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1 USING THE ICASL AUDIT MANUAL

1.1 Introduction

The ICASL Audit Manual (the manual) is a stand-alone system, with complete audit documentation available for use as required. It incorporates all the documentation required to enable compliance with the Sri Lanka Auditing Standards. The system is very flexible, allowing you, through the planning, to decide the best approach to auditing each of the relevant sections. This enables you to comply with all the relevant standards as efficiently and effectively as possible.

1.2 Referencing system

All working papers generated during the course of the audit or documents filed on the audit working paper file should be referenced and cross-referenced to facilitate review. The system contains detailed indices for all sections.

1.3 Forms

The forms in the manual have been designed to facilitate and encourage review and conclusions.

Where a form requires a formal conclusion, this will always be found at the bottom of the form, where space is provided for originator and reviewer to sign. Many of the forms may be signed by staff other than the audit principal, hence the use of the terms 'prepared by' and 'reviewed by'. Where, however, a signature is required by a senior/manager and/or partner specifically, the forms specify this.

Where forms do not require a formal conclusion, the 'prepared by' and 'reviewed by' sections are to be found at the head of the form or schedule. Staff of appropriate seniority, should complete these with reviewers, in particular, being trained to carry out the task. There is also a box at the top of the page to indicate that the form has been tailored at the planning stage by a particular individual, and allowing for review of the tailoring. This is essential to allow for the overall review of the planning by the audit principal.

The term 'partner' or 'principal' has been used to denote the responsible individual engagement partner on the audit, who may be a sole practitioner. In certain circumstances, 'second partner' may refer to another firm, sole practitioner or other external agency with whom consultation has taken place. Incorporated practices should interpret these terms accordingly.

1.4 Printing

The Excel Programme Generator allows a tailored selection of programmes to be produced in Microsoft Excel with the clients name and period end together with some tailoring of the programmes themselves. The forms may then be printed at this stage and completed manually or completed on-screen.

2 Key Issues from SLAUS

There are many more similarities between the old Sri Lanka Auditing Standards and the new Sri Lanka Auditing Standards than there are differences. In terms of the number of standards most have no significant changes. However, where there are changes, particularly in relation to risk assessment and internal controls, the changes are significant and pervade the whole audit approach.

The three key standards where there are the most significant changes are:

- SLAuS 240: The Auditor's Responsibilities to Consider Fraud in an Audit of Financial Statements.
- SLAuS 315: Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement.
- SLAuS 330: The Auditor's Procedures in Response to Assessed Risks.

This section of the guidance highlights key issues from the above standards and explains how they are addressed in the manual.

2.1 SLAuS 315: Understanding the entity and its environment and assessing the risks of material misstatement.

This auditing standard sets out two areas that are key to the audit planning process. The first is the information you need to demonstrate that you have understood the entity and its environment, the second is your assessment of the risk of a material misstatement arising within that entity and environment.

Basic Principle

SLAuS 315 Paragraph 2

The auditor should obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatement of the financial statements whether due to fraud or error, and sufficient to design and perform further audit procedures.

Fraud is dealt with separately under SLAuS 240 and is looked at later in these guidance notes. What is considered 'sufficient' is a matter of professional judgement and compliance with aspects of the auditing standard. The standard does refer in various sections to smaller entities having a less structured and rigorous control procedure but elements of the assessment of both the entity and the risks still need to be recorded.

The introduction to this standard also introduces the concept of '***Risk Assessment Procedures***'. This is defined as those procedures aimed at obtaining an understanding of the entity, its environment and the related internal control procedures. It says that these procedures can be carried out in conjunction with substantive testing and control testing.

Procedures to obtain an understanding of the entity, its environment including its internal control

SLAuS 315 Paragraph 7

The auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control:

a) Inquiries of the management and others within the entity;

b) Analytical procedures; and

c) Observation and inspection.

These activities are very much the approach that would have been taken to recording the accounting systems and controls over those systems under the old auditing standards. This would include the use of walk-through tests to ensure that your understanding of the process is complete. It should be noted that these procedures must be documented and you are not permitted to do only (a) above you must cover all three areas.

A large amount of this information will be filed on the permanent file. For example the ***Know Your Client Checklist (PAF 04)*** will guide you through the requirements of SLAuS 315 help to identify some of these areas. The SLAuS says that if you are going to rely on information that has been obtained in previous periods then you need to ensure that the information is still relevant and up to date (SLAuS 315 Paragraph 12).

SLAuS 315 Paragraph 14

The members of the engagement team should discuss the susceptibility of the entity's financial statements to material misstatements.

This discussion is aimed at the following issues:

- Understanding the risks of fraud and error
- Reviewing the audit approach to these risk areas
- Emphasising the need for professional scepticism when carryout the audit and reviewing the test results.

This process is evidenced on the C section by the use of ***C4 Notes of Planning Meeting***.

<u>Specific Areas that the audit team need to understand</u>

The SLAUS then goes on to cover specific issues with respect to the entity and its environment that the audit team need to understand to demonstrate that they have assessed the risk of material misstatement adequately.

The following bold paragraphs in SLAuS 315 set out the background knowledge that is specifically needed. As notes above, the ***Know Your Client Checklist (PAF 04)*** is a guide to the information required.

Paragraph 22 – **The auditor should obtain an understanding of relevant industry, regulatory, and other external factors including the applicable financial reporting framework.**

Paragraph 25 – **The auditor should obtain an understanding of the nature of the entity.**

Paragraph 28 – **The auditor should obtain an understanding of the entity's selection and application of accounting policies and consider whether they are appropriate for its business**

and consistent with the applicable financial reporting framework and accounting policies used in the relevant industry.

Paragraph 20 highlights the following areas that should be considered in order to understand the entity and its environment:

a) Industry, regulatory and other external factors, including the applicable financial reporting framework.

b) Nature of the entity, including the entity's selection and application of accounting policies.

c) Objectives and strategies and the related business risk that may result in a material misstatement of the financial statements.

d) Measurement and review of the entity's financial performance.

e) Internal control

These paragraphs indicate a much greater emphasis on understanding the industry within which the clients business operates so that you can form a judgement about the accounting policies adopted by the client.

Understanding the clients business plan

SLAuS 315 Paragraph 30

The auditor should obtain an understanding of the entity's objectives and strategies, and the related business risk that may result in material misstatement of the financial statements.

The overall business plan for the client will cover many areas that have little immediate effect on the accounts. The auditors should focus on those business risk issues that may be relevant to the current information in the accounts. In the long run nearly all areas covered in a business plan will feed through into the accounts in some format. By updating your understanding of the client's objectives you should be able to track the corresponding changes within the accounts.

A business plan is a statement of objectives by the management team for that business. Strategies are the activities that the management team has adopted to achieve those objectives. Business risk arises from poor/inappropriate objectives and strategies or circumstances that could adversely affect the entity's ability to achieve its objectives. As the business develops the business plan and hence the objectives and strategies will change. The auditor needs to review the business plan and make an assessment of the business risk issues associated with that plan.

Paragraph 34 says that for the smaller business it may not have a formal process of recording its objectives and strategies. The auditor in these circumstances should obtain an understanding of the business plan through inquires of the management and observation of how the client reacts to risk issues.

This may also represent an opportunity to help the client develop a business plan and a risk map for his business.

Ratios and Performance Indicators

SLAuS 315 Paragraph 35

The auditor should obtain an understanding of the measurement and review of the entity's financial performance.

This requires the auditor to have some understanding of the information (internal and external) that may be generated to help the management team review and track the performance of the business. The SLAuS defines this information as consisting of:

Internal Information

- Key Performance Indicators (Financial and non-financial)
- Budgets
- Variance analysis
- Segment information and divisional, departmental or other level performance reports
- Comparisons with competitors

External Information

- Analyst's reports
- Credit rating agency reports

Paragraph 40 deals with smaller entities by saying that they often do not have a formal process for measuring the performance of the business. However, management often rely on certain key information which experience tells them is a good indicator of how the business is performing. The audit team should understand this key information.

