA 530, *"The auditor should select items for the sample with the expectation that all sampling units in the population have* a *chance of selection".*

The sample selection methods will depend on whether statistical or judgemental sampling is used.

The principal methods of sample selection are as follows:

a) Random selection - using of a computerized random number generator (through CAATs) or random number tables.
b) Systematic selection - The number of sampling units in the population is divided by the sample size to give a sampling interval, for example 50, and having determined a starting point within the first 50, each 50th sampling unit thereafter is selected. Although the starting point may be determined haphazardly, the sample is more likely to be truly random if it is determined by use of a computerized random number generator or random number tables. When using systematic selection, the engagement team would need to determine that sampling units within the population are not structured in such a way that the sampling interval corresponds with a particular pattern in the population.

c) Monetary Unit Sampling – is a type of value-weighted selection in which a sample size, selection and evaluation results in a conclusion in monetary amounts.
d) Haphazard selection - In this, the sample is selected without following a structured technique Although no structured technique is used, one would nonetheless avoid any conscious bias or predictability (for example, avoiding difficult to locate items, or always choosing or avoiding the first or last entries on a page) and thus attempt to ensure that all items in the population have a chance of selection. Haphazard selection is not appropriate when using statistical sampling.
e) Block selection - This involves selecting a block(s) of contiguous items from within the population. Block selection cannot ordinarily be used in audit sampling because most populations are structured such that items in a sequence can be expected to have similar characteristics to each other, but different characteristics from items elsewhere in the population. Although in some circumstances it may be an appropriate audit procedure to examine a block of items, it would rarely be an appropriate sample selection technique when one intends to draw valid inferences about the entire population based on the sample. An example of where block selection can be used as a sample selection technique is when testing for cut-offs.

14.7. Planning the Sample

When planning the sample, the following need to be considered:

- **The audit objectives**

In particular, this would be whether tests are for overstatement or understatement, or whether it is a test of controls.

- **The population**

The parameters of the population to be tested need to be determined. It must be ensured that the population, from which the sample is to be drawn, is appropriate for the specific audit objective (for example, if testing trade receivables, the population should be the trade receivable balances listing; if testing trade payables, the population should be subsequent disbursements, unpaid invoices and suppliers' statements). When defining a population, the following should be remembered:

- The results of a test on a sample can only be evaluated to form a conclusion on the population from which the sample is taken.
- Sampling from a population does not establish the completeness of that population.
- The extent of key or high value items must be considered.
- The different considerations that apply to debit or credit balances within an account balance.
- The extent to which a population can be divided into smaller populations, each of which is a group of sampling units with similar characteristics (that is, how stratified the population can be).

- **The sampling unit**

The sampling unit needs to be defined, as the selection of the sample and the evaluation of the test results depend on the unit selected. The value of all units must equal the total value of the account balance or class of transactions. Often the population can be divided into sampling units in a variety of ways (for example, in trade receivables balances confirmation requests, customer balances, individual invoices or items on invoices can be used). Efficiency will be the main consideration in determining the sampling unit.

- **The definition of error**

There must be a clear definition of what constitutes an error (such as a departure from a control or an error in monetary terms) and to define it there must be a clear understanding of the objective of the test. For example, the purpose of examining trade receivables is to determine whether individual balances in the total trade receivables account are actually owed to the entity, and to assist in determining whether sales cut-off has been performed satisfactorily. The purpose of the test is not to determine whether the debtor will be able to pay (although information may be received during the confirmation procedure that will indicate this).

- **Defining tolerable and expected error**

Having defined an error, consideration must be given as to what the tolerable error will be. Tolerable error has is considered at the planning stage and, for substantive procedures, is related to judgement on materiality. The smaller the tolerable error, the greater the sample size will need to be.

14.8. Setting the Sample Size

In determining the sample size, the engagement team should consider whether sampling risk is reduced to an acceptably low level. The lower the sampling risk that the team is willing to accept, the greater the sample size will be.

The following factors are particularly important when setting a sample size:

- The sampling risk.
- The tolerable error rate.
- The expected error rate.
- The population value (substantive tests of account balances only).
- The number of items in the population (small populations only).

Sampling risk will always be present if a sample is tested within a population, rather than the entire population being tested. The key factor is to decide the level of sampling risk to accept. This decision is influenced by the amount of reliance being placed on the test. Reliance on the test will be low if:

a. The population tested is inherently unlikely to contain errors;
b. Reliance is being placed on analytical procedures;
c. Reliance is being placed on internal controls; or
d. Reliance is being placed on other substantive procedures.

Judgmental selection of sample sizes will mainly take place on smaller audits or where statistical sampling is not considered appropriate (for example, for some substantive tests on transactions a. I population may not be easily defined). The reasons for selecting a sample size chosen judgementally must be documented.

The approach to sample sizes in respect of each audit area should be noted on the overall plan.

Appendix 20 and 21 provide examples of factor that influence sample size**.**

14.9. Performing the Audit Process

The engagement team should perform audit procedures appropriate to the particular audit objective on each item selected.

If a selected item is not appropriate for the application of the audit procedure, the audit procedure is ordinarily performed on a replacement item. For example, a cancelled delivery note may be selected when testing operating effectiveness of controls over sales. If the engagement team is satisfied that the delivery note has been properly cancelled such that it does not constitute an error an appropriately chosen replacement can be examined.

In certain instances, the engagement team may unable to apply the designed audit procedures to a selected item because, for instance, documentation relating to that item has been lost. If suitable alternative audit procedures cannot be performed on that item, the engagement team ordinarily considers that item to be in error. An example of a suitable alternative audit procedure might be the examination of subsequent receipts when no reply has been received in response to a positive confirmation request.

Nature and Cause of Errors

The engagement team should consider the sample results, the nature and cause of any errors identified, and their possible effect on the particular audit objective and on other areas of the audit.

In analyzing any errors discovered, the engagement team may observe that many have a common feature, for example, type of transaction, location, and product line or period of time. In such circumstances, the engagement team may decide to identify all items in the population that possess the common feature, and extend audit procedures in that stratum. In addition, such errors may b€ -intentional, and may indicate the possibility of fraud.

Sometimes, the engagement team may be able to establish that an error is an anomalous error. For an error to be considered an anomalous error, the engagement team has to have a high degree of certainty that such error is not representative of the population. This certainty can be obtained by performing additional audit procedures, which would depend on the situation, but should be adequate to provide the engagement team with sufficient appropriate audit evidence that the error does not affect the remaining part of the population. An example of such an error is an error an error caused by use of an incorrect formula in calculating all inventory values at one particular branch. To establish that this is an anomalous error, the engagement team will need to ensure the correct formula has been used at other branches.

Projecting Errors

For tests of details, the engagement team should project monetary errors found in the sample to the population, and should consider the effect of the projected error on the particular audit objective and on other areas of the audit. The engagement team should project the total error for the population to obtain a broad view of the scale of errors, and to compare this to the tolerable error. For tests of details, tolerable error is the tolerable misstatement, and will be an amount less than or equal to the materiality used for the individual class of transactions or account balances being audited.

When an error has been established as an anomalous error, it may be excluded when projecting sample errors to the population. The effect of any such error, if uncorrected, still needs to be considered in addition to the projection of the non-anomalous errors. If a class of transactions or account balance has been divided into strata, the error is projected for each stratum separately. Projected errors plus anomalous errors for each stratum are then combined when considering the possible effect of errors on the total class of transactions or account balance.

For tests of controls, no explicit projection of errors is necessary since the sample error rate is also the projected rate of error for the population as a whole.

14.10. Evaluating the Results

The engagement team should evaluate the sample results to determine whether the assessment of the relevant characteristic of the population is confirmed or needs to be revised.

If an unexpectedly high sample error rate is established during the testing of controls, it may lead the engagement team to increase the assessed risk of material misstatement, unless further audit evidence substantiating the initial assessment is obtained. In the case of tests of details, an unexpectedly high error amount in a sample may lead the engagement team to assess that a class of transactions or account balance is materially misstated, if further audit evidence to the contrary does not exist.

If the total amount of projected error plus anomalous error is less than but close to the tolerable error, the engagement team should consider the persuasiveness of the sample results in the light of other audit procedures, and may consider it appropriate to obtain additional audit evidence.

If the evaluation of sample results indicates that the assessment of the relevant characteristic of the population needs to be revised, the engagement team may:

a) Request management to investigate identified errors and the potential for further errors, and to make any necessary adjustments; and **/** or
b) Modify the nature, timing and extent of further audit procedures. For example, in the case of tests of controls, the engagement team might extend the sample size, test an alternative control or modify related substantive procedures; and **/** or
c) Consider the effect on the audit report.

15. RELATED PARTIES

15.1. Introduction

The engagement team should perform audit procedures designed to obtain an understanding of related party relationships and transactions sufficient to be able:

(i) To recognize fraud risk factors, if any, arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud; and
(ii) To conclude, based on the audit evidence obtained, whether the financial statements, insofar as they are affected by those relationships and transactions: achieve fair presentation; or that they are not misleading.

