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Audit Evidence

Mr. Samira Anthony

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-Samira Anthony-

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- ***"SLAuS 500 Audit evidence requires auditors to design and perform audit procedures that are appropriate in the circumstances for the purposes of obtaining sufficient appropriate audit evidence".***
  - Sufficiency is the measure of the **quantity** of audit evidence.
  - Appropriateness is the measure of the **quality or reliability** of the audit evidence.

The following generalizations may help in assessing the **reliability of audit** evidence.

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

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Financial Statement Assertions

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

Assertions about classes of transactions and events and related disclosures	Assertions about account balances and Related disclosures
Occurrence:	Existence:
Completeness:	Completeness:
Accuracy:	Accuracy, valuation and allocation:
Cut-off:	Rights and obligations:
Classification:.	Classification:
Presentation:	Presentation:

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Audit Procedures to Obtain Audit Evidence - Audit Procedures

Risk Assessment Procedures	Obtain an understanding of the entity and its environment to assess the risks of material misstatement at the financial statement and assertion levels
Risk Assessment Procedures	Test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level
Risk Assessment Procedures	Detect material misstatements at the assertion level Substantive analytical procedures & Tests of detail of classes of transactions, account balances and disclosures

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Methods of Gathering Evidenced

- Inspection of tangible assets
- Inspection of documentation or records
- Observation
- Enquiry
- Confirmation
- Recalculation
- Re-performance
- Analytical procedures

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Analytical Procedures

SLAuS 520 Analytical procedures provides guidance to auditors on the use of analytical procedures as substantive procedures.

- ✓ The consideration of comparisons with:
  - **Comparable information** for prior periods
  - **Anticipated results** of the entity, from budgets or forecasts
  - **Expectations** prepared by the auditors (eg estimation of depreciation)
  - **Industry information**
- ✓ Those between elements of financial information that are expected to conform to a predicted pattern based on the entity's experience, such as the relationship of gross profit to sales.
- ✓ Those between financial information and relevant non-financial information, such as the relationship of payroll costs to number of employees

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SLAuS 520 states that, when using analytical procedures as substantive tests, the auditor must:

- ✓ Determine the **suitability** of particular analytical procedures for given assertions.
- ✓ Evaluate the **reliability of data** from which the auditor's expectation of recorded amounts or ratios is developed.
- ✓ **Develop an expectation** of recorded amounts or ratios and evaluate whether this is **sufficiently precise** to identify a misstatement that may cause the financial statements to be materially misstated.
- ✓ Determine the amount of any difference that is **acceptable** without further investigation.

Reliability of data

The SLAuS sets out factors which influence the reliability of data which are set out in the following table, with examples.

- ✓ *Source of the Information*
- ✓ *Comparability of information available*
- ✓ *Nature and relevance of the information available*
- ✓ *Controls over the preparation of the information to ensure its completeness, accuracy and validity*

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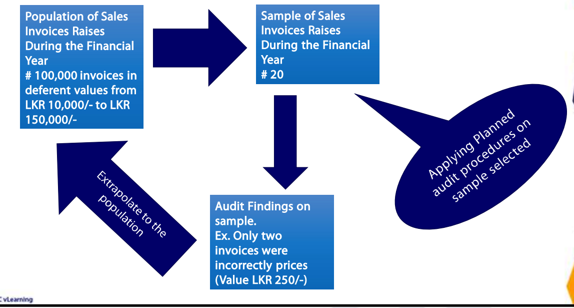
Audit Sampling



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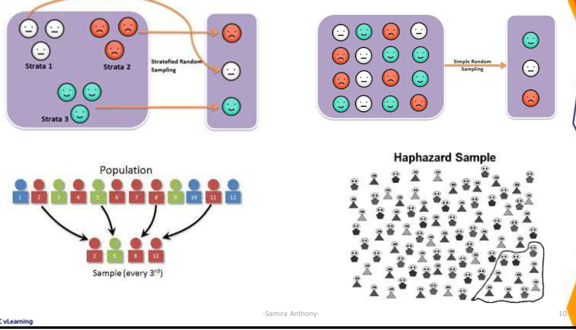

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SlAuS 530 Audit Sampling Provides Guidance to Auditors.

Some testing procedures do not involve sampling, such as:

- Testing 100% of items in a population
- Testing all items with a certain characteristic as selection is not representative

Auditors are unlikely to test 100% of items when carrying out tests of controls, but 100% testing may be appropriate for certain substantive procedures.

For example, if the population is made up of a small number of high-value items, where there is a high risk of material misstatement and other means do not provide sufficient appropriate audit evidence, then 100% examination may be appropriate.

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The auditor may, alternatively, select certain items from a population because of specific characteristics they possess. The results of items selected in this non-statistical way cannot be projected onto the whole population but may be used in conjunction with other audit evidence concerning the rest of the population.

- High-value or key items. The auditor may select high-value items or items that are suspicious, unusual or prone to error.
- All items over a certain amount. Selecting items this way may mean a large proportion of the population can be verified by testing a few items.
- Items to obtain information about the client's business, the nature of transactions, or the client's accounting and control systems.
- Items to test procedures, to see whether particular procedures are being performed.

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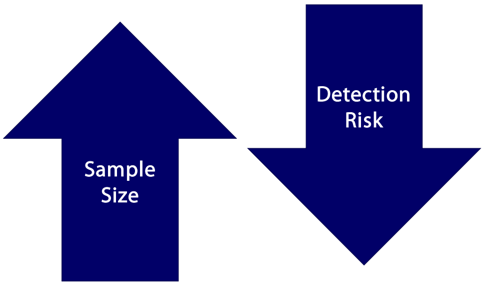
Design of the Sample

- Sampling risk is the risk that the auditor's conclusion based on a sample of a certain size may be different from the conclusion if the entire population were subjected to the same audit procedure.
- **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 such as, for example, the use of inappropriate audit procedures, or misinterpretation of audit evidence and failure to recognize a misstatement or deviation.
- **Sampling unit** is the individual items constituting a population. This may be a physical item (eg credit entries on bank statements, sales invoices, receivables balances), or a monetary unit.
- **Stratification** is the process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics (often monetary value).
- The auditor must consider the **purpose** of the audit procedure when designing an audit sample.
- The auditor must also consider the **characteristics of the population**. When considering the characteristics of the population, the auditor might determine that stratification or value-weighted selection is appropriate.