Internal Control

SLAuS 315 Paragraph 41

The auditor should obtain an understanding of internal control relevant to the audit.

SLAuS 315 Paragraph 67

The auditor should obtain an understanding of the control environment

It is important to note that you are required to obtain an understanding of the internal control operated by the client regardless of whether you intend to rely on those controls or not. The SLAuS draws a distinction between understanding the controls and testing the operation of those controls during the accounting period in question.

Paragraph 43 identifies that internal control has the following components:

- The control environment.
- The entity's risk assessment process.

- The information system, including the related business processes, relevant to financial reporting and communication.
- Control activities
- Monitoring of controls

The auditor is only interested in those internal controls that relate to the preparation of accounts that give a true and fair view and the management of risk that may give rise to a material misstatement in the accounts.

The SLAuS does concede that smaller entities will have less formal controls and the control activities may be dependant on the management and so the components of the internal control may not be clearly distinguishable. However the underlying purpose of the control is still equally valid.

The auditor should review the following areas that go to make up the control environment:

- Communication and enforcement of integrity and ethical values.
- Commitment to competence.
- Participation by those charged with governance.
- Managements philosophy and operating style.
- Organisational structure.
- Assignment of authority and responsibility.
- Human resource policies and practices.

For smaller entities the client may cover the above areas in an informal way. However, it is important for the auditors of a smaller entity to understand the owners/directors attitude and behaviour towards the control environment. Paragraph 54 of the standard requires the auditor to consider the design of a control in determining whether to consider its implementation. A poorly designed control may give rise to a material weakness in the companies control systems and should be reported to the client via the management letter.

As far as the auditor is concerned the client may implement the control in an informal way but he will still be required to document that control on the audit file. This is addressed on ***C5.1 Review of Design and Implementation of Internal Controls***.

<u>The Clients approach to Risk Assessment</u>

SLAuS 315 Paragraph 76

The auditor should obtain an understanding of the entity's process for identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks, and the results thereof.

Smaller entities may not have a formal risk assessment process. For these entities the auditor discusses with the management how risks to the business are identified and addressed.

Understanding the clients systems

SLAuS 315 Paragraph 81

The auditor should obtain an understanding of the information systems, including the related business 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 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 systems 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.**

This is a detailed requirement to understand how the client deals with the information within the business and how that information is controlled and recorded.

Linked in to the above assessment is the following requirement:

SLAuS 315 Paragraph 90

The auditor should obtain a sufficient understanding of control activities to assess the risks of material misstatement at the assertion level and to design further audit procedures responsive to assessed risks.

The SLAuS gives the following examples of specific control activities that may be identified.

- Authorization
- Performance reviews
- Information processing
- Physical controls
- Segregation of duties

There is also now a specific requirement regarding IT.

SLAuS 315 Paragraph 93

The auditor should obtain an understanding of how the entity has responded to risks arising from IT.

The SLAuS recommends that you should consider IT-controls over the following areas:

- Data centre and network operations.
- Software acquisition, change and maintenance
- Access security
- Systems acquisition, development and maintenance

<u>The ICASL Manual Approach</u>

The above illustrates that there is a much more detailed requirement to understand the entity, its business and the environment in which it operates. There are a number of forms designed to address this requirement in the permanent file.

In particular the manual has a ***Know your Client Checklist (PAF 04)***. This is designed to cover a number of the areas highlighted above. The checklist is at the back of this section. Section 3 of the permanent file deals with the accounting systems and this has the following sections:

- 3.2 Review of design and implementation of controls
- 3.3 Internal Control Questionnaire
- 3.4 Systems Notes

The approach to assessing the internal control is covered by checklist ***S4 Internal Control Questionnaire*** and ***S3 Internal Control Evaluation.***

At the planning stage the requirement to assess the internal control is picked up by schedule ***C5.1 Review of Design and Implementation of Internal Controls***. This schedule notes that work such as inspecting documents or tracing transactions through the system is required to confirm the control evaluation.

<u>Assessing the risks associated with the entity's environment</u>

SLAuS 315 Paragraph 100

The auditor should identify and assess the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances, and disclosures.

The financial statement level is addressed on ***C6.4*** and ***C6***.

The assertion level is covered by ***C6.2*** and ***C6.3*** and also ***C6.4.***

SLAuS 315 Paragraph 108

As part of the risk assessment as described in paragraph 100, the auditor should determine which of the risks identified are, in the auditor's judgement, risks that require special audit consideration (such risks are defined as "significant risks").

This is covered on schedule ***C6.3*** in the manual by identifying the risk as high, which would indicate that it is considered to be a significant risk.

SLAuS 315 Paragraph 113

For significant risks, to the extent the auditor has not already done so, the auditor should evaluate the design of the entity's related controls, including relevant control activities, and determine whether they have been implemented.

Having identified risk issues the auditor should consider if the risk is a 'significant risk'. This is defined as a risk that by its nature could give rise to a material misstatement or multiple misstatements and has a reasonable likelihood of occurring. The auditor when considering the nature of the risks identified should consider the following:

- Whether the risk is a risk of fraud.

- Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention.

- The complexity of the transaction.

- 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.

The process of understanding the entity and its environment should lead you to automatically identify and assess risk issues. Risks that are associated with strong internal control activities can be mitigated through some reliance on the controls that exist. Risks that are associated with poor or weak internal control activities need to be highlighted and considered when the overall audit plan is put together.

SLAuS 315 Paragraph 115

As part of the risk assessment as described in paragraph 100, the auditor should evaluate the design and determine the implementation of the entity's controls, including relevant control activities, over those risks for which, in the auditor's judgement, it is not possible or practicable to reduce the risks of material misstatements at the assertion level to an acceptably low level with audit evidence obtained only from substantive procedures.

This would be the situation were the client is processing a large number of transactions electronically in an integrated system so there is little audit trial to follow. In this case you may be forced to rely to a high degree on the controls operated by the client to ensure that all the transactions are processed.

<u>Management Letters</u>

SLAuS 315 Paragraph 120

The auditor 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 control which have come to the auditor's attention.

<u>Documentation</u>

SLAuS 315 Paragraph 122

The auditor should document:

a) **The discussions among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to error or fraud, and the significant decisions reached;**

b) **Key elements of the understanding obtained regarding each of the aspects of the entity and its environment identified in paragraph 20, including each of the internal control components identified in paragraph 43, to assess the risks of material misstatements of the financial statements; the sources of information from which the understanding was obtained; and the risk assessment procedures;**

c) **The identified and assessed risks of material misstatement at the financial statement level and at the assertion level as required by paragraph 100; and**

d) **The risks identified and related controls evaluated as a result of the requirements in paragraphs 113 and 115.**

These documentation requirements will be met by improving the detail and information on the permanent file. The Know Your Client checklist is a guide to the sort of areas that should be included.

The supporting notes to this area say that the form and extent of the documentation will be influenced by the nature, size and complexity of the business and its internal control. The availability of information from the business and the audit approach adopted by the firm will also have an impact on the level of information.

Ordinarily, the more complex the entity and the more extensive the audit procedures performed by the auditor, the more extensive the auditor's documentation will be.

<u>2.2 SLAuS 330: The Auditors Procedures in Response to Assessed Risks</u>

This standard sets out the response that the audit team should have to the risks that have been identified at the planning stage. It also covers the further response that may be needed if additional risks are identified during the audit stage.