However, it should be noted that an audit cannot be expected to detect all related party transactions due to the degree of uncertainty associated with assertions regarding completeness of related parties. ISA 550, identifies audit procedures aimed at providing sufficient appropriate audit evidence regarding identification of related parties and transactions with them. If the engagement team becomes aware of circumstances that increase the risk of material misstatement beyond that which would ordinarily be expected, or indicate that a material misstatement regarding related parties has occurred, and then the team should perform modified, extended or additional audit procedures as are appropriate in the circumstances.

ISA 550 adopts the definitions of IAS 24, "Related Party Disclosures", in defining related parties and, related party transactions. These definitions are:

Related party - A party is related to an entity if:

a. Directly, or indirectly through one or more intermediaries, the party:

    (i) Controls, is controlled by or is under common control with, the entity (this includes parents subsidiaries and fellow subsidiaries);
    (ii) Has an interest in the entity that gives it significant influence over the entity; or
    (iii) Has joint control over the entity;

b. The party is an associate (as defined in IAS 28, "Investments in Associates") of the entity;
c. The party is a joint venture in which the entity is a ventures (see IAS 31, "Interest in Joint Ventures");
d. The party is a member of the key management personnel of the entity or its parent;
e. The party is a close member of the family of any individual referred to in (a) or (d);
f. The party is an entity that is controlled, jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e); or
g. The party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.

Related party transactions - A transfer of resources, services or obligations between related parties, regardless of whether a price is charged.

15.2. Existence and Disclosure of Related Parties

It is the responsibility of management to identify and disclose related parties and transactions with related parties. Thus, management should ensure that there are adequate internal controls over transactions with related parties to ensure that they are appropriately identified and disclosed in the financial statements.

The engagement team should have a sufficient understanding of the entity and its environment to enable identification of the events, transactions and practices that may result in a risk of material misstatement regarding related parties and transactions with such parties. While the existence of related parties and transactions between such parties are considered ordinary features of business, the auditor needs to be aware of them because:

a. IAS 24, "Related Party Disclosures", requires disclosure of related party relationships and transactions in the financial statements;
b. The existence of related parties or related party transactions may affect the financial statements. For example, the entity's tax liability and expense may be affected by the tax laws in various jurisdictions which require special consideration when related parties exist;
c. The source of audit evidence affects the auditor's assessment of its reliability. Generally a greater degree of reliance may be placed on audit evidence that is obtained from or created by unrelated third parties; and
d. A related party transaction may be motivated by other than ordinary business considerations, for example, profit sharing or even fraud.

In addition the existence of related party relationships and transactions poses higher risks of material misstatement of the financial statements than transactions with unrelated parties. For example:

- Related parties may operate through an extensive and complex range of relationships and structures, with a corresponding increase in the complexity of related party transactions.
- Information systems may be ineffective at identifying or summarizing transactions and outstanding balances between an entity and its related parties.
- Related party transactions may not be conducted under normal market terms and conditions; for example, some related party transactions may be conducted with no exchange of consideration.

15.3. Audit Approach

As per ISA 550, the engagement team should review information provided by management identifying the names of all known related parties and should perform the following audit procedures in respect of the completeness of this information:

a. Review prior year working papers for names of known related parties;
b. Review the entity's procedures for identification of related parties;
c. Inquire as to the affiliation of those charged with governance and officers with other entities;
d. Review shareholder records to determine the names of principal shareholders or, if appropriate, obtain a listing of principal shareholders from the share register;

e. Review minutes of the meetings of shareholders and those charged with governance and other relevant statutory records such as the register of directors' interests;
f. Inquire of other auditors currently involved in the audit, or predecessor auditors, as to their knowledge of additional related parties; and
g. Review the entity's income tax returns and other information supplied to regulatory agencies.

The above procedures may be modified if, in the engagement team's judgement, there is a lower risk of significant related parties remaining undetected.

The engagement team should ensure that disclosure requirements as required by IAS 24 have been adequately met.

The engagement team should review information provided by management on related party transactions and should be alert for other material related party transactions. The team should also assess the adequacy of management's control activities over the authorisation and recording of related party transactions.

While performing the audit, the engagement team should be on the look out for unusual transactions which may indicate the existence of previously unidentified related parties. Examples of these transactions are:

- Transactions at unusual prices, interest rates, guarantees and repayment terms (e.g. advancing amounts with have no specific repayment terms, interest free and unsecured).
- Transactions that appear to have no logical business reasons for their occurrence.
- Transactions in which substance differs from form.
- High volumes or significant transactions with certain parties as compared to others.
- Unrecorded transactions such as receipt or provision of management services at no charge.
- Payments and collections made, or expenses incurred on behalf of other parties.

The engagement team can perform the following audit procedures to identify existence transactions with related parties:

- Performing detailed tests of transactions and balances.
- Reviewing minutes of meetings of the board of directors and shareholders.
- Reviewing accounting records for large or unusual transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.
- Reviewing confirmations of loans receivable and payable and confirmations from banks. Such a review may indicate guarantor relationship and other related party transactions.
- Reviewing investment transactions, for example, purchase or sale of an equity interest in a joint venture or other entity.

15.4. Evaluating Results

The engagement team should obtain sufficient appropriate audit evidence as to whether identified ~ related party transactions have been properly recorded and disclosed. Due to the nature of related party transactions, the audit evidence available for such transactions may be limited. As such, the engagement team should consider performing the following additional audit procedures:

- Obtaining an independent confirmation from the related party on the terms and amount of the transaction.
- Inspection of information in possession of the related party.
- Confirming or discussing information with persons associated with the transaction, such as banks, lawyers, guarantors and agents.

The engagement team should obtain written representation from management concerning:

(a) The completeness of information provided regarding the identification of related parties; and
(b) The adequacy of related party disclosures in the financial statements.

If the engagement team is unable to obtain sufficient appropriate audit evidence concerning related parties and transactions with such parties or concludes that their disclosure in the financial statements is not adequate, the auditor's report should be modified appropriately.

16. MANAGEMENT REPRESENTATIONS

16.1 Introduction

Under ISA 580, the auditor should:

- Obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor;
- Support other audit evidence relevant to the financial statements or specific assertions in the financial statements by means of written representations if determined necessary by the auditor or required by other ISAs; and
- Respond appropriately to written representations provided by management and, where appropriate, those charged with governance, or if management or, where appropriate, those charged with governance do not provide the written representations requested by the auditor.

16.2 Representations as Audit Evidence

The engagement team should obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist.

The team should obtain written representation from management that:

a. It acknowledges its responsibility for the design and implementation of internal control to prevent and detect error; and
b. It believes the effects of those uncorrected financial statement misstatements aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representations.

In certain instances, the only audit evidence that can be available to the auditor is that obtained from inquiry. Therefore, the need to obtain written representations from management arises.

Where representations relate to matters that are material to the financial statements, the engagement team should:

- Seek corroborative audit evidence from sources inside or outside the entity;
- Evaluate the reasonableness of management representations and consistency with other audit evidence; and
- Consider whether the individuals making the representations are knowledgeable on those particular matters.

Where other audit evidence could reasonably be expected to be available, management representations cannot be substituted for that audit evidence. For example, a representation by management as to the cost of an asset is not a substitute for the audit evidence of such cost that an engagement team would ordinarily expect to obtain. Where audit evidence is reasonably expected to be available, relating to a matter that is material to the financial statements, and the engagement team is unable to obtain such evidence, consideration should be given to modifying the auditor's report with a limitation of scope paragraph. This will be the case even if management representation on that particular matter has been received.

Where management representations are contradicted by other audit evidence, the engagement team should investigate the circumstances and, if need be, reconsider the reliability of other representations made by management.

Appendix 22 provides a list of ISAs containing requirements for written representations.

16.3 Documentation

Documentary evidence is more reliable than oral evidence. Thus, management's representations should be obtained in a written form. This also reduces the possibility of misunderstandings between the engagement team and management.

The basic elements of the management representation letter are:

- It should be addressed to the auditor.
- It is dated the same date as the auditor's report.
- It is normally signed by members of management who have responsibility for the entity and financial aspects (normally the directors), based on the best of their knowledge and belief.

If management refuses to provide a representation then this constitutes a limitation in scope a consideration should be given to expressing a qualified opinion or a disclaimer of opinion.

An Illustrative letter of representation is provided in **Appendix 23.**

17. USING OR RELYING ON THE WORK OF OTHERS

17.1 Using the Work of Another Auditor

An entity may include in its financial statements the financial information of one or more components such as a division, branch or subsidiary, which has been audited by an auditor other than the principal auditor of the entity. In such situations, the engagement team will seek to rely on the work of the component auditor.

When the principal auditor uses the work of another auditor, the principal auditor should determine how the work of the other auditor will affect the audit".