The main methods of selecting samples are random selection, systematic selection and haphazard selection. We discuss these, and other methods, below.

- ✓ **Random selection** ensures that all items in the population have an equal chance of selection, eg by use of random number tables or random number generators.
- ✓ **Systematic selection** involves selecting items using a constant interval between selections, the first interval having a random start. When using systematic selection auditors must ensure that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population.
- ✓ **Monetary unit sampling** is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts.
- ✓ **Haphazard selection** may be an alternative to random selection, provided auditors are satisfied that the sample is representative of the entire population.
- ✓ **Block selection** may be used to check whether certain items have particular characteristics. For example, an auditor may use a sample of 50 consecutive cheques to test whether cheques are signed by authorized signatories rather than picking 50 single cheques throughout the year.

Sample Size & Detection Risk / Audit Risk



Auditing opening balances

Opening balances

- **Opening balances** are those account balances that exist at the beginning of the period.
- They are based on the closing balances of the prior period and reflect the effects of transactions of prior periods and accounting policies applied in the prior period.
- They also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

An **initial audit engagement** is one in which either:

a) the financial statements for the prior period were not audited; or

b) the financial statements for the prior period were audited by a predecessor auditor.

SLAuS 510 *Initial audit engagements – opening balances* provides guidance to auditors on the audit of opening balances when conducting an initial audit engagement

The SLAuS states that, for initial audit engagements, the ***auditor's objective*** is to obtain sufficient appropriate audit evidence whether:

- Opening balances contain misstatements that materially affect the current period's financial statements.
- Appropriate accounting policies are consistently applied or changes have been properly accounted for and adequately presented and disclosed.

Audit Procedures

- Determining whether the prior period's closing balances have been correctly brought forward or restated
- Determining whether the opening balances reflect the application of appropriate accounting policies.
- Performing one or more of the following:

  - ✓ Where the prior period's financial statements were audited, reviewing the predecessor auditor's working papers
  - ✓ Evaluating whether audit procedures performed in the current period provide evidence relevant to opening balances
  - ✓ Performing specific audit procedures to obtain evidence regarding opening balances

Opening Balances – Audit Conclusions and Reporting

- If the auditor cannot obtain sufficient appropriate audit evidence for opening balances, the auditor shall express a qualified opinion or a disclaimer of opinion.
- If the opening balances contain misstatements that materially affect the current year's financial statements, the auditor shall express a qualified opinion or an adverse opinion.
- If the auditor concludes that the current period's accounting policies are not consistently applied in relation to opening balances, or changes have not been properly accounted for and adequately presented and disclosed, the auditor shall express a qualified opinion or an adverse opinion.
- If a prior-period modification remains relevant and material to the current period's financial statements, the auditor shall modify the auditor's opinion on the current period's financial statements accordingly.

Comparative Information

Consolidated statement of financial position

(All amounts in Sri Lankan Rupees thousands)

As at 31 March	Notes	Group 2019	2018
ASSETS			
Non-Current Assets			
Right to use of land	13	77,120	80,079
Property, plant and equipment	14	2,200,469	2,048,247
Intangible assets	15	24,925	24,844
Bearer biological assets	16	2,673,393	2,489,314
Biological assets - consumable	17.1	38,356	37,966
Biological assets - livestock	17.2	662,620	539,602
Investment fund	18	312,051	288,595
Investment in subsidiaries	19	-	-
Investment in debenture	20	-	-
Total Non-Current Assets		5,988,934	5,508,647
Current Assets			
Inventories	21	143,089	291,830
Biological assets-produce on bearer plants	17.3	31,271	29,143
Trade and other receivables	22	313,198	391,205
Loan given to related party	23	-	-
Amount due from related party	24	21,918	10,311
Cash and cash equivalents	25	204,001	180,264
Total Current Assets		713,477	902,753

Comparative Information
Corresponding figures

SLAuS 710
Comparative information

This comparative information may be presented in one of two ways:

✓ **Corresponding figures**, where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period. (Auditors report refers only current financial statements.)

✓ Comparative financial statements where amounts and other disclosures for the prior period are included for comparison with the financial statements of the current period but, if audited, are referred to in the auditor's opinion.

Auditor's responsibilities for comparative information

The SLAuS states that the auditor must determine whether the financial statements include the comparative information required by the applicable financial reporting framework and whether it is appropriately classified. This includes an evaluation of whether:

- The **accounting policies** used for corresponding figures or comparative financial statements are consistent with the current period.
- The corresponding figures or comparative financial statements **agree** with the amounts and other disclosures presented in the prior period.

If the auditor becomes aware of a possible material misstatement regarding the comparative information, the auditor must perform additional audit procedures to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists.

SLAuS 710 requires the auditor to obtain a **written representation** for all periods referred to in the auditor's opinion and a specific written representation regarding any restatements made to correct a material misstatement in prior period financial statements that affect the comparative information.

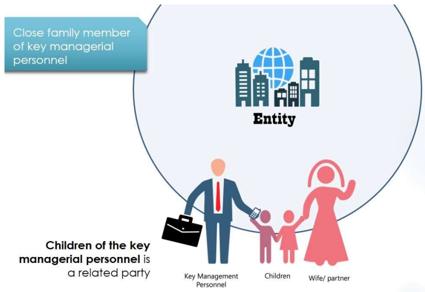
Corresponding figures – reporting

In terms of reporting, the audit report does not specifically refer to the corresponding figures because the opinion is on the current period's financial statements as a whole, and this includes the corresponding figures.