The standard requires the auditor to demonstrate that his planned audit approach has a link between the level of assessed risk and the type of audit evidence obtained in response to this risk. The standard considers the auditors response to risks identified at the financial statement level and risks identified at the assertion level. The financial statement level relates to the overall view given by the accounts as a whole and the assertion level relates to specific assertions in individual areas.

SLAuS 330 Paragraph 3

In order to reduce audit risk to an acceptably low level, the auditor should determine overall responses to assessed risks at the financial statement level, and should design and perform further audit procedures to respond to assessed risks at the assertion level.

This is covered by ***C6.3 Specific Risk Action Plan*** for risks that have an impact at the assertion level and on ***C6 Audit Risk Summary*** for financial statement risks not addressed on ***C6.3***.

The standard then goes on to expand on the approach in these two areas.

SLAuS 330 Paragraph 4

The auditor should determine overall responses to address the risks of material misstatement at the financial statement level.

Where risks can be addressed at the assertion level then this should be documented on ***C6.3***. So for example, the sale of the business could be seen as a financial statement risk; however, if we know that the sale price will be based on a multiple of profits then this can be linked to the assertions for overstatement of income and understatement of expenses. Where a risk requires a more general response such as the use of staff with particular experience or qualifications then this should be documented on ***C6***.

This assessment of risk at the financial statement level will be affected by your understanding of the control environment. If the control environment is good then this may give you confidence with regard to the reliability of the audit evidence generated internally. The response to this low risk level may be to test the controls as part of an interim audit approach to justify your reliance on them. If the controls are weak then you may focus more of your audit testing into the final audit and seek more extensive audit evidence from substantive procedures.

This is similar to the old audit approach of deciding on a systems approach combined with some substantive testing or a substantive approach with no reliance on the systems and controls.

There is however a key difference in the SLAuS approach. SLAuS 315 requires us to '***obtain an understanding of internal control relevant to the audit***'. We have to do this regardless of whether we intend to rely on the control or not. Further more the SLAUS goes on to say that inquiry alone is not sufficient to understand the internal control we have to also consider further work such as inspection of documents or performing a walk through test. Just asking the client about his controls will not be sufficient audit evidence whereas in the past it has been if no reliance was being placed on the systems.

Audit approach at the Assertion Level

SLAuS 330 Paragraph 7

The auditor should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the assertion level.

If the audit approach is to be only substantive the auditor needs to consider if the audit evidence generated by a substantive only approach will be sufficient to reduce the risk of a material misstatement to an acceptably low level.

This will link into your risk assessments for individual material areas within the balance sheet and profit and loss account. (***See C6.2***) If you are assessing the risk of a material misstatement in, say, debtors as being low because the client has good systems (for example they are using a proprietary programme) then the audit file will need some additional testing of the internal controls that you are relying on when making this assessment. This would be a test of the effectiveness of the controls, which is additional to the work required to understand the controls.

It may be more cost effective to assess the risk in debtors as medium and thus increase your substantive testing and not place any reliance on the systems being used by the client. This approach would be valid provided you conclude that the increased substantive testing would reduce the risk to an acceptably low level.

Testing of Controls

SLAuS 330 Paragraph 23

When the auditor's assessment of risks of material misstatements at the assertion level includes an expectation that controls are operating effectively, the auditor should perform tests of controls to obtain sufficient appropriate audit evidence that the controls were operating effectively at relevant times during the period under audit.

To continue the example above using debtors, if we have concluded that debtors are low risk due to the operation of the accounting system we would need to identify the controls that are relevant to this area. These controls may be:

- Reconciliations of the sales ledger control account monthly.
- Review of all debtors over 90 days together with a review of any individual client who is over his credit limit.
- Authorisation of credit notes.

We would then on the audit file need to test the operational effectiveness of these controls by reviewing the documentary evidence for their existence during the accounting period.

SLAuS 330 Paragraph 25

When, in accordance with paragraph 115 of SLAuS 315, the auditor 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 auditor should perform tests of relevant controls to obtain audit evidence about their operating effectiveness.

An example of an area where substantive testing may not be sufficient on its own would be completeness of income. For many clients we will place some reliance on their own controls when assessing if income is complete. To do this under the new SLAuS approach will involve us in some systems testing to justify that reliance.

The SLAuS draws a distinction between operating effectiveness and checking that controls have been implemented. When obtaining audit evidence of implementation by performing risk assessment procedures, the auditor determines that the relevant controls exist and that the entity is using them.

When performing tests of the operating effectiveness of controls, the auditor obtains audit evidence that controls operate effectively. This would include checking that the controls were in operation for the period concerned or at the relevant time within the period.

Unless we conclude that substantive testing alone is insufficient or our risk assessments relies on the controls being in operation we have the choice as to whether we take a systems approach or not. If we decide to rely on the systems then we have to follow the testing approach as set out in the SLAuS.

Testing the operational effectiveness of controls

SLAuS 330 Paragraph 29

The auditor should perform other audit procedures in combination with inquiry to test the operating effectiveness of controls.

Clearly inquiry on its own will be insufficient. The auditor can consider combining inquiry with:

- Inspection of documentary evidence
- Re-performance of the control
- Observation (This has limitations as a control can only be observed at a point in time)
- Use of computer aided audit techniques (CAAT)

In some areas the test of control can be combined with the test of detail and the test performed concurrently.

If a material misstatement is detected by the auditor's testing that was not identified by the entity this is indicative of the existence of a material weakness in internal control and this should be communicated to management and those charged with governance.

Interim Audit Work

SLAuS 330 Paragraph 37

When the auditor obtains audit evidence about the operating effectiveness of controls during an interim period, the auditor should determine what additional audit evidence should be obtained for the remaining period.

Reliance on past systems testing

SLAuS 330 Paragraph 39

If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in prior audits, the auditor should obtain audit evidence about whether changes in those specific controls have occurred subsequent to the prior audit. The auditor should obtain audit evidence about whether such changes have occurred by performing inquiry in combination with observation or inspection to confirm the understanding of those specific controls.

SLAuS 330 Paragraph 40

If the auditor plans to rely on controls that have changed since they were last tested, the auditor should test the operating effectiveness of such controls in the current audit.

SLAuS 330 Paragraph 41

If the auditor plans to rely on controls that have not changed since they were last tested, the auditor should test the operating effectiveness of such controls at least once in every third audit.

This may mean that for some clients it is cost effective over a number of years to take a systems approach to the audit and test the controls every three years. However, a further restriction on this approach is given in paragraph 43.

SLAuS 330 Paragraph 43

When there are a number of controls for which the auditor determines that it is appropriate to use audit evidence obtained in prior audits, the auditor should test the operating effectiveness of some controls each audit.

There is also a further restriction linked into the assessment of 'significant risk' in SLAUS 315.

SLAuS 330 Paragraph 44

When, in accordance with paragraph 108 of SLAuS 315, the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk and the auditor plans to rely on the operating effectiveness of controls intended to mitigate that significant risk, the auditor should obtain the audit evidence about the operating effectiveness of those controls from tests of controls performed in the current period.

The Audit programme ***S2 Operational Effectiveness of Controls*** sets out the procedures required.

<u>The Substantive Approach (Some times called tick and bash auditing)</u>

SLAuS 330 Paragraph 49

Irrespective of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

The standard says that substantive procedures are performed in order to detect material misstatements at the assertion level and include tests of details of classes of transaction, account balances and disclosures and substantive analytical procedures.

Paragraph 49 effectively means that you cannot have a systems only audit there must be some substantive audit work on all files. It does however underline that certain analytical review procedures would be considered substantive audit evidence.

SLAuS 330 Paragraph 50

The auditor's substantive procedures should include the following audit procedures related to the financial statement closing process:

- **Agreeing the financial statements to the underlying accounting records; and**
- **Examining material journal entries and other adjustments made during the course of preparing the financial statements.**

SLAuS 330 Paragraph 51

When, in accordance with paragraph 108 of SLAuS 315, the auditor has determined that an assessed risk of material misstatement at the assertion level is a significant risk, the auditor should perform substantive procedures that are specifically responsive to that risk.