When accepting appointment as the auditor, the firm, as the principle auditor, needs to consider the extent of its involvement in the overall audit. The following factors need to be considered:

- The materiality of the portion of financial statements being audited by the firm;
- The firm's degree of knowledge of the component's business;
- The risk of material misstatement in the financial statements of the component being audited by another auditor; and
- The performance of additional audit procedures on the components which are being audited by another auditor.

17.1.1 The Principal Auditor's Procedures

The principal auditor should consider the professional competence of the other auditor when planning to use the work of the other auditor. The engagement team will need to perform procedures to obtain sufficient appropriate audit evidence that the work of the other auditor is adequate for the purposes of the audit. For these purposes, the engagement partner would need to advise the other auditor of:

- The independence requirements regarding both the entity and the component and obtain written representation as to compliance with them;
- The use that is to be made of the other auditor's work and report and make sufficient arrangements for the coordination of their efforts at the initial planning stage of the audit. The other auditor should be informed of areas requiring special consideration, procedures for the identification of inter-company transactions that may require disclosure and the timetable for completion of the audit; and
- The accounting, auditing and reporting requirements and obtain written representation as to compliance with them.

The engagement partner will also need to consider the need to discuss with the other auditor the audit procedures applied by the other auditor. In most cases, the engagement team will require the other auditor to complete a checklist or sign a written confirmation, which highlights the audit procedures applied by the other auditor and also any further audit procedures that the engagement team requires the other auditor to perform. The engagement partner may also wish to review the working papers of the other auditor.

The engagement partner may' consider that it is not necessary to apply the above audit procedures where previous sufficient appropriate audit evidence has been obtained, and where acceptable quality control policies and procedures are complied with in the conduct of the other auditor's practice. This can be the case when two affiliated firms may be subject to periodic inter-firm reviews relating to operating policies and procedures and review of working papers of selected audits,

The engagement partner should consider the significant findings of the other auditor, and of appropriate, discuss these with the other auditor and management of the component. The engagement partner should also consider if supplementary tests of records of the component are necessary.

The engagement team should document in the audit working papers the components whose financial information was audited by other auditors, their significance to the financial statements *or* the entity as a whole, the names of the other auditors and any conclusions reached that individual components are immaterial. The engagement team would also document the procedures performed and the conclusions reached.

17.1.2. Cooperation between Auditors

The other auditor, knowing the context in which the principal auditor will use the other auditor's work, should cooperate with the principal auditor. For example, if any of the additional procedures required by the principal auditor cannot be carried out as requested, the other auditor would need to bring this to the attention of the principal auditor. Similarly, subject to legal and professional considerations, the engagement partner need to advise the other auditor of any matters that come to the attention of the engagement team, which may have an important bearing on the other auditor's work.

17.1.3 Reporting

ISA 600 requires that "When the principal auditor concludes that the work of the other auditor cannot be used and the principal auditor has not been able to perform sufficient additional procedures regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation in the scope of the audit".

If the other auditor issues a modified auditor's report on the financial statements of a component, the engagement team will need to consider if modification of the auditor's report is required' depending on whether the matter on which the other auditor has issued a modified report is material in relation to the financial statements of the entity.

17.2. Considering the Work of Internal Audit

Internal Auditing is an appraisal activity, established within an entity as a service to the entity. Its functions include examining, evaluating and monitoring the adequacy and effectiveness of internal control.

The scope of work of the internal audit function will depend on the size and structure of the entity. Management determines the role of internal audit and their objectives differ from those of the external auditor, who is independent.

ISA 610 requires that the external auditor should consider the activities of internal auditing and their effect, if any, on external audit procedures.

While the firm has sole responsibility for the audit opinion expressed and for determining the nature, timing and extent of external audit procedures, certain parts of internal auditing work may be useful to the engagement team. The engagement team should obtain a sufficient understanding of internal audit activities to identify and assess the risks of material misstatement of the financial statements and to design and perform further audit procedures.

When internal auditing is relevant to the engagement team's assessment of risk, the team should perform an assessment of the internal audit function. This will influence the engagement team's judgment in making risk assessments and thereby modifying the nature, timing and extent of further external audit procedures.

The engagement team should consider the following criteria when assessing the whether the work of the internal auditors is likely to be adequate for purposes of the audit.

Objectivity

- The status of the internal audit function within the entity and the effect such status has on the ability of the internal auditors to be objective.
- Whether the internal audit function reports to those charged with governance or an officer with appropriate authority, and whether the internal auditors have direct access to those charged with governance.
- Whether the internal auditors are free of any conflicting responsibilities.
- Whether those charged with governance oversee employment decisions related to the internal audit function.
- Whether there are any constraints or restrictions placed on the internal audit function by management or those charged with governance.
- Whether, and to what extent, management acts on the recommendations of the internal audit function, and how such action is evidenced.

Technical competence

- Whether the internal auditors are members of relevant professional bodies.
- Whether the internal auditors have adequate technical training and proficiency as internal auditors.
- Whether there are established policies for hiring and training internal auditors.

Due professional care

- Whether activities of the internal audit function are properly planned, supervised, reviewed and documented.
- The existence and adequacy of audit manuals or other similar documents, work programs and internal audit documentation.

Communication

Communication between the external auditor and the internal auditors may be most effective when the internal auditors are free to communicate openly with the external auditors, and:

- Meetings are held at appropriate intervals throughout the period;

- The external auditor is advised of and has access to relevant internal audit reports and is informed of any significant matters that come to the attention of the internal auditors when such matters may affect the work of the external auditor; and
- The external auditor informs the internal auditors of any significant matters that may affect the internal audit function.

The engagement team should record conclusions regarding the specific internal auditing work that has been evaluated and the audit procedures performed on the internal auditor's work.

17.3 Using the Work of Other Offices within the Firm

The principles involved here are similar to those for using the work of another auditor. The principal auditor will need to consider the professional competence of the other office and confirm that the firm's own audit procedures have been applied.

The engagement partner may consider it necessary for the other office to complete a questionnaire or checklist that highlights audit procedures performed by the other office and any further audit procedures required by the engagement team. The engagement partner may also wish to review the working papers of the other office in order to obtain satisfaction that sufficient appropriate audit evidence has been obtained on which to base the auditor's conclusions.

17.4 Using the Work of an Expert

In obtaining an understanding of the entity and performing further procedures in response to assessed risks, the engagement team may need to obtain, in conjunction with the entity c-independently, audit evidence in the form of reports, opinions, valuations and statements of an expert. An 'expert' is a person or firm possessing special skill, knowledge and experience in a particular field other than accounting and auditing.

Examples of situations when the need to use the work of an expert arises include:

- The valuation of complex financial instruments, land and buildings, plant and machinery, jewellery, works of art, antiques, intangible assets, assets acquired and liabilities assumed in business combinations and assets that may have been impaired.
- The actuarial calculation of liabilities associated with insurance contracts or employee benefit plans.
- The estimation of oil and gas reserves.
- The valuation of environmental liabilities, and site clean-up costs.
- The interpretation of contracts, laws and regulations.
- The analysis of complex or unusual tax compliance issues.

When determining the need to use the work of an expert, the engagement team should consider:

- The nature of the matter to which that expert’s work relates;
- The risks of material misstatement in the matter to which that expert’s work relates;
- The significance of that expert’s work in the context of the audit;

- The auditor's knowledge of and experience with previous work performed by that expert; and
- Whether that expert is subject to the auditor's firm's quality control policies and procedures.

ISA 620 requires that when using the work performed by an expert, the auditor should determine whether that work is adequate for the purposes of the audit. When planning to use the work of an expert, the engagement team should consider the competence, capabilities and objectivity of the expert. In evaluating the expert's professional competence, the engagement team will look at professional certification or membership of the expert in an appropriate professional body. When assessing the objectivity of the expert, the engagement team would ordinarily consider whether the expert is employed by the entity or related to the entity in some other manner.

If the engagement team is concerned regarding the competence or objectivity of the expert, then the team needs to discuss this with management and consider whether any reliance can be placed on the work of the expert. In this case, the engagement partner should consider the need to seek audit evidence from another expert.

The engagement team should obtain sufficient audit evidence that the scope of the expert's work is adequate for the purposes of the audit. This can be achieved through a review of the terms of reference from the entity to the expert. Where instructions to the expert are not set out in writing, the engagement team may need to communicate directly with the expert to obtain the relevant audit evidence.

When planning to place reliance on the work of an expert, the engagement team should also evaluate whether the expert's work is appropriate audit evidence regarding the assertion being considered during the audit. This will involve consideration of:

- The source data used. The engagement team will need to make inquiries regarding any procedures undertaken by the expert, and review or test the data used by the expert.
- The assumptions and methods used and their consistency with prior periods. The engagement team will need to obtain an understanding of the assumptions and methods used by the expert and consider the appropriateness of these in light of the engagement team's knowledge of the business and the results of other audit procedures
- Results of the expert's work.