Comparative financial statements – reporting

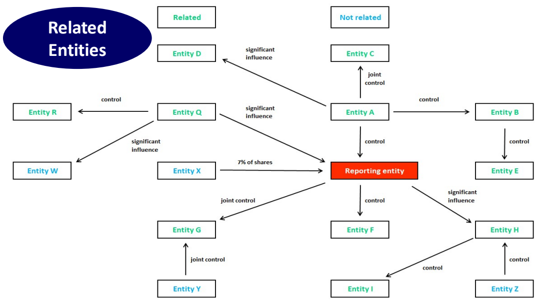
Comparative financial statements are not required in Sri Lanka. The only requirement is to include corresponding figures.

Related Party Transactions



Related Person

Related Entities



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<u>An audit cannot be expected to detect all material related party transactions.</u>

<u>The risk that undisclosed related party transactions will not be detected by the auditors is especially high when: (why Audit risk is high?)</u>

- **Related party transactions** have **taken place without charge**.
- **Related party transactions** are **not self-evident** to the auditors.
- Transactions are with a party that the auditors could **not reasonably** be expected to **know** is a **related party**.
- **Active steps** have been taken by **management** to **conceal** either the full terms of a transaction, or that a transaction is, in substance, with a related party.
- The **corporate structure** is **complex**.

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SLAuS 550.9

The objectives of the auditor are:

(a) Irrespective of whether the applicable financial reporting framework establishes related party requirements, 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 (for fair presentation frameworks), or
  - Are not misleading (for compliance frameworks)

b) In addition, where the applicable financial reporting framework establishes related party requirements, to obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately identified, accounted for and disclosed in the financial statements in accordance with the framework.

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Assessment and Identification of Risks (Procedures @ Planning Stage)

- Audit team discussion of risk shall include specific consideration of susceptibility of financial statements to material misstatement through related parties and their transactions
- Auditor shall inquire of management:
  - The identity of related parties including changes from prior period
  - The nature of the relationships between the entity and its related parties
  - Whether any transactions occurred between the parties, and if so, what
  - What controls the entity has to identify, account for and disclose related party relationships and transactions
  - What controls the entity has to authorize and approve significant transactions and arrangements with related parties
  - What controls the entity has to authorize and approve significant transactions and arrangements outside the normal course of business

(The auditor may have to perform risk assessment procedures, in addition, in respect of the latter three points.)

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- Maintain alert for evidence of related party transactions when obtaining other audit evidence, in particular, when scrutinizing bank and legal confirmations and minutes of meetings
- If significant transactions outside the normal course of business are discovered, enquire of management the nature of the transactions and whether related parties could be involved
- Share information obtained about related parties with the audit team.

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The Following Procedures May be Helpful: (How to Identify RP)

- ✓ Enquire of management and the directors as to whether transactions have taken place with related parties that are required to be disclosed by the disclosure requirements which are applicable to the entity
- ✓ Review prior-year working papers for names of known related parties
- ✓ Review minutes of meetings of shareholders and directors and other relevant statutory records such as the register of directors' interests
- ✓ Review accounting records for large or unusual transactions or balances, in particular transactions recognised at, or near, the end of the financial period
- ✓ Review confirmations of loans receivable and payable and confirmations from banks. Such a review may indicate the relationship, if any, of guarantors to the entity
- ✓ Review investment transactions, for example purchase or sale of an interest in a joint venture or other entity

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- Enquire as to the names of all pension and other trusts established for the benefit of employees and the names of their management and trustees
- Enquire as to the affiliation of directors and officers with other entities
- Review the register of interests in shares to determine the names of principal shareholders
- Enquire of other auditors currently involved in the audit, or predecessor auditors, as to their knowledge of additional related parties
- Review the entity's tax returns, returns made under statute and other information supplied to regulatory agencies for evidence of the existence of related parties
- Review invoices and correspondence from lawyers for indications of the existence of related parties or related party transactions

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Audit Procedures - Related Party Transactions

Auditor suspects existence of related parties not disclosed by management.	01. Determine whether the information does confirm the existence of related parties.
Auditor identifies related parties not disclosed by management.	1.Tell the rest of the audit team 2. Request management to identify all transactions with identified related party 3. Enquire as to why company controls failed to identify related party 4. Perform substantive procedures relating to related party and its transactions with entity – Making enquiries of third parties presumed to have knowledge, such as legal counsel – Conducting an analysis of accounting records for transactions with the related party (using a CAAT?) – Verifying terms and conditions of transactions by looking at the contract 5. Reconsider the risk of further related parties existing and not being disclosed to the auditor 6. If non-disclosure appears intentional, and therefore indicative of fraud, evaluate implications for audit.

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Auditor identifies related party transactions outside normal course of business	Inspect contracts/agreements and evaluate whether – The business rationale (or lack thereof) suggests a fraudulent purpose (is it overly complex, does it have unusual terms of trade, does it lack a logical business purpose?) – The terms of the transactions are consistent with management's explanations – The transactions have been accounted for and disclosed properly
Management has asserted in the financial statements that related party transactions were conducted at arm's length	Obtain sufficient appropriate evidence that this is true by looking at the terms of the contract and assessing: – Price – Credit terms – Contingencies – Specific charges

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Audit Procedures

Further audit procedures to be adopted should include the following.

- **Inspect** the **board minutes** and other records of transactions with directors and connected persons to consider their adequacy and whether or not they appear to have been kept up to date
- **Examine** any **agreements** and **contracts** involving **directors and connected persons**, including tracing the details of such transactions to any source documentation available
- **Consider** whether **transactions** disclosed are on **commercial** terms
- **Assess** the **recoverability** of amounts due from directors or connected persons
- **Review** the **legality** of the disclosable transactions recorded by the company.