The audit team should be mindful that in order to obtain audit evidence that is sufficient and appropriate the substantive audit test that covers a significant risk should be designed to obtain a high level of reliability. This response to a significant risk would be recorded on schedule ***C6.3 Specific Risk Action Plan***.

<u>Use of Analytical Review as a substantive audit procedure</u>

The auditing standard allows for the use of analytical review in this area. It says that in some situations the auditor may decide that performing only analytical procedures may be sufficient to reduce the risk of misstatement to an acceptably low level.

When considering the use of analytical procedures the auditor should consider the following:

- The suitability of using substantive analytical procedures given the assertions.
- The reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed.
- Whether the expectation is sufficiently precise to identify a material misstatement at the desired level of assurance.
- The amount of any difference in recorded amounts from expected values that is acceptable.

The audit team can also consider testing the controls over the information used for analytical procedures. Good controls will increase the reliance the auditor can place on the results of the analytical procedures.

Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained

SLAuS 330 Paragraph 66

Based on the audit procedures performed and the audit evidence obtained, the auditor should evaluate whether the assessments of the risks of material misstatements at the assertion level remain appropriate.

At the end of the audit work the auditor should review the risk assessments and the audit evidence. Any changes to the risks should be noted and any additional audit work to cover those changes identified.

The auditor cannot assume that an instance of fraud or error is an isolated occurrence and hence must consider if the detection of a misstatement will have any affect on the assessed risks for the client.

SLAuS 330 Paragraph 70

The auditor should conclude whether sufficient appropriate audit evidence has been obtained to reduce to an acceptably low level the risk of material misstatement in the financial statements.

The Approach to Internal Controls

If internal controls are to be relied on then section S of the audit programme will need to be completed. ***S2*** covers the operational effectiveness of controls and ***S3*** records the evaluation and compliance testing of relevant controls.

2.3 SLAuS 240 The Auditors responsibility to consider fraud in an audit of financial statements

These guidance notes consider the requirements of SLAuS 240 as they affect the planning stage of the audit. The issues concerning fraud and completion of the audit are considered later.

The term 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.

The auditor is primarily concerned with any fraud or risk of fraud that may cause a material misstatement in the financial statements. The auditor is not expected or required to make a legal determination as to whether fraud has actually taken place or not.

The guidance draws a distinction between error as being an unintentional situation and fraud as being an intentional situation. The two types of fraud that the auditor should focus on are:

- Misappropriation of assets
- Fraudulent financial reporting

SLAuS 240 Paragraph 3

In planning and performing the audit to reduce audit risk to an acceptably low level, the auditor should consider the risk of material misstatements in the financial statements due to fraud.

The standard makes clear that the main responsibility for the prevention and detection of fraud rests with the management and those charged with corporate governance. This responsibility is met by the systems of internal control and the culture within the organisation. It also underlines that the discovery of a material misstatement within the accounts resulting from fraud does not in itself indicate a failure to comply with the SLAuSs.

<u>The auditors responsibilities under the SLAuS 240</u>

The audit should be conducted in such away so as to give reasonable assurance that the accounts when taken as a whole are free from material misstatement, whether caused by fraud or error.

SLAuS 240 Paragraph 24

The auditor should maintain an attitude of professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity about the honesty and integrity of management and those charged with governance.

This does not mean that you need to accuse your client of being dishonest but you should check the information and explanation that are given to you against other information generated during the course of the audit. Any audit testing should be reviewed taking into account the fact that the management have the potential to override the controls and the test may not be effective for discovering fraud.

Equally the auditor is entitled to accept that records and documents given to him are genuine unless he has reason to be suspicious with regard to the information he has. In other words common sense should prevail when reviewing documentary evidence as part of the audit approach.

<u>Audit team discussions on fraud</u>

SLAuS 240 Paragraph 27

Members of the engagement team should discuss the susceptibility of the entity's financial statements to material misstatement due to fraud.

SLAuS 240 Paragraph 29

The engagement partner should consider which matters are to be communicated to members of the engagement team not involved in the discussion.

This discussion should consider the following issues:

- The client's susceptibility to fraud through the nature of their trading or poor internal controls.
- Any indications that the client is likely to be aggressively managing the earnings of the business.
- A review of any external or internal factors that may affect the fraud risk assessment.
- Any issues associated with high-risk assets such as cash or attractive high value goods that are portable.
- Any unexplained transactions or unusual transactions that the client is involved in.
- Any unexplained or sudden changes in the life style of the managers/directors of the business.
- Consideration of any reports of fraud that have been made.
- A review of the audit testing and the issue of professional scepticism.

This list is not exhaustive but gives an indication of the main areas that should be highlighted.

Talking to the client

SLAuS 240 Paragraph 34

When obtaining an understanding of the entity and its environment, including its internal control, the auditor should make inquires of management regarding:

a) **Management's assessment of the risk that the financial statements may be materially misstated due to fraud;**

b) **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 account balances, classes of transactions or disclosures for which a risk of fraud is likely to exist;**

c) **Management's communication, if any, to those charged with governance regarding its processes for identifying and responding to the risks of fraud in the entity; and**

d) **Management's communication, if any, to employees regarding its views on business practices and ethical behaviour.**

For the smaller audit this will mean discussing with the directors their views on fraud and the possibility for fraud within their business. You should be able to ascertain from the client what controls they have in place to guard against fraud. You should also take in to account that with the smaller business the oversight provided by the directors will be more effective than in larger businesses but the opportunity for the directors to override the controls will be greater.

Fraud Risk Factors

SLAuS 240 Paragraph 48

When obtaining an understanding of the entity and its environment, including its internal control, the auditor should consider whether the information obtained indicates that one or more fraud risk factors are present.

Fraud risk factors can be classified into three headings:

- The existence of an incentive or pressure to commit fraud.
    - For example this could be poor pay and conditions, an overly harsh management style, or a culture of fraud within the work force.
- A perceived opportunity to commit fraud.
    - This is likely to be poor internal control.
- The ability to rationalise the fraudulent action
    - This is likely to come from the culture within the business, everyone is doing it so why shouldn't I, or they owed this to us so we took it etc.

Other risks

The standard highlights the risk of fraud associated with revenue recognition. It says that in many cases there is a risk that either revenue will be overstated or understated within the business depending on the desire to report good results or the desire to avoid paying tax. Paragraph 110 of the documentation standard picks up this specific point and has the following bold type requirement:

When the auditor has concluded that the presumption that there is a risk of material misstatement due to fraud related to revenue recognition is not applicable in the circumstances of the engagement, the auditor should document the reasons for that conclusion.

Audit procedures in response to Management Override

Clearly for many businesses, both large and small, the management will be in a position to override internal controls designed to ensure that the information is accurate. The standard considers this possibility and has the following bold paragraph:

SLAuS 240 Paragraph 76

To respond to the risk of management override of controls, the auditor should design and perform audit procedures to:

a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of financial statements;

b) Review accounting estimates for biases that could result in material misstatement due to fraud; and

c) Obtain an understanding of the business rationale of significant transactions that the auditor becomes aware of that are outside of the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment.

For the smaller audit the firm will draft the accounts and so any journal adjustments should already be on the audit/accounts file and should be adequately explained. The audit file will need to consider the use of any estimates in the accounts and identify any unusual transactions.

Documentation at the planning stage

SLAuS 240 Paragraph 107

The documentation of the auditors understanding of the entity and its environment and the auditor's assessment of the risks of material misstatement required by paragraph 122 of SLAuS 315 should include:

a) The significant decisions reached during the discussion among the engagement team regarding the susceptibility of the entity's financial statements to material misstatement due to fraud; and

b) The identified and assessed risks of material misstatement due to fraud at the financial statement level and at the assertion level.