Reporting

When issuing an unmodified auditor's report, reference should not be made to the work of an expert. However, if the auditor's report needs to be modified as a result of the expert's work, it may be appropriate to refer to or describe the work of the expert (including the expert's name and extent of involvement). In this case, expert's permission should be sought. If permission is refused and the engagement partner believes a reference is necessary, the partner should seek legal advice.

Where the results of the expert's work do not provide sufficient appropriate audit evidence, or are not consistent with results of other audit evidence, the engagement partner should discuss this with management and the expert and consider applying additional audit procedures, including engaging another expert, or modifying the auditor's report.

18. COMPLETION AND REVIEW

18.1. Objectives

Audit completion procedures are carried out to ensure that:

a. Sufficient audit evidence has been obtained to support the audit opinion;
b. All decisions taken have been documented;
c. The audit file has been completed; and
d. Any audit matters of governance interest have been documented and discussed with the client.

Audit completion procedures include:

- Applying analytical procedures.
- Review of subsequent events.
- Confirmation that the entity is a going concern.
- Review of presentation and disclosure - do the financial statements comply with requirements of International Financial Reporting Standards (IFRSs) and the Companies Act.
- Engagement partner review.
- Consultation, where necessary.
- Obtaining written representations from management.

18.2 Subsequent Events

IAS 10 "Events after the Balance Sheet Date", defines subsequent events as "those events, favourable and unfavourable, that occur between the balance sheet date and the date when the financial statements are authorised for issue".

There are two types of events:

- **Adjusting events** (those that provide evidence of conditions that existed at the balance sheet date). Examples of adjusting subsequent events include:
  - The subsequent determination of the price of assets sold before the year-end.
  - Impairment of assets identified following an impairment review (under IAS 36, the need to write down following a valuation may not be necessary if the value in use supports the carrying value).
  - The receipt of sale proceeds after the balance sheet date, or other evidence, concerning the net realisable value of inventories.
  - Evidence that a previous estimate of accrued profit on a long-term contract, was materially inaccurate.
  - The re-negotiation of amounts owing by customers, or the insolvency of a customer.
  - The effect of changes in taxation rates.
  - Amounts received or receivable in respect of insurance claims, which were in the course of negotiation at the balance sheet date.
  - The discovery of error or fraud, provided the error or fraud discovered occurred prior to the year-end.

- **Non-adjusting events** (those that are indicative of conditions that arose after the balance sheet date). Examples of non-adjusting subsequent events include:

- Mergers and acquisitions.
- Change of principal activities.
- Issues of shares and loan stocks.
- Purchases and sales of Property, plant and equipment, and investments.
- The consequences of natural disaster such as flood or earthquake.
- Opening new trading activities or extending existing trading activities.
- A significant part of the trading activities becoming a discontinued operation, if it was not anticipated at the year-end.
- Post year-end decline in the value of property or other investments.
- Changes in foreign exchange rates.
- Government action.
- Strikes and other labour disputes.

ISA 560 provides the following definitions:

(a) **Date of the financial statements** - the date of the end of the latest period covered by the financial statements, which is normally the date of the most recent balance sheet in the financial statements subject to audit.

(b) **Date of approval of the financial statements** - the date on which the directors assert that they have prepared the entity's complete set of financial statements, including the related notes, and that they have taken responsibility for them.

(c) **Date of the auditor's report** - the date selected by the auditor to date the report on the financial statements. The auditor's report is not dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements. Sufficient appropriate audit evidence includes evidence that the entity's complete set of financial statements has been prepared and that the directors have asserted that they have taken responsibility for them.

(d) **Date the financial statements are issued** - the date that the auditor's report and audited financial statements are made available to third parties, which may be, in many circumstances, the date that they are filed with a regulatory authority.

18.3 Audit Procedures

ISA 560 requires that the auditor:

- To obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require, adjustment of, or disclosure in, the financial statements are appropriately reflected in those financial statements in accordance with the applicable financial reporting framework.

- To respond appropriately to facts that become known to the auditor after the date of the auditor’s report, that, had they been known to the auditor at that date, may have caused the auditor to amend the auditor’s report.

These procedures are in addition to routine procedures, such as checking for subsequent receipts from customers, testing of inventory cut-off and payments to suppliers, which are applied after the date of the financial statements to obtain audit evidence on account balances at the date of the financial statements.

A subsequent events review is performed as near as practicable to the date of the auditor's report and would normally include the following procedures:

- Reviewing managements' procedures over identification of subsequent events.
- Reviewing minutes of the meetings of shareholders, the board of directors and audit and executive committees held after the date of the financial statements and inquiring about matters discussed at meetings for which minutes are not yet available.
- Reviewing the entity's latest available interim financial statements and, as considered necessary and appropriate, budgets, cash flow forecasts and other related management reports. '
- Inquiring of the entity's lawyers concerning litigation and claims. ~ Inquiring of management as to whether any subsequent events have occurred which might affect the financial statements. Examples of inquiries of management on specific matters are:
  - The current status of items that were accounted for on the basis of preliminary or inconclusive data.
  - Whether new commitments, borrowings or guarantees have been entered into.
  - Whether sales of assets have occurred or are planned.
  - Whether the issue of new shares or debentures or an agreement to merge or liquidate has been made or is planned.
  - Whether any assets have been appropriated by government or destroyed, for example, by fire or flood.
  - Whether there have been any developments regarding risk areas and contingencies.
  - Whether any unusual accounting adjustments have been made or are contemplated.
  - Whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements as would be the case, for example, if such events call into question the validity of the going concern assumption.

18.4 Recording and Conclusion

The engagement team will need to ensure that any identified subsequent events, which materially affect the financial statements, are properly accounted for and adequately disclosed in the financial statements. '

All audit procedures undertaken and conclusions reached should be fully documented. The working papers should include detailed notes of meetings, including who was present, the matters discussed and the outcome of the discussions.

18.5 Action after the Audit Report is signed but Before the Financial Statements are issued

As per ISA 560, it is not the auditor's responsibility to perform audit procedures or make inquiries regarding the financial statements after the date of the auditor's report. Should any matters, which materially affect the financial statements, arise after the financial statements have been issued, it is the responsibility of management to inform the auditor of these matters.

When, after the financial statements have been issued, the firm becomes aware of a fact which may materially affect the financial statements, the engagement partner should consider whether the financial statements need amendment and should discuss the matter with management. The engagement partner should take the action appropriate in the circumstances.

If management amends the financial statements, the engagement partner should carry out the audit procedures identified in Section 18.2 above and issue a new audit report, which should be signed after the date of approval of the amended financial statements.

If, even after the engagement partner has asked management to amend the financial statements and management refuses to do so, but the auditor's report has not been released to the entity, the engagement partner should express a qualified opinion or an adverse opinion. Where the audit report has already been sent to the entity, the engagement partner should ask management not to issue the financial statements and auditor's report to third parties. If the financial statements have already been released, the engagement partner should seek legal advice on how to prevent reliance being placed on the auditor's report.

18.6 Action after the Financial Statements are Adopted by the Members

When, after the financial statements have been issued, the firm becomes aware of a fact which existed at the date of the auditor's report and which, if known at that date, may have caused the firm to modify the auditor's report, the engagement partner should consider whether the financial statements need revision and should discuss the matter with management. The partner should take -the action appropriate in the circumstances.

If management amends the financial statements, the engagement team should carry out the audit procedures identified in Section 18.2 above. In addition, the team will need to review the steps taken by management in informing all recipients of the previously issued financial statements and auditor's report of the situation.

The engagement partner will need to issue a new audit report on the revised financial statements, which should be signed after the date of approval of the amended financial statements. The new auditor's report should contain an emphasis of matter paragraph referring to a note to the financial statements that discusses the amendment to the previously issued financial statements and earlier auditor’s report.

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Where management does not amend the financial statements and does not take necessary steps to inform all recipients of the previously issued financial statements and auditor's report of the situation, the engagement partner may need to seek legal advice on the best course of action to take to prevent reliance being placed on the auditor's report.

18.7 Contingencies

IAS 37, “Provisions, Contingent Liabilities and Contingent Assets" provides the following definitions:

Contingent liability:

a. A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

b. A present obligation that arises from past events but is not recognised because:

- It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
- The amount of the obligation cannot be measured with sufficient reliability.

Contingent liabilities can arise as a result of:
a. Contractual or other legal disputes.
b. Defects in goods / products.
c. Warranties / insurance claims.
d. Guarantees.

Contingent asset - This is a possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

It is the responsibility of management to assess the probability of uncertain future events occurring, and then estimate the possible outcome. The auditor should review management's procedures in identifying contingencies existing at the balance sheet date and should ensure that all required disclosures are made in the financial statements in accordance with the entity's applicable financial reporting framework.

18.8 Going Concern

The going concern assumption is a fundamental principle in the preparation of financial statements. It implies that the entity will continue in operation for the foreseeable future. It assumes that the entity has neither the intention nor the necessity of liquidation, or of curtailing materially the scale of its operations.