Where auditors are of the opinion that a transaction is illegal, they should:

– Immediately advise the directors of their view

– Give careful consideration as to whether any reference to the matter will be required in the audit report

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- **Advise** the **client** to **seek legal advice** in those cases where there are doubts as to the legality and/or disclosable nature of a transaction
- **Consider** the **possibility** that the **company's details** of **disclosable transactions** may be incomplete as regards those directors (and connected persons) who have not been in office throughout the year
- **Review subsequent events** in order to consider whether they might have any impact on the matters requiring disclosure Finally, auditors should consider obtaining **written representations** from each director giving confirmation of any disclosable transaction which relates to himself and any persons connected with him.

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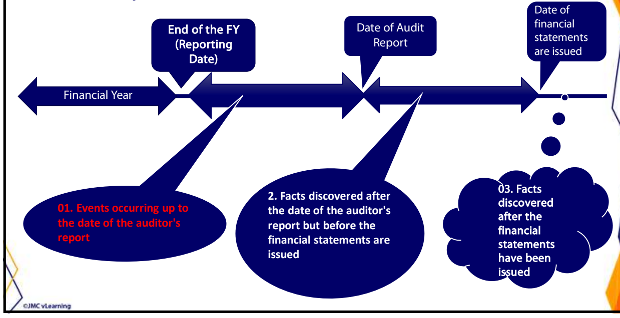
Subsequent Events



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SLAuS 560 Subsequent Events Provides Guidance To Auditors In This Area.

The objectives of the auditor are:

- To obtain sufficient appropriate audit evidence about whether events occurring between the date of the financial statements and the date of the auditor's report that need adjustment or disclosure in the financial statements are properly reflected in the financial statements
- To respond appropriately to facts that become known to the auditor after the date of the auditor's report that may have caused the auditor to amend the auditor's report, had they been known to the auditor at the date of the report

01. Events occurring up to the date of the auditor's report

The auditor shall perform procedures designed 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 have been identified.

Audit procedures - subsequent events.

- ✓ **Enquiries of management w**hether there are any new **commitments, borrowings or guarantees**
- ✓ Whether there have been any:
  - **Sales** or destruction of **assets**
  - **Issues** of **shares/debentures** or changes in business structure
  - **Developments** involving **risk areas, provisions** and **contingencies**
  - **Unusual accounting adjustments**
  - **Major events** (eg going concern problems) affecting appropriateness of accounting policies for estimates
  - Litigations or claims.

- ✓ **Review** management procedures for identifying subsequent events to ensure that such events are identified.
- ✓ **Read minutes** of general board/committee meetings and enquire about unusual items.
- ✓ **Review latest available interim financial statements** and budgets, cash flow forecasts and other management reports.
- ✓ **Obtain evidence** concerning any litigation or claims from the company's solicitors (only with client permission).
- ✓ Obtain **written representation** that all events occurring subsequent to the period-end which need adjustment or disclosure have been adjusted or disclosed.

02. Facts discovered after the date of the auditor's report but before the financial statements are issued

The financial statements are the management's responsibility. They should therefore inform the auditors of any material subsequent events between the date of the auditors' report and the date the financial statements are issued. The auditor does **not** have any obligation to perform procedures, or make enquires regarding the financial statements, **after** the date of the report.

However, if the auditor becomes aware of a fact that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

- ✓ **Discuss** the matter with management and those charged with governance.
- ✓ **Determine** whether the financial statements need amendment.
- ✓ If amendment is required, **enquire** how management intends to address the matter in the financial statements.

If amendment is required to the financial statements and management makes the necessary changes, the auditor must carry out a number of procedures:

- Undertake any **necessary audit procedures** on the changes made.
- **Extend audit procedures** for identifying subsequent events that may require adjustment of, or disclosure, in the financial statements to the date of the new auditor's report.
- Provide a **new auditor's report** on the amended financial statements.

If management does not amend the financial statements:

- If the auditor's report has not yet been provided to the entity, the auditor shall **modify the opinion** and then provide the auditor's report.
- If the auditor's report has already been provided to the entity, the auditor shall notify management and those charged with governance **not to issue** the financial statements before the amendments are made; but if the financial statements are issued anyway, the auditor shall take action to seek to **prevent reliance** on the auditor's report.

03. Facts discovered after the financial statements have been issued

Auditors have **no obligations** to perform procedures or make enquiries regarding the financial statements **after** they have been issued.

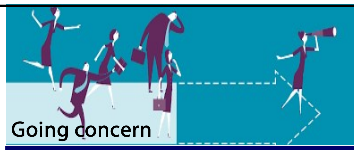
However, if the auditor becomes aware of a fact that, had it been known to the auditor at the date of the auditor's report, may have caused the auditor to amend the auditor's report, the auditor shall:

- ✓ **Discuss** the matter with management and those charged with governance.
- ✓ **Determine** whether the financial statements need amendment.
- ✓ If amendment is required, **enquire** how management intends to address the matter in the financial statements.

- If management amends the financial statements, the auditor shall carry out any necessary procedures on the amendment and review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements is **informed**.
- The auditor shall also issue a **new or amended auditor's report,** which will include an **explanatory paragraph** (known as an **emphasis of matter paragraph** or **other matter paragraph**) that refers to a note in the financial statements that discusses the reason for the amendment. Audit procedures will be extended up to the date of the new report.
- If management does not take the necessary steps, the auditor shall **notify** management and those charged with governance that the auditor will **seek to prevent future reliance** on the report. If management still does not act, the auditor shall take appropriate action to **seek to prevent reliance** on the auditor's report.

SLAuS 570 (Revised) *Going Concern*

Under the **going concern basis of accounting**, the financial statements are prepared on the assumption that the entity is a going concern and will continue its operations for the foreseeable future.



Going concern

- When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.
- The financial statements should be prepared on the going concern basis unless management either intends to liquidate the entity or has no realistic alternative but to do so.
- ***If the going concern basis is not appropriate, the financial statements are prepared on another basis, such as the liquidation basis.***

The objectives of the auditor are:

- To obtain sufficient appropriate audit evidence regarding, and conclude on, the **appropriateness** of management's use of the going concern basis of accounting in the preparation of the financial statements;
- To conclude, based on the evidence obtained, whether a **material uncertainty** exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern; and
- To determine the **implications** for the auditor's report SLAuS 570 includes examples of events or conditions that may cast doubt about the going concern assumption.