SLAuS 240 Paragraph 108

The documentation of the auditor's responses to the assessed risks of material misstatement required by paragraph 73 of SLAuS 330 should include:

a) The overall responses to the assessed risks of material misstatement due to fraud at the financial statement level and the nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to fraud at the assertion level; and

b) The results of the audit procedures, including those designed to address the risk of management override of controls.

The standard also says that the extent to which these issues are documented is for the auditor to determine using professional judgement.

Documentation for fraud at the planning stage

Schedule ***C2 Audit Planning Checklist*** includes question 7.4 that says

> *Ensure that members of the audit team discuss the susceptibility of the entity's financial statements to material misstatement and in particular misstatement due to fraud.*

This is cross-referenced to schedule ***C4 Notes of Planning Meeting***. This can be used to record the susceptibility of the entity to fraud following the audit team meeting and discussion.

It should be noted that these issues could be covered in an audit planning memorandum.

Schedule ***C2*** also includes question 7.8 that says

> *Where there is a risk of management override of controls plan audit procedures to:*
>
> *a) Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the accounts;*
>
> *b) Review accounting estimates for bias that could result in material misstatement due to fraud, and*

c) *Obtain an understanding of the business rationale of significant transactions that are outside of the normal course of business for the entity, or that otherwise appear to be unusual given our understanding of the entity and its environment.*

3 CONTROL

This chapter provides detailed guidance on the use of the documentation, including the way in which the forms should be completed for the preparation of a well-documented audit file.

3.1 Accounts

The A section should contain the final draft of the accounts and all subsequent journals, up to the final accounts.

The signed letter of representation and a copy of the letter of comment should also be filed on this section as they are an essential part of the audit evidence and they will often contain issues of significance for future years.

SLAuS 580: *Management representations* make it clear that a letter of representation should be obtained from the client. Remember, however, that it is not acceptable to use the letter as an excuse for not carrying out necessary audit work. The letter of representation is not an audit substitute.

Care must, therefore, be taken not to place excessive assurance on management representations. Although the client will confirm responsibility for the accounts, make sure that during this confirmation the client fully understands what is being signed.

A7 Disclosure checklist

With the increasing sophistication of accounts preparation packages it is not essential that a checklist be completed each year. However, an annual review for proper preparation of the accounts in accordance with legislation and applicable standards should take place and will form part of the critical review of the accounts.

It is suggested that a full checklist should be completed as necessary on very small companies and more frequently for larger or more complex companies. It will generally be necessary to complete a new checklist following any major change in disclosure requirements or in the size/operating characteristics of the client in question. A disclosure checklist dealing with the disclosure required for non-listed companies is included as part of this manual.

3.2 Partner completion

The partner completion is dealt with in two stages on the file, to reflect the way that the completion process is dealt with within a practice.

Final (Section A)

The final partner completion should be completed when the client has returned the signed accounts. It provides a checklist to ensure all necessary procedures have been undertaken before the audit report is signed.

Where considered necessary or where required by the firm's procedures, an independent partner should review the file and complete the relevant clearance section on this schedule.

In the case of a sole practitioner seeking consultation with another practitioner or other external agency, it would be appropriate for the other practitioner to complete that section although the audit firm would retain the ultimate responsibility.

Initial (Section B)

The initial partner completion should be signed off before the accounts are sent to the client for approval. The form allows the manager or partner to detail any work that needs to be undertaken before the audit report is signed.

At this stage all significant audit work should have been undertaken but you may still be waiting for some answers to queries or direct confirmations.

3.3 Completion

B2 Audit standards questionnaire

This should be the final form to be completed where considered necessary before the initial partner completion.

The purpose of the form is to ensure compliance with the Sri Lanka Auditing Standards, it can be a useful aid when completing a review of the file, particularly where the reviewer is a little uncertain about the quality of the evidence on the file or the reviewer is relatively inexperienced.

The form contains one or more questions relating to each of the Sri Lanka Auditing Standards. It provides a final check to ensure that full consideration has been given to compliance with all the Sri Lanka Auditing Standards.

B3 File completion questionnaires

A senior member of staff on the audit should complete the completion questionnaires.

The first section (**B3.1**) should be completed before the initial partner review. The second section (**B3.2**) should be completed before the partner authorises the issue of accounts to the client for approval.

B4 Critical review of accounts questionnaire

A final critical review of the accounts should be performed in conjunction with the updating of the annual summary of statistics on the Permanent audit file or within your accounts preparation package. The ratios and trends noted on the permanent file should be specific and appropriate to the client. They should not just be ratios for ratios sake.

This final critical review is not, of itself, a sufficient basis for the expression of an audit opinion on the accounts, but it should hopefully support the conclusions drawn from other audit work or else indicate areas in need of further enquiry.

The form requires consideration of a number of factors in addition to ratio analysis. For this review to be effective, it must be carried out by someone with adequate skill and experience and with sufficient knowledge of the business to appreciate the expected trends, results and ratios as well as to prepare this free-form report highlighting the significance of apparent inconsistencies.

B5 Audit highlights report

There is no standard form for this; however, it is still an essential document. The senior member of staff should use this schedule to highlight the major issues that have arisen during the audit, the key risk areas, any contentious issues and how they were resolved. It is useful also to summarise the extent of audit coverage in each audit area, and each major balance within that area. This will help the partner to structure the review to ensure that adequate consideration is given to areas of importance.

Preparation of an audit highlights report is a good discipline for the senior and manager as it helps ensure that all key areas identified at the planning stage have been addressed. If the audit highlights report is properly drafted it will save partner time at the review stage as the partner will be able to review the file selectively concentrating on key and problem areas.

B6 Justification of audit report

The purpose of this form is to ensure that there is adequate evidence that the suitability of the audit report has been considered. Any problems encountered should be scheduled and their effect on the audit report considered.

The form specifically directs the auditor to consider any problems resulting from issues such as:

- a qualification in the previous year;
- inadequate books and records;
- difficulties obtaining adequate information from the directors or from branches not visited;
- a refusal by the directors to confirm certain representations in writing; and
- doubts over going concern.

The final question asks about other problems which could impact on the audit report. This is obviously meant to consider any questions not specifically asked.

B7 Summary of unadjusted errors

All errors should be recorded, so that their cumulative impact on the accounts may be assessed, and so that their disposal may be documented.

Extrapolated errors and actual errors should be disclosed separately on this form. Errors should not be netted off or judged not material before being carried forward to this form. Any unaudited balances (for example where petty cash expenditure is immaterial and hence has not been audited) should be recorded as potential errors. At the end of the job the total of the unadjusted errors should be compared with materiality and adjustment should be made where necessary. It should be noted that no adjustment should be made in respect of extrapolated errors until such time as further work has been undertaken to determine the extent of the actual error with reasonable certainty.

The form includes a column to indicate whether or not errors are below a designated amount: an amount below which uncorrected misstatements need not be reported to management (SLAuS 260.11b). It is essential that this column is completed and concluded upon in order to demonstrate compliance with SLAuS 260.11a.

Following on from this point SLAuS 580.5a states:

The auditor 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 representation.

This point is addressed in the wording of the suggested conclusion on **B7**.

B9 Final analytical review form

Where a preliminary analytical review has been carried out and documented on **C7**, possibly in conjunction with extensive analytical review during the course of the audit, final analytical review should confirm that any points arising at early stages of the audit have been satisfactorily thought through and that the ratios in the final accounts are consistent with those originally calculated. Any differences should be adequately explained, documented and considered in the light of the audit work performed.

If figures were not available for the preliminary analytical review, the final analytical review form **B9** should be completed, in order that an adequate review can be carried out.