Therefore, when financial statements are prepared on a going concern basis:

- ♦ It is assumed that the entity will continue in operating existence, for at least the next twelve months from the balance sheet date;
- ♦ Assets are recorded on the basis that that the entity will be able to realise them at their recorded values in the normal course of operations; and
- ♦ Liabilities are recognised on the basis that they will be discharged during the normal course of business.

18.9 Respective Responsibilities of the Management and the Auditor

18.9.1. Management's Responsibilities

IAS 1, "Presentation of Financial Statements", states, "When preparing financial statements management shall make an assessment of an entity's ability to continue as a going concern. Financial statements shall be prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so".

Making the going concern assumption involves judgement. Management will need to consider the following factors:

- Since the degree of uncertainty associated with the outcome of an event increases the further into the future the judgement relating to that event is made, IAS 1 specifies that management considers information at least twelve months from the balance sheet date.
- Judgement about the future is based on information available at the time that the judgement is made and can be contradicted by subsequent events.
- The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors all affect the judgment regarding the outcome of events or conditions.

When there is a history of profitable operations and a ready access to financial resources management may make its assessment without detailed analysis.

Examples of some events or conditions (as highlighted by ISA 570) that may cast significant doubt about the going concern assumption, and which management will need to consider are:

Financial

a. Net liability or net current liability position.
b. Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
c. Indications of withdrawal of financial support by debtors and other creditors
d. Negative operating cash flows indicated by historical or prospective financial statements.
e. Adverse key financial ratios.
f. Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
g. Arrears or discontinuance of dividends.
h. Inability to pay creditors on due dates.
i. Inability to comply with the terms of loan agreements.
j. Change from credit to cash-on-delivery transactions with suppliers.
k. Inability to obtain financing for essential new product development or other essential investments.

Operating

a. Loss of key management without replacement.
b. Loss of a major market, franchise, license, or principal supplier.
c. Labour difficulties or shortages of important supplies.

Other

a. Non-compliance with capital or other statutory requirements.
b. Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that are unlikely to be satisfied.

c. Changes in legislation or government policy expected to adversely affect the entity.

IAS further states, "When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability '0 continue as a going concern, those uncertainties shall be disclosed. When financial statements are not prepared on a going concern basis, that fact shall be disclosed, together with the basis on which the financial statements are prepared and the reasons why the entity is not regarded as a going concern".

18.9.2. Auditor's Responsibilities

The engagement team should consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements. The engagement team should further consider whether there are material uncertainties about the entity's ability to continue as a going concern that need to be disclosed in the financial statements.

18.10 Audit Approach

In obtaining an understanding of the entity, the auditor should consider whether there are events or conditions and related business risks which may cast significant doubt on the entity's ability to continue as a going concern.

When planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements. Assessing the entity's ability to management, review of management's plans and resolution of any identified going concern issues. It will also affect the nature, timing and extent of the auditor's further procedures in response to the assessed risks.

The engagement team should also remain alert throughout the audit, for any events or conditions that may indicate that the entity's ability to continue as a going concern is doubtful, and assess the impact of those events or conditions on the assessment of risks of material misstatement.

The engagement team should note that there may exist events or conditions that may cast a significant doubt on the entity's ability to continue as a going concern and that there might be facts mitigating those events or conditions, e.g. the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposal of assets, rescheduling of loan repayments c~, obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

If management has not made a preliminary assessment of the entity's ability to continue as a going concern, the engagement team should inquire from management whether there are any conditions or events, that exist. The engagement team should also discuss with management their basis for assuming that the entity will continue as a going concern.

18.11 Audit Evidence

The engagement team should evaluate management's assessment of the entity's ability to continue as a going concern and consider the same time period as used by management, under the relevant financial reporting framework. However, if this is less than twelve months from the balance sheet date, the engagement team should ask management to extend the assessment accordingly. This evaluation is a key audit consideration of the going concern assumption and includes reviewing the assumptions on which the assessment is based and management's plans for future action. The engagement team should also inquire of management about any events or conditions existing beyond the period of assessment, which could affect the going concern assumption and be alert to the possibility of such events or conditions occurring during the audit process.

If adequate disclosures are not included in the financial statements, the engagement team may consider the need to obtain a statement in writing from the management as to whether the going concern basis is appropriate. For larger entities, a statement is only likely to be valuable if supported by forecasts and budgets and schedules of borrowing facilities. For smaller entities, with uncomplicated circumstances, it may be appropriate for a written assertion to be prepared, as a record of any discussions held. In such circumstances, the management must take responsibility for the record, which should give sufficient details of their opinion. Any statement should ideally be' obtained early in the audit process, and may need to be confirmed in the letter of representation.

In certain instances, the engagement team may wish to obtain a letter or support or subordination to support the going concern assumption of the entity. A sample letter of support is set out in Appendix I of this Section. This letter of support is a guarantee from third parties, (such as the parent company, directors or shareholders, or the entity's bankers and other creditors) that they will continue to financially support the entity to enable it to meet its liabilities as they fall due, for at least the next twelve months from the date the financial statements are approved for issue, while a letter of subordination is usually provided by a creditor or lender subordinating an entity's debt to other payables. If the entity's total debts is less the liquid assets exceed the subordinated debts, a letter of subordination alone will not give the required protection.

The letter should be addressed to the entity and copied to us as the auditors. The letter should ideally be prepared by a lawyer. It should always be ratified by the board, and the financial statements should adequately disclose the existence of this letter.

The engagement team should consider the need to perform further audit procedures to obtain satisfaction on the appropriateness of the letter of support or subordination. Such audit procedures may include inspection of the financial statements of the third party providing the letter of support or subordination (if the third party is a parent company or creditor). In the case of the entity's bankers, the evidence would be an agreement for renewal of facilities.

18.12 Additional Audit Procedures when Events or Conditions are identified

When events or conditions have been identified (either at the planning stage or during the course of the audit) which may cast significant doubt on the entity's ability to continue as a going concern, the engagement team should:

a. Review management's plans for future actions based on its going concern assessment;

b. Gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists through carrying out audit procedures considered necessary, including considering the effect of any plans of management and other mitigating factors; and
c. Seek written representations from management regarding its plans for future action.

Other evidence that may be considered includes:

- Analysing and discussing cash flow, profit and other relevant forecasts with management, and reviewing the assumptions underlying such forecasts.
- Analysing and discussing the entity's latest available interim financial statements.
- Reviewing the terms of debentures and loan agreements and determining whether any have been breached.
- Reviewing minutes of the meetings of shareholders, those charged with governance and relevant committees for reference to financing difficulties.
- Inquiring of the entity's lawyer regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
- Confirming the existence, legality and enforceability of arrangement to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
  Appendix 24 provides an illustrative letter of support.
- Considering the entity's plans to deal with unfilled customer orders.
- Reviewing events after period end to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.

18.13 Audit Conclusion

Based on the audit evidence obtained, the engagement team should determine if, in the it's judgement, a material uncertainty exists related to events or conditions that alone or in aggregate may cast significant doubt on the entity's ability to continue as a going concern.

If the use of the going concern assumption is appropriate but a material uncertainty exists consideration should be given to whether the financial statements:

a. Adequately describe the principal events or conditions that give rise to the significant doubt on the entity's ability to continue in operation and management's plans to deal with these events or conditions; and
b. State clearly that there is a material uncertainty related to events or conditions which may cast significant doubt on the entity's ability to continue as a going concern and, therefore, that it may be unable to realise its assets and discharge its liabilities in the normal course of business.

If adequate disclosure is made in the financial statements, an unqualified opinion should be expressed but the auditor's report should be modified by adding an emphasis of matter paragraph that highlights the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern and draws attention to the note in the financial statements that discloses the matters set out in the paragraph above.

In extreme cases, such as situations involving multiple material uncertainties that are significant to the financial statements, it may consider it appropriate to express a disclaimer of opinion instead of adding an emphasis of matter paragraph.

If adequate disclosure is not made in the financial statements a qualified or adverse opinion, as appropriate, should be given (See Section 23 of the Manual). The report should include specific reference to the fact that there is a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern.

If, in the engagement team's judgment, the entity will not be able to continue as a going concern, an adverse opinion should be expressed if the financial statements have been prepared on a going concern basis.

In some circumstances, where management feels that preparation of the financial statements on a going concern assumption is not appropriate, the financial statements may be prepared on an alternative authoritative basis. If the engagement team determines that this alternative basis is appropriate, an unqualified opinion may be issued, if there is adequate disclosure made in the financial statements. However one may be required to include an emphasis of matter paragraph in the auditor's report to draw the user's attention to that basis.

If management is unwilling to make an assessment on the going concern assumption when requested to do so by the engagement team, one should consider the need to modify the auditor's report as a result of the limitation on the scope of the audit work.