Financial

- Net liability or net current liability position
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment
- Indications of withdrawal of financial support by creditors
- Negative operating cash flows (historical or prospective)
- Adverse key financial ratios
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows
- Arrears or discontinuance of dividends
- Inability to pay creditors on due dates
- Inability to comply with terms of loan agreements
- Change from credit to cash-on-delivery transactions with suppliers
- Inability to obtain financing for essential new product development or other essential investments

Operating

- Management intentions to liquidate or cease operations
- Loss of key management without replacement
- Loss of a major market, key customers, licence, or principal suppliers
- Labour difficulties
- Shortages of important supplies
- Emergence of a highly successful competitor.

Other

- Non-compliance with capital or other statutory requirements
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that the entity is unlikely to be able to satisfy
- Changes in laws/regulations/government policy expected to adversely affect the entity
- Uninsured or underinsured catastrophes when they occur

- ✓ The auditor must **remain alert** throughout the audit for evidence of events or conditions that may cast significant doubt on the entity's ability to continue as a going concern.
- ✓ However, the auditor also has specific responsibilities in relation to management's assessment.
- ✓ The auditor shall **evaluate** management's assessment of the entity's ability to continue as a going concern.
- ✓ However, if this assessment covers less than 12 months from the date of the financial statements, the auditor shall ask management to extend its assessment period to **at least 12 months** from that date.
- ✓ The auditor shall also enquire of management its knowledge of events or conditions beyond the period of the assessment that may cast significant doubt on the entity's ability to continue as a going concern.

responsibilities in relation to management's assessment

Audit Procedures Applied in Performing Going Concern Reviews

- ✓ **Analyse and discuss cash flow**, profit and other relevant forecasts with management
- ✓ **Analyse and discuss** the entity's latest available **interim financial statements** (or management accounts)
- ✓ **Review the terms of debentures and loan agreements** and determine whether they have been breached
- ✓ **Read minutes** of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties
- ✓ **Enquire** of the entity's lawyer regarding **litigation and claims**
- ✓ **Confirm the existence, legality and enforceability** of arrangements to provide or maintain financial support with related and third parties
- ✓ **Assess** the **financial ability** of such parties to **provide additional funds**
- ✓ **Consider the entity's position** concerning unfulfilled customer orders
- ✓ **Review events after the period-end** for items affecting the entity's ability to continue as a going concern
- ✓ Confirm the existence, terms and **adequacy of borrowing facilities**
- ✓ Obtaining and **reviewing reports of regulatory actions**
- ✓ Determining the **adequacy of support for any planned disposals** of assets

Auditor Reporting

1. Going concern assumption appropriate but material uncertainty which is adequately disclosed
   Unmodified opinion
   Emphasis of matter - Section headed 'Material Uncertainty Related to Going Concern'

2. Going concern assumption appropriate but material uncertainty which is not adequately disclosed
   Qualified or adverse opinion (ie modified opinion)

3. Use of going concern assumption inappropriate
   Adverse opinion (ie modified opinion)

3. Management unwilling to make or extend its assessment
   Qualified or disclaimer of opinion (ie modified opinion)

Auditing Accounting Estimates

- Examples of accounting estimates include:
- Allowance for doubtful accounts
- Inventory obsolescence
- Warranty obligations
- Depreciation method or asset useful life
- Outcome of long-term contracts
- Costs arising from litigation settlements
- and judgements
- Provision against the carrying amount of
- an investment where there is uncertainty regarding its
- recoverability

SLAuS 540 ***Auditing accounting estimates***

Are your estimates reasonable?

When auditing accounting estimates auditors must:
- ✓ **Test the management process**
- ✓ **Use an independent estimate**
- ✓ **Review subsequent events**

Risk Assessment Procedures

- SLAuS 540 states that the auditor shall obtain an understanding of the following to provide a basis for the identification and assessment of the risks of material misstatement for accounting estimates:
  - ✓ The requirements of the applicable financial reporting framework
  - ✓ How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates
  - ✓ How management makes the accounting estimates and an understanding of the data on which they are based, including:
    - – Method
    - – Relevant controls
    - – Assumptions
    - – Whether change from prior period in method used
    - – Whether management has assessed the effect of estimation uncertainty
- The SLAuS also states that the auditor shall review the **outcome** of accounting estimates included in the **prior period**.

Responding to the Assessed Risks

The SLAuS requires the auditor to perform one or more of the following:

- Determine whether events occurring up to the date of the auditor's report provide audit evidence regarding the accounting estimate.
- Test how management made the accounting estimate and the data on which it is based.
- Test the operating effectiveness of controls over how the accounting estimate was made.
- Develop a point estimate or a range to evaluate management's point estimate.

Substantive procedures in response to significant risks

Where the auditor judges that the accounting estimate gives rise to a significant risk, he shall evaluate the following in accordance with SLAuS 540:

- How management has considered alternative assumptions and why these have been rejected
- Whether the assumptions used are reasonable
- Management's intent to carry out specific courses of action and its ability to do so

If the auditor considers that management has not adequately addressed the effects of estimation uncertainty on accounting estimates that give rise to significant risks, he shall, if necessary, develop a **range** with which to evaluate the reasonableness of the accounting estimate.

Other audit procedures

SLAuS 540 requires the auditor to do the following:

- ✓ Evaluate whether the accounting estimates are either **reasonable or misstated**.
- ✓ Obtain sufficient appropriate audit evidence about whether **disclosures** are correct.
- ✓ For accounting estimates that give rise to significant risks, evaluate the adequacy of **disclosure of their estimation uncertainty**.
- ✓ Review the judgements and decisions of management in making the accounting estimates to identify if there are indications of **possible management bias**.
- ✓ Obtain **written representations** from management whether management believes significant assumptions used are reasonable.