The main purpose of this final review is to consider whether the accounts make sense in view of the audit evidence obtained and your knowledge of the client. Of central importance here are those trends and ratios of direct relevance to the client. It is far more important to analyse, comment and conclude upon these than merely to file a schedule of standard ratios from the accounts preparation package.

B10 Points forward to next year

It is essential that all points forward of relevance to next year's audit are identified and recorded. This should not be restricted to issues such as a proposed capital purchase but should be used to comment on any points that would ensure the subsequent year's audit would be as effective and efficient as possible.

B13 Cleared audit queries

A record of audit queries and their resolution, where retained, should be filed here. It is essential that the working papers are updated to reflect the answer to the original query and that the answer is not just recorded on the review schedule as this will lead to a loss of audit evidence. This is all the more important if the audit queries themselves are not retained.

3.4 Planning

C1 Planning summary

This schedule is effectively a sign-off sheet to evidence:

- approval of the planning by the engagement partner;
- reading of the audit plan by the engagement team; and

- final review of the planning at the completion stage.

C1.1 Acceptance procedures

This form is designed to demonstrate that adequate consideration has been given to independence in accepting appointment/reappointment for the audit. It also demonstrates that the firm has adequate resources and the appropriate technical knowledge necessary to carry out the audit properly.

The form must be completed and signed by the partner prior to any detailed work being commenced on the audit. This includes the completion of the detailed planning.

Where any of the questions have been answered with a 'yes', the partner must specify precisely what action is to be taken to safeguard independence or overcome the problems with available resources or technical knowledge.

Any 'yes' answer will create either an ethical or practical issue, which may require consultation. As a result, the form may have to be signed off by a second partner who is independent from the audit. This is a mandatory requirement in the case of 'public interest' audits and those of higher audit risk. If this is not possible, the form may have to be signed by the firm or organisation with whom consultation takes place. However, the audit firm retains ultimate responsibility for the audit.

Where a 'yes' answer is given to question 11 'rotation of senior assurance team personnel' it may not be necessary to have a second partner review. However, there must be evidence to show that the engagement partner has considered any long relationship with the client as this could affect auditor independence. A second partner or other independent agency will normally corroborate this decision. There will normally be an undertaking that the file will be subjected to a second review where any contentious issues, such as a potential or actual qualification, have arisen.

Where there are any fees outstanding it is necessary for the responsible individual to consider whether the fees outstanding taken together with the fees for the current audit could constitute a significant loan. Significance should be measured in respect of the individual partner and the practice fees and not in respect of materiality for the client. If the decision is that the work can commence this should be corroborated by a second partner. This is not necessary if you are a sole practitioner.

At the end of each audit, consideration should be given to whether or not it is appropriate to be reappointed/ continue in office for the following year. This is undertaken on the **B3.2** file completion questionnaire.

C2 Audit Planning Checklist

This checklist should be completed as a control over the planning of the audit. It will ensure that all initial steps are properly taken. In particular it will guide users through completion of the risk assessment and internal control evaluation forms.

C2 sets out the planning procedures required in the order they should be undertaken. It therefore starts with preliminary engagement activities including agreement of engagement terms and then moves onto planning activities: firstly at a strategic level, and then in greater detail.

In addition, a free-form planning memorandum should be prepared dealing with such matters as:

- introduction: an outline of the background of the business, the markets it serves, its major customers and supplier, its principal business risks and ownership structure;

- development in the business: an outline of changes in key market suppliers, customers or altered business strategy;
- risk and materiality overview: an assessment of the overall engagement risk and a commentary of the major risks perceived within the assignment;
- audit timetable;
- planned staffing and budget.

An example form (***C3***) provides an outline for such a memorandum. It should be stressed that the form at ***C3*** is an example showing the sort of headings that should be included. This form should not be used!

A well-planned audit will save considerable time, particularly in the final stages. Where you are looking to improve the efficiency and effectiveness of the audit through reliance on internal controls and/or the use of extensive analytical review it is absolutely essential that thought and time is put into the planning of the audit to determine the most appropriate approach. Proper planning will also help ensure compliance with Sri Lanka Auditing Standards.

C2.1 Points forward from last year

A copy of the points forward from last year's audit should be filed on the current working paper file and actioned accordingly.

Care must be taken to ensure that all the points have been properly addressed and dealt with. These should be recorded in the relevant part of the file and cross-referenced on the form itself.

C4 Record of planning meeting

SLAuS 240: *The auditor's responsibility to consider fraud in an audit of financial statements* and SLAuS 315: *Understanding the entity and its environment and assessing the risks of material misstatement* both require the audit engagement team to have a meeting to brainstorm ideas on the susceptibility of the company's financial statements to material misstatement due to fraud or error. The purpose of ***C4*** is to provide a convenient layout to record the results of that meeting.

It is not essential to use the form provided at ***C4***. Such matters could easily be recorded in the detailed planning memorandum. Where that is the case the ***C4*** slot should be used to file notes used to brief staff at the planning meeting.

C5 Systems and internal controls summary

SLAuS 315: *Understanding the entity and its environment and assessing the risks of material misstatement* requires a much deeper understanding of the clients procedures and system of internal control than was the case previously. The purpose of ***C5*** is therefore twofold:

- to guide users through the completion of the relevant forms to document that deeper understanding; and
- to record the conclusions in relation to internal controls at the planning and completion stages.

The approach to systems and internal control required by the manual is set out below.

Understanding of the company

SLAuS 315.20 requires the auditor to obtain an understanding of the company and the environment in which it operates. This includes:

a) Industry, regulatory, and other external factors, including the applicable financial reporting framework.

b) Nature of the entity, including the entity's selection and application of accounting policies.

c) Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements.

d) Measurement and review of the entity's financial performance.

e) Internal control.

The ***Know your client checklist (PAF04)*** has been provided to assist firms in recording the necessary detail. Other permanent file forms provided include:

- a proforma register of laws and regulations is also provided (***PAF05***);
- details of related parties (***PAF 06***); and
- significant accounting policies (***PAF 07***).

System of internal control (point 'e' above) has a wide definition under SLAuS 315 and includes:

a) The control environment.

b) The entity's risk assessment process.

c) The information system, including the related business processes, relevant to financial reporting, and communication.

d) Control activities.

e) Monitoring of controls.

Controls relevant to the audit

SLAuS 315.41 states that as part of obtaining an understanding of the company and its environment the auditor should obtain an understanding of the internal control environment relevant to the audit. Again this in itself does not sound onerous; however, SLAuS 315.54 states:

> *Obtaining an understanding of internal control involves evaluating the design of a control and determining whether it has been implemented. Evaluating the design of a control involves considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements.*

S4 Internal Control Questionnaire has been provided to assist with the identification of controls relevant to the audit.

C5.1 Review of design and implementation of controls

As noted above SLAuS 315.54 requires the auditor to obtain an understanding of the design and implementation of controls relevant to the audit. This is required regardless of whether any reliance will be placed on those controls. Testing the operational effectiveness of controls (traditional compliance testing) is a different issue. SLAuS 315.56 makes this clear: 'obtaining an understanding of an entity's controls is not sufficient to serve as testing the operating effectiveness of controls'.

The review of the design and implementation of controls relevant to the audit should be documented on ***C5.1***. This form must be completed on every audit as a review of the design and implementation of controls relevant to the audit is required on every audit.

Testing the operation effectiveness of internal controls so as to reduce the amount of substantive testing should be considered where this approach is expected to be more effective. However, there are two occasions where testing the operational effectiveness of controls is a requirement.

1. When the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls are operating effectively, the auditor should perform tests of controls to obtain sufficient appropriate audit evidence that the controls were operating effectively at relevant times during the period under audit. (SLAuS 330.23)

2. When the auditor 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 auditor should perform tests of relevant controls to obtain audit evidence about their operating effectiveness. (SLAuS 330.25)

Testing the operational effectiveness of controls is dealt with in Section **S**.