18.13 Completion of Audit Areas

18.13.1. Lead and Supporting Schedules

Lead schedules and appropriate supporting schedules should be completed and cross referenced for each relevant audit area.
Lead schedules for audit work should clearly show the audit objective, the work performed and the conclusions reached. Lead schedule figures should be cross-referenced to relevant audit working papers and to the financial statements.
The preparer of the schedule should consider whether the detailed information contained in all schedules has been adequately summarised, and required disclosures have been properly reflected in the financial statements.
All schedules should be carefully reviewed to ensure that audit procedures have been carried out in accordance with the audit plan and audit programmes. Each schedule should normally show documentary evidence of such review (e.g. the reviewer's initials).
Any adjustments made to the figures in the financial statements should also be reflected in relevant schedules.

18.13.2. Analytical Review

Analytical review procedures should be summarised and notes made of the explanation of material changes and variations. This enables the reviewer to corroborate conclusions formed during the audit of individual components or elements of the financial statements and assist in arriving at the overall conclusion as to the reasonableness of the financial statements.

18.13.3. Audit Area Conclusions

While the ISA 230 requires a conclusion on all significant aspects of the audit, is recommended that a conclusion be drawn for each audit area by the engagement team member in charge of the audit area.
Before drawing a conclusion, the engagement team member in charge of the audit area should ensure that the audit has been carried out in accordance with the Audit Strategy and Plan and that audit procedures indicated in the audit programmes have been carried out as required. Any deviations from the Audit Strategy and Plan should be documented, substantiated and approval obtained from the engagement partner.

- The working papers should also be updated by the audit senior to ensure reflects responses to queries raised by the reviewer.
- Internal control and other weaknesses should also be documented.
- Any areas where the engagement team has had to rely on representations should be documented.
- Any points identified during the audit, which are particularly relevant to the planning of the following year's audit, should be documented.

18.13.4 Points for Partner's Attention

All matters, which have an effect on the audit opinion or need to be discussed with management, should be recorded in From 03.09 - Matters for Partner's Attention.

The points for partner's attention is ordinarily drafted by the senior, completed by the manager and reviewed by the engagement partner. The points for partner's attention include any material problems or other uncleared matters encountered during the course of the audit. Unusual matters note should also be included in the points for partner's attention for information purposes, even if these have been cleared during the course of the audit.

Points for partner's attention would ordinarily summarise the following points:

- Major points for the engagement partner's attention.
- Analytical review at the completion stages.
- Errors found, distinguishing between adjusted errors (Form 06.04) and unadjusted errors (Form 03. 14).

All matters recorded in the points for partner's attention should be cleared by the engagement partner, who should sign the document to confirm that all matters have been cleared satisfactorily.

18.14. Review of Financial Statements

18.14.1 Accounting policies

The entity's accounting policies should be reviewed as part of the substantive procedures adopted to ensure that:

- The policies disclosed in the previous year's financial statements have been amended to reflect:
  - Changes as a result of changes to the financial reporting framework and corporate legislation;
  - Any policies not previously disclosed; and
  - Modifications to accounting policies (such as a change in the useful life of assets).

The accounting policies used by the entity are:

- Acceptable (Le. in accordance with IFRS);
- Consistently applied; and
- Appropriate to the nature of business, industry and environment in which the entity operates.

Requirements of the entity's applicable financial framework have been complied with in relation to any changes in the accounting policies.

18.14.2 Compliance with local legal requirements and applicable financial reporting standards

The financial statements should be checked for compliance with local legal requirements and the entity's applicable financial reporting framework. (In the context of Uganda, this would be compliance with the Companies' Act and International Financial Reporting Standards respectively).

18.14.3 Presentation and disclosure

The financial statements should be presented and disclosures made in accordance with legal requirements and the entity's applicable financial reporting framework.

The engagement team should consider the use of checklists (e.g. IFRS disclosure checklist, Companies Act checklist etc.) or compare the entity's financial statements with the firm's model set of financial statements to ensure consistency and compliance with requirements. The financial statements should also be proof-read to ensure that clerical errors are eliminated. The audit senior should ensure:

- All the additions and cross-casts are correct.
- Items shown in more than one place on the financial statements are all shown at the correct amounts.
- Cross-references and page references are complete and correct.
- The audit opinion is supported by the audit evidence on the file.
- Comparative figures agree with the previous year's financial statements.
- All pages and paragraphs are numbered and follow in sequence. .
- Dates have been changed from the previous period's financial statements.
- All page and column headings are correct.
- There are no errors of fact (for example, directors' names are correct).

ISA 518 requires the auditor to apply analytical procedures at or near the end of the audit, when forming an overall conclusion as to whether the - 11 financial statements, as a whole, are consistent with the auditor's understanding of the entity. The conclusions drawn from the results of such audit procedures are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements and assist in arriving at the overall conclusion as to the reasonableness of the financial - statements.

Audit opinion
The review of the financial statements, together with the results of other appropriate audit procedures, should enable the auditor to give an opinion on the financial statements.

18.15. Review of File

The objectives of review of the audit file and working papers are to:

- Check for compliance with the firm's and professional standards of work.
- Ensure that the work has been carried out in accordance with audit plan and strategy, modified as necessary during the course of the audit.
- Confirm that working papers provide sufficient appropriate audit evidence to support conclusions reached.
- Assess whether work has been performed efficiently, within timetable and budget.
- Identify areas of weakness in the client's system of internal controls and opportunities for provision of additional services to the client.
- Communicate learning points to those whose work is being reviewed, so as to develop their understanding and professional competence.

18.15.1 Factors to consider in the review of audit files are:

- Working papers should be reviewed as soon as possible after completion of the work.
- The review should be neat and legible.
- The review should be carried out positively, and review points clearly explained, including an explanation of their importance.
- Sarcastic and flippant remarks should be avoided.
- Issues arising from the review and discussed with those whose work is being reviewed. Those being reviewed should, whenever possible, be present when heir work is being reviewed.
- The person who carried out the work should resolve any queries raised by the reviewer, on the relevant working papers, and not on the face of the review notes.
- Matters identified during the review should be promptly followed up, and cleared by the reviewer.
- The review should be evidenced by signatures on the working papers reviewed, the audit programme and the review notes.
- The reviewer should balance his review between "file maintenance points" (such as cross-referencing and signatures missing), and points of significance to the audit opinion. A review which solely consists of administrative points may indicate a failure to take a view of the audit and financial statement as a whole, and hence a failure to identify important points.

18.15.2 When reviewing the working papers, the reviewer should check for the following:

- Each schedule is headed, dated, initialled, and indexed.
- Cross-referencing is complete.
- Audit ticks used are clearly explained.
- Working papers are organised in a logical fashion.

- The tests carried out are explained.
- Sample sizes appear adequate.
- The method and basis of sample selection has been explained.
- All outstanding points from the tests have been cleared.
- Errors and exceptions have been properly treated, and where appropriate, entered on the summary of errors' schedule.
- Conclusions to tests are meaningful, accurate and supported by the facts.

18.15.3 Manager Review

Depending on the structure of the engagement team, the manager should review the senior's working papers in detail, and enough of the audit assistants' working papers, to ensure that the senior has carried out a proper review of the audit assistants' work.

The manager should also review the financial statements in detail, taking an overview to ensure the important issues affecting the financial statements have been satisfactorily treated, and there is sufficient appropriate audit evidence to support the audit opinion.

The manager should normally review the audit file at the client's premises. The advantages of this are:

- Any additional information required to clear review points can easily be obtained
- The staff carrying out the work are available to answer questions and / or carry out further audit procedures, as required.
- It improves relationship with the client. There can be commercial advantages in a manager reviewing on site and taking an opportunity at the same time to strengthen the firm's professional relationship with the client.

18.15.4 Engagement Partner Review

Before the auditor's report is issued, the engagement partner, through review of the audit documentation and discussion with the engagement team, should be satisfied that sufficient appropriate audit evidence has been obtained to support the conclusions reached for the auditor's report to be issued.

In order to do this, the engagement partner should at least review the following sections of the file:

- Financial Statements.
- Matters for Partner's Attention.
- Letter of Representation
- Management letter.
- Audit Strategy and Plan (to ensure the original strategy has been followed and is still considered appropriate).
- Time budgets and summary.
- Lead schedules and audit conclusions of each material area.
- A more detailed review of specific areas where necessary.

The engagement partner is also responsible for ensuring that any contentious areas discussed with the client have been recorded in From 03.12 - Client Meeting Agenda / Notes, including the, conclusions reached.

The engagement partner should review the manager's work, to ensure that the manager has carried out a proper review.

18.16. Overall Audit Conclusion

During the final stages of the audit, there are usually one or more meetings between the engagement partner, audit manager and senior members of the client's staff. At these meetings any final adjustments are agreed, any other matters identified in the points for partner's attention are discussed, and all outstanding points are cleared. Notes should be made of all such meetings including notes of any contentious areas discussed and conclusions reached.

After the final adjustments have been made, the audit manager should complete the overall audit conclusions schedule, noting any outstanding matters (usually, only matters to be signed at the same time as the financial statements, such as the letter of representation) and the engagement partner should countersign this schedule.