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Audit of Inventory

SLAuS 501

✓ **Existence (Physical Inventory Count)**

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Completeness

- ✓ **Trace** test counts to the detailed inventory listing.
- ✓ Where inventory is held in **third-party locations**, **physically inspect** this inventory or **review confirmations** received from the third party and match to the general ledger.
- ✓ **Compare** the gross profit % to the previous year or industry data.
- ✓ Complete the **disclosure checklist** to ensure that all the disclosures relevant to inventory have been made.

Existence

- Observe the **physical inventory count**

Rights and obligations

- ✓ Verify that any **inventory held for third parties** is not included in the year-end inventory figure by being appropriately segregated during the inventory count.
- ✓ For any **'bill-and-hold' inventory** (ie where the inventory has been sold but is being held by the entity until the customer requires it), identify such inventory and ensure that it is segregated during the inventory count so that it is not included in the year-end inventory figure.
- ✓ Confirm that any inventory held at **third-party locations** is included in the year-end inventory figure.

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Accuracy, Valuation and Allocation

- ✓ Obtain a copy of the inventory listing and **agree** the totals to the general ledger.
- ✓ **Cast** the inventory listing to ensure it is mathematically correct.
- ✓ Confirm that an appropriate **basis of valuation** (eg FIFO) is being used by discussing with management.
- ✓ **Vouch** a sample of inventory items to suppliers' invoices to ensure they are correctly valued.
- ✓ Where **standard costing** is used, test a sample of inventory to ensure it is correctly valued.
- ✓ For **materials**, agree the valuation of raw materials to invoices and price lists.
- ✓ For **labour** costs, agree costs to wage records.
- ✓ **Review** standard labour costs in the light of actual costs and production.
- ✓ **Reconcile** labour hours to time summaries.
- ✓ Make **enquiries of management** to ascertain any slow-moving or obsolete inventory that should be written down.
- ✓ **Examine prices** at which finished goods have been sold after the year-end to ascertain whether any finished goods need to be written down.
- ✓ If significant levels of finished goods remain unsold for an unusual period of time, **discuss** with management and consider the need to make allowance.

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- ✓ **Compare** the gross profit % to the previous year or industry data.
- ✓ **Compare** raw material, finished goods and total inventory turnover to the previous year and industry averages.
- ✓ **Compare** inventory days to the previous year and industry average.
- ✓ **Compare** the current year standard costs to the previous year after considering current conditions.
- ✓ **Compare** actual manufacturing overhead costs with budgeted or standard manufacturing overhead costs.
- Obtain a copy of the inventory listing and **cast** it, and test the mathematical extensions of quantity multiplied by price.
- **Trace** test counts back to the inventory listing.
- If the entity has adjusted the general ledger to agree with the physical inventory count amounts, **agree** the two amounts.
- Where a **continuous (perpetual) inventory system** is maintained, agree the total on the inventory listing to the continuous inventory records, using CAATs.

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Cut-off

- ✓ Note the numbers of the **last GDNs and GRNs** before the year-end and the **first GDNs and GRNs** after the year-end and check that these have been included in the correct financial year.

Occurrence and rights and obligations

- ✓ **Enquire** of management and **review** any loan agreements and board minutes for evidence that inventory has been pledged or assigned.
- ✓ Enquire of management about warranty obligation issues.

Classification

- ✓ **Review** the inventory listing to ensure that inventory has been properly classified between raw materials, work-inprogress and finished goods.
- ✓ **Read** the notes to the accounts relating to inventory to ensure they are understandable.

Presentation

- ✓ **Review** the financial statements to confirm whether the cost method used to value inventory is accurately disclosed.
- ✓ **Read** the notes to the accounts to ensure that the information is accurate and properly presented at the appropriate amounts.

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Audit Procedures at the Inventory Count

- SLAuS 501 *Audit evidence – specific considerations for selected items* provides guidance to auditors on attending the physical inventory count to obtain evidence regarding *the existence and condition* of inventory.

- **Planning attendance at inventory count**

  Audit procedures

  Gain knowledge

- **Review** previous year's **arrangements**.
- **Discuss with management** the inventory count arrangements and significant changes.

Assess key factors

- The **nature** and **volume** of the **inventory**
- **Risks** relating to inventory
- **Identification** of **high-value items**
- **Method of accounting for inventory**
- **Unit of measurement of inventory**
- **Location** of inventory and how it affects inventory control and recording
- **Internal control** and **accounting systems** to identify potential areas of difficulty

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Plan procedures

- **Ensure** a **representative selection** of **locations**, **inventory** and **procedures** are covered.
- Ensure sufficient attention is given to **high-value items**.
- **Arrange to obtain,** from any **third parties, confirmation** of inventory they hold.
- Consider the need for **expert help**.

Organization of count

- **Supervision** by senior staff including senior staff not normally involved with inventory
- **Tidying** and **marking** inventory to help counting
- **Restriction** and **control** of the production process and inventory movements during the count
- **Identification of damaged, obsolete, slow-moving, thirdparty** and **returnable** inventory

Counting

- **Systematic counting** to ensure all inventory is counted
- Teams of **two counters,** with one counting and the other checking or **two independent counts**

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Recording

- **Serial numbering, control** and **return** of all inventory sheets
- Inventory sheets being **completed** in **ink** and **signed**
- **Information** to be recorded on the **count records** (location and identity, count units, quantity counted, conditions of items, stage reached in production process)
- Recording of **quantity, conditions** and **stage of production** of **work-in-progress**
- Recording of last numbers of **goods inwards** and **outwards** records and of internal transfer records
- **Reconciliation** with **inventory records** and **investigation** and correction of any **differences**

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Attendance at inventory count

During the count the auditors should **observe** whether the count is being carried out according to instructions, carry out **test counts**, and watch out for **third-party inventory** and **slow-moving inventory** and **cut-off problems.**

Audit procedures - attendance at inventory count

- ✓ **Observe** whether the **client's staff** are following instructions as this will help to ensure the count is complete and accurate.
- ✓ **Perform test counts** to ensure procedures and internal controls are working properly, and to gain evidence over existence and completeness of inventory.
- ✓ **Ensure** that the **procedures** for **identifying damaged, obsolete** and **slow-moving** inventory operate properly; the auditors should obtain information about the inventory's condition, age, usage and, in the case of work-in-progress, its stage of completion, to ensure that it is valued appropriately.
- ✓ **Confirm** that **inventory held** on behalf of **third parties** is separately identified and accounted for so that inventory is not overstated.
- ✓ **Conclude** whether the **count** has been **properly carried out** and is sufficiently reliable as a basis for determining the existence of inventories.
- ✓ **Consider** whether any **amendment** is necessary to subsequent **audit procedures**.
- ✓ **Gain** an **overall impression** of the levels and values of inventories held so that the auditors may, in due course, judge whether the figure for inventory appearing in the financial statements is reasonable.