A blank version of C5.1 (**C5.1op**) is provided as a continuation sheet where this is required.

Completing C5.1

The purpose of **C5.1** is to document the review of the design and implementation of controls that are relevant to the audit. As the precise nature of controls and their relevance to the audit will vary from one company to another the form is of necessity mainly blank boxes. Guidance is given below on completion of this form.

Heading	***Guidance on completion***
Outline of information system and controls	A brief outline of the system and controls relevant to each business area should be given. It is not necessary to reproduce the system notes from the permanent file here! The description should be sufficient to identify the controls being evaluated.
Comment on design and effectiveness of controls	Comment on the design and the potential effectiveness of a control by considering whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. Inquiry alone is not sufficient to evaluate the design of a control: further work such as inspecting documents or tracing transactions through the system is required. Comments made on the design should include the nature of the work undertaken.

	Any weaknesses in design should be flagged and recorded on the draft letter of comment to the client.
Comment on implementation of controls	Comment on the implementation of the control: did the control exist and was the company using it as intended? Again inquiry alone is not sufficient to evaluate the implementation of a control: further work such as inspecting documents or tracing transactions through the system is required. Comments made on the implementation should include the nature of the work undertaken. And again, any weaknesses in implementation should also be flagged and recorded on the draft letter of comment to the client.
Is this a key control? Y/N	Not all controls relevant to the audit will be key controls. If a control could be relied upon to reduce the level of substantive testing in a particular area then that is a key control. This is only relevant if tests of the operational effectiveness of controls are to be undertaken. Clearly there will be little value in testing the operational effectiveness of controls that are not key controls.
Further testing required? Y/N	Testing of the operational effectiveness of internal controls must be undertaken where: • The risk assessment includes an expectation that controls are operating effectively; or • Substantive tests alone do not provide sufficient evidence of operation. If either of these circumstances apply the question should be answered yes and a compliance test of the operational effectiveness designed on ***S3.*** In addition, where testing the operational effectiveness of controls is more effective than relying solely on substantive procedures this question should be answered yes and a suitable test designed.
Ref to ICE (S3)	This is simply a cross referenced to the schedule referred to above.

C6 Audit Risk Summary

SLAuSs 315 and 330 require the auditor to document:

- the identified and assessed risks of material misstatement at the financial statement level and at the assertion level; and

- the overall responses to address the assessed risks of material misstatement at the financial statement level and the nature, timing, and extent of the further audit procedures, the linkage of those procedures with the assessed risks at the assertion level, and the results of the audit procedures.

C6 is a summary sheet that confirms that the necessary procedures have been undertaken at the planning stage and reviewed as part of the audit completion. It also summarises the response to financial statement level risks that do not have a direct impact at the assertion level.

C6.1 Audit risk checklist

The audit risk checklist at **C6.1** serves two purposes:

- Firstly it acts as a guide through the various stages in assessing risk and determining the responses to those risks.

- Secondly it is a checklist to help ensure that all those stages are followed.

The approach to risk assessment under the manual is set out below.

Risk assessment

As noted above in relation to controls, SLAUS 315.20 requires the auditor to obtain an understanding of the company and the environment in which it operates. This is the starting point, as this process should gather sufficient information that will enable identification of the various risks facing the company.

SLAuS 315.100 states that:

> *The auditor should identify and assess the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balances, and disclosures. For this purpose, the auditor:*
>
> - *Identifies 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;*
>
> - *Relates the identified risks to what can go wrong at the assertion level;*
>
> - *Considers whether the risks are of a magnitude that could result in a material misstatement of the financial statements; and*
>
> - *Considers the likelihood that the risks could result in a material misstatement of the financial statements.*

C6.4 Detailed Risk Assessment should be completed as a means of identifying all risks facing the company at both the financial statement and assertion levels. This assessment is also used to determine the overall risk at the financial statement level attaching to the assignment, which plays an important part in determining sample sizes.

Response to risk

Once risks have been identified SLAuS 330.4 requires the auditor to determine overall responses to address the risks of material misstatement at the financial statement level, and SLAuS 330.7 requires the design and performance further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the assertion level.

Documenting the response to risk at the assertion level is considered on the C6.3 Specific Risk Action Plan and C6.2 Risk Response Summary which pulls together the work in respect of specific risks with the approach to testing in other areas. This is a key schedule as it documents in respect of each area:

- Whether any testing at all is required.

- If testing is required, whether the standard programme is sufficient.
- Additional or alternative procedures to be undertaken.

The response to risk at the financial statement level to the extent that it is not already addressed on ***C6.3*** is summarised on ***C6***.

Guidance on the completion of these forms is given below.

C6.2 Risk response summary

The purpose of the risk response summary is to summarise the responses to risks and set out the audit approach section by section. Risks on this schedule are therefore considered in summary and are categorised by financial statement area rather than by the nature of the risk or the order they were recorded.

The Risk response summary relates to the individual financial statement areas. For example, the audit could be generally high risk, because there are outside shareholders, and the company is being sold based on balance sheet values. That said, fixed assets may specifically be a low risk area, because there is little or no danger of misstatement within this area of the audit. Conversely, it is quite feasible for areas of the audit to be identified as a specific high risk, even where the general risk is low. The Risk response summary sets out the approach by financial statement area in such circumstances.

In addition to summarising risks by financial statement area the Risk response summary plays an important part in determining sample sizes through the setting of a risk level for each financial statement area.

Completing C6.2

Heading	***Guidance on completion***
Issues & risks identified	The issues and risks affecting the financial statement area that have been identified should be noted. These need not be shown in any great detail as this will be set out on ***C6.3***. The purpose here is to give an overview of main risks.
Risks for other assertions (H, M, L)	The assessment here is effectively the residual risk. If there is a major risk factor, the existence of inventories for example, but other areas / assertions in inventories such as valuation are well controlled then the assessment of the other risks could be low. Specific procedures will be documented on ***C6.3*** in relation to the risks affecting existence; these do not affect valuation so the conclusion in this area can be low risk. It will also be possible to conclude that the risk in a particular area is medium or high even though there are no specific risk factors. This may be because of value – perhaps say trade debtors are the largest item in the balance sheet and whilst there are no indications of problems and the controls are good, if there is going to be a material error in the accounts this is where it would be! This approach allows the audit work to increased in areas where the risk is higher and reduced where the risk is lower since the risk assessments made for each section affect the sample size for that area.

Justification of risks for other assertions (See SLAuS 500.17)	This column provides space for an explanation of the risk assessed as discussed above. In particular, an explanation should be given where the assessment is other than low, or where the assessment is low and there are factors that suggest that this should not be the case.
Audit approach & reference to programme	A summary of the approach to this financial statement area should be given. This will often be completion of the standard programme as amended by additional tests identified on **C6.3**. Where a decision is taken to use a bespoke programme then this should be explained. It would also be appropriate to opt out of using the standard audit programme in the following instances: • For an immaterial area of the audit; or • Where a more efficient or effective audit approach can be performed, e.g., proof in total; or • Where it is a specialist area, such as some types of work in progress and the standard audit programme is not judged appropriate. Where the standard programme is not used, explain what work is to be carried out on that section or cross-reference it to a tailored audit programme. There are optional blank programmes that can be used should these be required. References to specific tests should be made where necessary.

C6.3 Specific risk action plan

SLAuS 330.73 requires that:

> *The auditor should document the overall responses to address the assessed risks of material misstatement at the financial statement level and the nature, timing, and extent of the further audit procedures, the linkage of those procedures with the assessed risks at the assertion level, and the results of the audit procedures.*

The purpose of **C6.3** is to document the responses to specific risks assessed and the work undertaken in response as required above. Proper completion of this schedule is therefore crucial to conducting and audit in compliance with SLAuSs. The schedule provides a link between the risks assessed, the controls if any in those areas, the audit approach and the outcome of the work.