The engagement partner should also sign off the overall audit conclusion prior to release of the financial statements for board's approval to ensure that all outstanding matters have been cleared.

18.17 Engagement Quality Control Review

As discussed in Section 4: Quality Control, ISQC 1 requires the firm to establish policies and procedures requiring, for appropriate engagements, an engagement quality control review that provides an objective evaluation of significant judgements made by the engagement team and the conclusions reached in arriving at the audit opinion. Refer to Section 4 of the Manual on audits where an engagement quality control is required, the process for carrying out the review and the completion requirements.

18.18 Effectiveness Review

Effectiveness review is an essential part of the audit process, necessary to ensure that lessons and improvements to efficiency are identified, and personal development is enhanced.

The key elements of effectiveness review are:

18.18.1 De-briefing meetings

The aims of de-briefing meetings are:

- To consider whether the overall audit approach should be changed in the following year.
- To identify any audit areas where changes in the approach or audit programmes should be made (e.g. where the audit was either ineffective or inefficient).
- To consider how factors that caused delays this year can be prevented in the following year.
- To identify any other points to be carried forward to next year's file.
- To seek opportunities to help the client.

Ideally, all members of the audit team, including the partner, should be able to contribute at a debriefing meeting.

18.18.2 Appraisals

Appraisals of all staff, including managers should be made after every assignment. In general, the appraiser should be the person to whom the individual has reported in the first instance. Appraisals can be informal or formal, but a formal appraisal should generally be carried out for lengthy assignments.

In order for appraisals to be effective, they must be carried out promptly.

The following questions are relevant when an appraisal of an assignment is made:

- Have the objectives of the task or role been met satisfactorily?
- Has the individual performed well?
- If not, where were the problems and what action needs to be taken to resolve them?
- Did the individual feel he or she was well briefed?
- Was the work allocated appropriately?
- Did the individual feel challenged by the task?
- Was the work too difficult for them and if so, how?
- Did unexpected problems or complications arise? If so, how well did the individual cope with them?
- Did the individual's performance exceed expectations and if so, how?
- Are there any changes that should be made to existing work patterns?
- Are there any new development areas that may benefit the individual?

19. AUDIT REPORT

19.1 Introduction

The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

In order to form that opinion, the auditor should conclude as to whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into account:

- The auditor’s conclusion, in accordance with ISA 330, whether sufficient appropriate audit evidence has been obtained;
- The auditor’s conclusion, in accordance with ISA 450, whether uncorrected misstatements are material, individually or in aggregate;
- Whether or not the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework.
- Whether or not the financial statements adequately disclose the significant accounting policies selected and applied;
- Whether or not the accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;
- Whether or not the accounting estimates made by management are reasonable;
- Whether or not the information presented in the financial statements is relevant, reliable, comparable and understandable;
- Whether or not the financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and
- Whether or not the terminology used in the financial statements, including the title of each financial statement, is appropriate.

19.2 Forming an Opinion on the Financial Statements

The auditor’s report should give a clear expression of the auditor's opinion on the financial statements.

When forming an opinion as to whether the financial statements give a true and fair view, the engagement partner will also need to assess the fair presentation of the financial statements, which includes considering the overall presentation, structure and content of the financial statements. The engagement partner will also need to assess whether the financial statements are consistent with engagement team's understanding of the entity and its environment. Analytical procedures performed at or near the end of the audit help to corroborate conclusions formed during the audit assist in arriving at the overall conclusion as to the fair presentation of the financial statements.

19.3 Basic Elements of the Auditor's Report

The basic elements of the auditor's report are:

a) Title

The title in the auditor's report should clearly indicate that it is the report of an independent auditor. This affirms that the firm has met all of the relevant ethical requirements regarding independence and distinguishes the independent auditor's report from reports issued by others.

b) Addressee

The auditor's report should be addressed appropriately as required by the circumstances of the engagement and local regulations. Ordinarily, the auditor's report is addressed to the shareholders (members) of the company.

c) Introductory Paragraph

The introductory paragraph in the auditor's report should identify the entity whose financial statements have been audited and should state that the financial statements have been audited.

The introductory paragraph should also:

- Identify the title of each of the financial statements that comprise the complete set of financial statements (in accordance with IFRS, this includes: the balance sheet, income statement, statement of changes in equity, cash flow statement, and a summary of significant accounting policies and other explanatory notes);
- Refer to the summary of significant accounting policies and other explanatory notes; and
- Specify the date and period covered by the financial statements.

d) Directors' Responsibility for the Financial Statements

The auditor's report should state that the directors are responsible for the preparation and fair presentation of the financial statements in accordance with IFRSs and the Ugandan Companies Act and that this responsibility includes:

- Designing, implementing and maintaining internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error;
- Selecting and applying appropriate accounting policies; and
- Making accounting estimates that are reasonable in the circumstances.

e) Auditor's Responsibility

The auditor's report should state that the responsibility of the auditor is to express an opinion on the financial statements based on the audit.

The auditor's report should also state that the audit was conducted in accordance with International Standards on Auditing and that those standards require that the auditor comply with ethical requirements and plan and perform the audit to obtain reasonable assurance that the financial statements are free from material misstatement. This will give the reader of the financial statements the assurance that the audit has been carried out in accordance with established standards.

As per ISA 200, the auditor cannot describe the audit as being conducted in accordance with ISAs unless all ISAs relevant to the audit have been fully complied with.

The auditor's report should describe the audit by stating that:

- An audit includes performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements;

- The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement, whether due to fraud or error. In making those risk assessments; the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements. This is done in order for the auditor to design appropriate audit procedures in the circumstances, and not to form an opinion on the effectiveness of the entity's internal control; and

- An audit also includes evaluating the appropriateness of the accounting policies used, the reasonableness of the accounting estimates made by the directors, as well as the overall presentation of the financial statements;

The report should state that the audit evidence obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

f) Auditor's Opinion

When the engagement partner concludes that the financial statements give a true and fair view of the financial position, financial performance and cash flows of the entity, in accordance with IFRS and the Ugandan Companies Act, an unmodified opinion should be expressed.

g) Auditor's signature

The report should be signed in the name of the audit firm or the personal name of the auditor, as appropriate.

h) Date of Report

The auditor should date the auditor's report no earlier than the date on which sufficient appropriate audit evidence, on which to base the opinion on the financial statements, has been received. This includes evidence that the entity's complete set of financial statements has been prepared and the directors have asserted that they have taken responsibility for them.

The date on the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date.

i) Auditor's Address

The auditor's address is normally the location in the country or jurisdiction where the auditor practices.

19.4 Audit Opinion

The auditor's opinion is normally based on whether the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with the applicable financial reporting framework and comply with statutory requirements.

The financial reporting framework is determined by IFRS with due regard to local legislation. To advise the reader of the context in which the auditor's opinion is expressed, the auditor's opinion indicates the framework upon which the financial statements are based. This designation helps the user to better understand which financial reporting framework was used in preparing the financial statements.

The following are the various types of audit opinions that the auditor can issue:

- Unmodified opinion.
- Modified opinions:
    - Emphasis of matter.
    - Qualified opinion.
    - Disclaimer of opinion.
    - Adverse opinion.

These are covered in detail below.

19.5 Types of Audit Opinions

Appendix 25 sets out examples of types of auditor's reports**.**

a) Unmodified Opinion

An unmodified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view in accordance with IFRS and Ugandan Companies Act. An unmodified opinion also indicates implicitly that any changes in accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements.

b) Modified Reports

Matters that Do Not Affect the Auditor's Opinion

In certain circumstances, an auditor's report may be modified by adding an emphasis of matter paragraph to highlight a matter affecting the financial statements, which is included in a note to the financial statements that more extensively discusses the matter. The emphasis of matter paragraph does not affect the auditor's opinion and is normally included after the auditor's opinion paragraph. The emphasis of matter paragraph would ordinarily refer to the fact that the auditor's opinion is not qualified in this respect.

The engagement partner would normally consider including an emphasis of matter paragraph in the auditor's report in the following circumstances:

- When there is a going concern problem; or
- When there is a significant uncertainty (other than a going concern problem), the resolution of which is dependent upon future events and which may affect the financial statements or
- When there is a material inconsistency in other information in documents containing financial statements (e.g. a directors' report), and the directors refuse to make an appropriate amendment.

Matters that Do Affect the Auditor's Opinion
In certain circumstances, the auditor may not be able to express an unmodified opinion. A qualified opinion is issued when:

- There is a limitation on the scope of the auditor's work (leads to a qualified opinion or disclaimer of opinion).
- There is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures (leads to a qualified opinion or adverse opinion).