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When carrying out test counts the auditors should select items from the count records and from the physical inventory and check one to the other, to confirm the accuracy of the count records. These two-way tests provide evidence for completeness and existence. The auditors should concentrate on high-value inventory. If the results of the test counts are not satisfactory, the auditors may request that inventory be recounted.

The auditor's working papers should include:

- Details of their **observations** and **tests**
- The manner in which **points** that are **relevant** and **material** to the inventory being counted or measured have been dealt with by the client
- Instances where the **client's procedures** have **not been satisfactorily carried out**
- **Items for subsequent testing**, such as photocopies of (or extracts from) rough inventory sheets
- **Details** of the **sequence** of **inventory sheets**
- The **auditors' conclusions**

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After the Inventory Count

After the count the auditors should check that final inventory sheets have been properly compiled from count records and that book inventory has been appropriately adjusted.

Audit procedures - following up inventory count.

- Trace items that were test counted to final inventory sheets.
- Observe whether all count records have been included in final inventory sheets.
- Inspect final inventory sheets to ensure they are supported by count records.
- Ensure that continuous inventory records have been adjusted to the amounts physically counted or measured, and that differences have been investigated.
- Confirm cut-off by using details of the last serial number of goods inwards and outwards notes and details of movements during the count.
- Review replies from third parties about inventory held by or for them.
- Confirm the client's final valuation of inventory has been calculated correctly.
- Follow up queries and notify problems to management.

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Inventory Held by Third Parties

- Where the entity has inventory that is held by third parties and which is material to the financial statements, the auditor shall obtain sufficient appropriate audit evidence by performing one or both of the following:
- **Direct confirmation** from the third party regarding quantities and condition (in accordance with SLAuS 505 *External confirmations*)
- **Inspection** or other **appropriate audit procedures** (if third party's integrity and objectivity are doubtful)

The other appropriate audit procedures referred to above could include the following:

- Attending, or arranging for another auditor to attend, the third party's inventory count
- Obtaining another auditor's report on the adequacy of the third party's internal control for ensuring that inventory is properly counted and adequately safeguarded
- Inspecting documentation in respect of third-party inventory (eg warehouse receipts)
- Requesting confirmation from other parties when inventory has been pledged as collateral

Audit Procedures –Cut Off

- The auditors should consider whether management has implemented adequate cut-off procedures: procedures intended to ensure that movements into, within and out of inventories are properly identified and reflected in the accounting records.
- (a) Appropriate systems of recording of receipts and dispatches of goods are in place, and also a system for documenting materials requisitions. Goods received notes (GRNs) and goods dispatched notes (GDNs) should be sequentially pre-numbered.
- (b) Final GRN and GDN and materials requisition numbers are noted. These numbers can then be used to subsequently check that purchases and sales have been recorded in the current period.
- (c) Arrangements should be made to ensure that the cut-off arrangement for inventories held by third parties are satisfactory.
- There should ideally be no movement of inventory during the count. Preferably, receipts and dispatches should be suspended for the full period of the count. It may not be practicable to suspend all deliveries, in which case any deliveries which are received during the count should be segregated from other inventory and carefully documented.

Using the Work of Others

Internal Auditor's Works

Expert's Works

Service Organization

In External Audit

Using the Work of an Expert

SLAuS 620 *Using the work of an auditor's expert*

evaluation of *expert*

evaluation of *works*

impact to the *audit report*

evaluation of *expert*

Competence, capabilities and objectivity of the auditor's expert

Information on these areas may come from the following sources:

- **Personal experience** with previous work done by the expert
- **Discussions with the expert**
- **Discussions with other people** who are familiar with the expert's work
- Knowledge of the expert's **qualifications, membership of a professional body or industry association,**
- **licence to practice** etc.
- **Published papers or books** by the expert
- The auditor's firm's **quality control policies and procedures**

Obtaining an understanding of the field of expertise

The auditor shall obtain a sufficient understanding of the auditor's expert's field of expertise to allow the auditor to determine the nature, scope and objectives of the work and to evaluate the adequacy of the work done.

Agreement

SLAuS 620 requires the auditor to agree in writing the following with the auditor's expert:

- **Nature, scope and objectives** of the work
- Respective **roles and responsibilities** of the auditor and the auditor's expert
- **Nature, timing and extent of communication** between auditor and auditor's expert, including the **form of any report**
- **Confidentiality requirements**

The agreement between the auditor and the auditor's expert is often in the form of an engagement letter. The Appendix to SLAuS 620 lists matters to consider for inclusion in the engagement letter.

evaluation of *works*

Evaluating the work of the auditor's expert

The auditor shall evaluate the adequacy of the auditor's expert's work, which will include the following:

- The **relevance and reasonableness** of the expert's work and **consistency** with other audit evidence
- The relevance and reasonableness of any **assumptions and methods** used
- The relevance, completeness and accuracy of any **source data** used

If the auditor's evaluation results in a conclusion that the expert's work is not adequate, the auditor must agree on the nature and extent of further work to be done by the expert, and perform additional audit procedures that may be necessary in the circumstances.

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impact to the *audit report*

Reference to the auditor's expert in the auditor's report

The auditor must not refer to the work of an auditor's expert in the auditor's report containing an unmodified opinion (unless required by law or regulation). If the auditor makes reference to the work of an auditor's expert in the auditor's report because it is relevant to understanding a modification to the opinion, the auditor must state in the auditor's report that this reference does not reduce the auditor's responsibility for the opinion.

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Using the Work of Internal Audit

SLAuS 610

- **The objectives of the auditor (as stated in SLAuS 610) are as follows.**
  - To determine whether, and to what extent, to use specific work of the internal auditors; and
  - Having made that determination and if using the work of the internal audit function, to determine whether that work is adequate for the purposes of the audit.

evaluation of *IA* → evaluation of *works* → impact to the *audit report*

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Evaluating the Internal Audit Function

evaluation of *IA*

Objectivity of the function

Consider the **status** of the internal audit function, to whom it **reports**, any **conflicting responsibilities**, any **constraints or restrictions**, whether those charged with governance oversee **employment decisions** regarding internal auditors, whether management acts on **recommendations** made.

Technical competence

Consider whether internal auditors are **members of relevant professional bodies**, have adequate **technical training and proficiency**, whether there are **established policies for hiring and training**

Due professional care

Consider whether internal audit activities are **properly planned, supervised, reviewed and documented**, the **existence of audit manuals**, **work programmes** and **internal audit documentation**

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Effective Communication

- Communication will be most effective when internal auditors are **free to communicate openly** with external auditors and **meetings are held regularly**, when the external auditor has **access** to relevant internal audit reports and is informed of any **significant matters**, and the external auditor informs the internal auditors of any **significant matters**.
- When determining the **areas and the extent** to which the work of the internal audit function can be used, the auditor must consider the:
- **Nature and scope** of specific work performed or to be performed
- Assessed risks of material misstatement at assertion level
- **Degree of subjectivity** involved in evaluation of audit evidence gathered by internal auditors

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Using the Work of Internal Audit

evaluation of *works*

- The external auditors need to **evaluate** and **perform audit procedures** on the work done by internal auditors that they might be able to use, in order to determine its adequacy. The evaluation includes the following:
  - Whether the work was done by internal auditors having **adequate technical training and proficiency**
  - Whether the work was **properly supervised, reviewed and documented**
  - Whether **adequate audit evidence** was obtained to allow the internal auditors to draw reasonable conclusions
  - Whether the **conclusions** reached are **appropriate** and any reports are **consistent** with the results of the work done
  - Whether any **exceptions or unusual matters** disclosed are **properly resolved** The nature, timing and extent of the audit procedures performed on specific work of the internal auditors will depend upon the external auditor's assessment of the risk of material misstatement of the area concerned, the evaluation of internal audit and the evaluation of the specific work of the internal auditors.

  Audit procedures might include:
  - Examination of items **already examined** by the internal auditors
  - Examination of **other similar items**
  - **Observation of procedures** performed by the internal auditors

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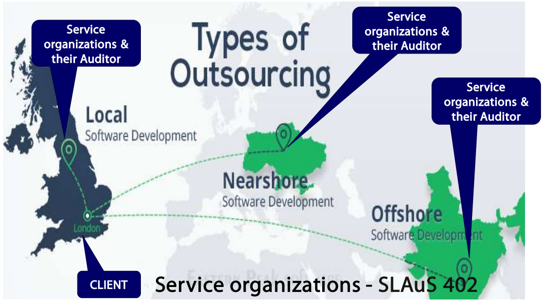

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- A **service organisation** provides services to user entities. There may be special considerations for the auditor of a user entity when that entity makes use of a service organisation.
- A **service organisation** is a third-party organisation that provides services to user entities that are part of those entities' information systems relevant to financial reporting.
- A **user entity** is an entity that uses a service organisation and whose financial statements are being audited.
- A **user auditor** is an auditor who audits and reports on the financial statements of a user entity.
- A **service auditor** is an auditor who, at the request of the service organisation, provides an assurance report on the controls of a service organisation.

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Understanding the Services Provided

User auditors must obtain an understanding of the services provided by the service organisation in accordance with SLAuS 315. This understanding must include the following:

- Nature of services provided and the significance of these to the user entity, including effect on user entity's internal control
- Nature and materiality of transactions processed or financial reporting processes affected
- Degree of interaction
- Nature of relationship, including contractual terms

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If the user auditor cannot get this understanding from the user entity, the understanding needs to be obtained from one or more of the following procedures:

- ✓ *Obtaining a type 1 report (report on description and design of controls at a service organisation) or type 2 report (report on the description, design and operating effectiveness of controls at a service organisation) from a service auditor, if available*
- ✓ *Contacting the service organisation through the user entity*
- ✓ *Visiting the service organisation and performing necessary procedures*
- ✓ *Using another auditor to perform necessary procedures*

If the user auditor uses a type 1 or type 2 report to obtain an understanding of the services, the auditor must be satisfied as to the service auditor's professional competence and independence, and the adequacy of standards used.

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Responding to the assessed risks of material misstatement
In responding to the assessed risks in accordance with SLAuS 330, the user auditor must:

- Determine whether **sufficient appropriate audit evidence** concerning the relevant financial statement assertions is available from records held at the user entity; and if not
- Perform further audit procedures to obtain sufficient appropriate audit evidence or use another auditor to perform those procedures at the service organisation on the user auditor's behalf.

Reporting by the user auditor

The user auditor is always **solely responsible** for the auditor's opinion. He must be assured that he has gained sufficient appropriate audit evidence to form an opinion on the financial statements and he must then express his opinion in the auditor's report. The user auditor must therefore not refer to the work of a service auditor in the user auditor's report if it contains an unmodified opinion (unless required by law or regulation). If the user auditor makes reference to the work of a service auditor in the user auditor's report because it is relevant to understanding a modification to the opinion, the user auditor must state in the user auditor's report that this reference does not reduce the user auditor's responsibility for the opinion.

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