As per ISA 701:

- A **qualified opinion** is expressed when the engagement partner concludes that an unmodified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion. A qualified opinion should be expressed as being 'except for' the effects of the matter to which the qualification relates.
- A **disclaimer of opinion** is expressed when the possible effect of a limitation on scope is so material and pervasive that the engagement team has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.
- An **adverse opinion** is expressed when the effect of a disagreement is so material and pervasive to the financial statements that the engagement partner concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

Whenever the auditor expresses an opinion that is other than unmodified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s) on the financial statements. This information is normally set out in a separate paragraph preceding the opinion or disclaimer of opinion and may include a reference to a note to the financial statements that more extensively discusses the matter.

Limitation on Scope

A limitation in the scope of the auditor's work can arise in the following circumstances:

- When the limitation in scope is imposed by the entity (for example, as a result of the terms of engagement).

- When the limitation on scope is imposed by circumstances (for example, the timing of the auditor's appointment is such that the auditor is unable to observe the counting of inventories or when the entity's accounting records are inadequate and the auditor is unable to carry out reasonable alternative procedures to obtain sufficient appropriate audit evidence to support an unmodified opinion).

- When there is a limitation on the scope of the auditor's work that requires expression of a qualified opinion or a disclaimer of opinion, the auditor's report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.

Disagreement with Management

Where the disagreement with management is material to the financial statements, the auditor should express a qualified or an adverse opinion. Examples of disagreements with management are:

- Disagreement on accounting policies due to inappropriate accounting method (qualified opinion).
- Disagreement on accounting policies due to inadequate disclosure (qualified or adverse opinion).

19.6 Issuing Financial Statements

The date of issue of the financial statements is the date that the auditor's report and audited financial statements are made available to third parties, which may be, in many circumstances, the date that they are filed with a regulatory authority (See Section 19.1 of the Manual).

The audited financial statements are ordinarily sent for the directors' approval after the engagement partner is satisfied that sufficient and appropriate audit evidence has been obtained to arrive at the conclusion on whether the financial statements give a true and fair view in accordance with IFRS and the Ugandan Companies Act.

19.7 Signing the Financial Statements

The engagement partner will sign and date the auditor's report on or after the date on which the financial statements are signed or approved by the directors the effect on the financial statements of all events and transactions that materially affect the financial statements from the date of conclusion of fieldwork to the date of signing the auditor's report. The engagement partner will also ensure that matters material to the financial statements, when other sufficient appropriate audit evidence cannot reasonably be expected to exist, has been received and is dated the same date as the auditor's report,

19.8 Other Information Issued With Audited Financial Statements (Incorporating ISA 720)

'Other information' is financial or non-financial information that the entity decides to include in its annual report, together with its audited financial statements and the auditor's report thereon. Examples of other information include the chairman's statement, financial summaries or highlights, employment data, financial ratios, planned capital expenditure etc.

ISA 720 requires that, "The auditor should read the **other information** to identify **material inconsistencies** with the audited financial statements"
A **'material inconsistency'** arises when other information contradicts information contained in the financial statements, thus raising doubts about the audit evidence previously obtained and on the basis for the auditor's opinion on the financial statements.

In order that the engagement team can consider other information included in the annual report, timely access to such information is required. The engagement team therefore needs to obtain such information prior to the date of the auditor's report.

19.9 Considerations

If, on reading the other information, the engagement team identifies a material inconsistency, the team should determine whether the audited financial statements or the other information should be amended.

If an amendment is necessary in the audited financial statements and the entity refuses to make the amendment, a qualified or adverse opinion should be issued.

If an amendment is necessary in the other information and the entity refuses to make the amendment, the engagement partner should consider including in the auditor's report an emphasis of matter paragraph describing the material inconsistency or taking other actions, which may include withdrawing from the engagement, or obtaining legal advice.

If the engagement team becomes aware that the other information appears to include a material misstatement of fact, the engagement partner should discuss the matter with the entity's management. A 'material misstatement of fact' arises when information, not relating to the audited financial statements, contained in the other information is incorrectly stated or presented.

When the engagement partner still considers that there is an apparent misstatement of fact, the partner should request management to consult with a qualified third party, such as the entity's legal counsel and should consider the advice received.

If the engagement partner concludes that there is a material misstatement of fact in the other information which management refuses to correct, consideration should be given to taking further appropriate action, which may include writing to those charged with governance on the concern and obtaining legal advice.

In certain instances, the engagement team may not obtain all the other information prior to the date of the auditor's report. In this case, reference should be made Section 21 of the Manual Subsequent Events and Contingencies for further guidance.

20. COMMUNICATION OF AUDIT MATTERS WITH THOSE CHARGED WITH GOVERNANCE

20.1. Introduction

ISA 260 requires that the auditor:

a. To communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit, and an overview of the planned scope and timing of the audit;
b. To obtain from those charged with governance information relevant to the audit;
c. To provide those charged with governance with timely observations arising from the audit that are significant and relevant to their responsibility to oversee the financial reporting process; and
d. To promote effective two-way communication between the auditor and those charged with governance.

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

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

20.2. Relevant Persons

In determining relevant persons to whom audit matters charged with governance should be communicated, the engagement partner should consider the legal responsibilities of those persons. The following guidelines may be used:

- Where the matter is of importance, it should be communicated to the whole board.
- In other cases, the engagement partner may communicate the matter to an audit committee, where this exists. If an audit committee does not exist, he may communicate it to a non executive director overseeing the audit and finance portfolio.
- To the extent possible, matters should not be communicated with those involved in management unless these persons also perform the governance function. This could be the case in owner managed companies.
- Where the governance structure is not well defined or those charged with governance are not clearly identified by the client or by legislation, e.g. in government or not for profit organisations, the engagement partner should agree with the client as to whom audit matters of governance should be communicated to.

It is a good practice to agree the channel of communication in the audit engagement letter. The effectiveness of communication is enhanced by developing a constructive working relationship between the firm and those charged with governance by maintaining an attitude of professional independence and objectivity.

In certain cases where the members of the board of director are involved in non-compliance, the engagement partner should report the matter to the next higher level of authority at the entity if it exists. Where no higher authority exists, or if the engagement partner believes that the communication may not be acted upon, or is unsure as to the person to whom to report, the partner should consider seeking legal advice.

ISA 260 does not provide guidance on communication by the auditor to parties other than the client e.g. regulatory bodies. The duty of confidentiality would ordinarily preclude reporting any matters concerning the entity's affairs to a third party without the express written consent of the entity. However, in certain circumstances the firm may be required by law to report to regulators or certain third parties. In such cases, the engagement partner must ensure that what is to be reported is covered under the act or regulation and the firm has immunity under the act to report such issues with or without entity's consent. Where potential conflicts arise between ethical and legal obligations and reporting requirements, the engagement partner should consider taking legal advice.

20.3. Audit Matters of Governance Interest to be communicated

The following is a list of matters that should ordinarily be communicated to those charged with the governance of the entity:

- The general approach and the overall scope of the audit, including any expected limitations thereon, or any additional requirements.
- The selection of, or changes in, significant accounting policies and practices that have, or could have, a material effect on the entity's financial statements.
- The potential effect on the financial statements of any material risks and exposures, such as pending litigation, other contingent liabilities and off-balance sheet risks, that are required to be disclosed in the financial statements:
- Non-compliance with laws or regulations.
- Audit adjustments, whether or not recorded by the entity that have, or could have, a material effect on the entity's financial statements including material misstatements resulting from fraud suspected fraud or error.
- Uncorrected misstatements aggregated during the audit that were determined by management to be immaterial, both individually and in the aggregate below a designated amount, to the financial statement taken as a whole.
- Material uncertainties related to events and conditions that may cast significant doubt on the entity's ability to continue as a going concern.
- Disagreements with management about matters that, individually or collectively, could be significant to the entity's financial statements or the auditor's report and the expected modifications to the audit report.
- Other matters warranting attention of those charged with governance, such as material weaknesses in internal controls, internal controls related to the prevention and detection of fraud and error, questions regarding management integrity and fraud involving management.
- Any other terms specifically agreed upon in the terms of audit engagement.

If the engagement team considers modification of the auditors report as required by ISA 700 communication between the auditor and those charged with governance cannot be regarded as a substitute.

20.4. Timing and Forms of Communication

Audit matters of governance interest should be communicated on a timely basis. This enables those charged with governance to take appropriate and timely action.

The engagement partner's decision whether to communicate matters orally or in writing depends on the entity's structure, the sensitivity and significance of the matter and prior arrangements made. Oral communications and responses should be documented in the working papers and consideration given to confirming these in writing with those charged with governance. The engagement team should consider whether matters previously communicated affect the current period and, if it continues to be a significant matter, whether the matter should be communicated again. One of the forms of communication is through a management letter.

20.5. Management Letter

A management letter is usually used to communicate key weaknesses in internal control and other issues that may have been noted during the course of the audit. A management letter does not absolve:

- The management from their responsibility to maintain sound control environment; and
- The auditor for his need to consider the effects of the weaknesses in the systems of internal control on the audit work and the audit opinion.

Appendix 26: Management Letter provides practical guidance on the contents and the follow up action of management letters**.**