Completing C6.3

When completing the form a summary of the relevant issues in each column should always be given and not simply a cross-reference. In this way **C6.3** will, for each risk, give a complete picture of the risk itself, the impact, the planned work and the outcome of that work.

Heading	*Guidance on completion*
Specific risk affecting the client	Details of the specific risk affecting the client should be recorded here. If details of the risk are set out elsewhere (such as ***C6.4***) then the full explanation need not be repeated here, just sufficient to identify the issue concerned with a cross reference to where the detail may be found.
H, M or L	The risk should be categorised as 'High', 'Medium'or 'Low'. A risk should be categorised as high where it is so significant as to require special audit consideration in accordance with SLAuS 315.108. Risks recorded on this schedule would not normally be categorised as low as specific testing would not normally be undertaken in response to a low risk. Where this is the case careful consideration should be given as to whether any specific testing is necessary or whether the risk is properly assessed as low.
Management response	This column should be used to record the management response to each risk. This may be in the form of relevant procedures; control activities such as authorisation or reconciliation; or monitoring controls by management. Where it appears that management were not aware of a risk or had ignored it then careful consideration should be given to the design of the audit approach. Any weaknesses in internal controls identified at this stage should be noted on the draft letter of comment. Details of any internal controls implemented by management should be cross-referenced to the review of the design and implementation of those controls on ***C5.1***. This is a requirement of SLAuS 315 in respect of internal controls in areas where: • the risk is classified as high/significant (SLAuS 315.113); or • it is not expected to be able to reduce the risks of material misstatement at the assertion level to an acceptably low level on the basis of substantive testing alone. (SLAuS 315.115) However, all controls identified on ***C6.3*** should be cross-referenced to ***C5.1***. There is a requirement to review the design and implementation of all controls relevant to the audit and it hard to see how a control referred to on ***C6.4*** could not fall into this category.
Financial reporting areas and assertions affected	The financial report area affected is relatively straightforward, for example 'balance sheet debtors'or profit and loss account sales'. However, the assertions must be more specific. The main financial statement assertions are set out in SLAuS 500.17; but it is not sufficient to simply reproduce the wording of the relevant assertion from the SLAuS. The assertion affected should be expressed in terms specific to the client so it is clear exactly how the risk will impact.

	For example, the assertion relating to completeness (SLAuS 500.17(a)(ii) is: *All transactions and events that should have been recorded have been recorded.* But, if the risk is that cash sales at a particular location may not have been recorded then the assertion should be worded in those terms. Where a general risk relates to all financial areas and assertions such as the possible sale of the business then 'All' should be included in this column.
Audit approach & reference to programme	The specific work to be undertaken in response to the identified risk should be recorded. This work will normally be additional bespoke tests. It is not necessary to specify in detail on ***C6.3*** the work that will be performed, a summary with a cross-reference to the programme where the detailed tests may be found is sufficient. Where the reference is to one or more of the standard tests then an explanation as to why these are sufficient should be given.
Outcome	A summary of the outcome of the work referred to above should be given. The key issue here is to record the overall conclusion on the work undertaken and whether the risk has been reduced to an acceptably low level. A cross reference should be given as to where the detailed results can be found.

C6.4 Detailed risk assessment

This detailed risk assessment serves three main purposes:

- as an aide memoire for identifying specific risks affecting the client that may require further action;
- a means of formally documenting the approach to issues where the risk is assessed as low and which may as a result not require specific additional testing; and
- a means of determining an overall risk assessment for the client.

The latter point is important as this has an impact on the sampling approach in the manual but also has wider implications for quality control issues such as the need for a quality control review as part of the firm's procedures under the completed checklist should obviously be reviewed with the client in the intervening years with particular attention paid to areas assessed as high risk or where further information available to the auditor suggests that an area should be reassessed as being higher risk.

Completing C6.4

Heading	***Guidance on completion***
Specific risk affecting the client	The first column of the checklist identifies general risk questions. The purpose of this column is to translate those general risk questions into a specific risk affecting the client.

Assessment H, M or L	The risk should be categorised as ‘High’, ‘Medium’or ‘Low’. A risk should be categorised as high where it is so significant as to require special audit consideration in accordance with SLAuS 315.108.
How will the audit risk be managed?	Where a risk is assessed as medium or high this will normally be carried forward to C6.3 and a reference to this effect will be sufficient. Where a risk is assessed as low then this column should explain how that risk would be managed.

Once the individual points on the form have been assessed as high, medium or low, the major risk areas must be identified in the 'conclusion' section, and an overall assessment of risk given to the audit. It must be stressed that the overall assessment is not an arithmetic average of the number of high, medium and low points recorded above. Indeed, any one high-risk item in the section, 'external interests', may be enough to give an overall high-risk assessment. Conversely, a number of the detailed points may be identified as high risk, but the overall general risk may still be set as low.

This is very much a matter of exercising professional judgement.

C7 Preliminary analytical review

SLAuS 520.8 states that the auditor should apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment. This applies even where there are no draft accounts available for analysis and comparison. The main purpose of this procedure is to determine the overall audit approach by, for example:

- identifying abnormal transactions, balances or ratios meriting further enquiry;
- highlighting new transactions, balances or areas of increased importance;
- indicating whether extensive analytical review or control reliance might be appropriate.

When undertaking detailed analytical review, it is necessary to set expectations (i.e., hypotheses). In setting these expectations, auditors need to establish plausible and predictable relationships relevant to the figures being audited. Often, analytical review is confined to a mere comparison of trend and ratios. This is of limited value as the information is all generated by the client.

For stronger analytical review, procedures involve the reconciliation of non-financial to financial data. It might also be possible to compare external data with internal data. An example of the latter are industry statistics (widely available on the web). Where autonomous divisions are operated, these can also be a source of good analytical review procedures.

'Proof in total' is the strongest form of analytical review. By breaking down a balance, it is often possible to prove the total of a stratum (for example, purchases from a main supplier) leaving only the remainder of the population to be substantively sampled.

Having set expectations, it is then necessary to predict the expected outcome. This prediction must then be compared with the actual figures and any material differences enquired into. Explanations given as to any variances must be corroborated, fully documented and the analytical review concluded upon.

For those entities with less formal needs of controlling and monitoring performance, it may be possible to extract relevant financial information from the accounting system (perhaps when preparing the draft financial statements, VAT returns and bank statements). Discussions with management, focused on identifying significant changes in the business since the prior financial period, may also be useful. In this scenario the auditor should look at whatever records the client has in order to assess if there are any particular changes indicated by the books and records.

For example, if the auditor can see, on looking at the bank statements, that the company appears to be trading at or around there overdraft limit, then this could indicate a potential going concern problem.

Many clients, although not being able to produce full financial accounts for the auditor to audit, may well prepare certain schedules from which the auditor can prepare the accounts. A potential example of this would be a sales daybook. The auditor could then assess whether or not the sales daybook indicated sales on a seasonal basis consistent with expectations and previous years.

The client may also have computerised purchase and sales ledgers. These might give the auditor not only balances owed to suppliers and due from customers but also the level of activity. From this information basic ratios can be calculated, such as creditors days and debtors days.

If this is not possible at the outset of the job, then the auditor should be looking to calculate key ratios such as inventories turnover and debtors days as and when the relevant information becomes available during accounts preparation work. If the figures and ratios vary significantly from previous periods and this cannot be adequately explained, then the risk assessments relating to that particular area need to be revised wherever necessary.

The other form that the analytical review at the planning stage may take is a discussion with the directors of the business as to how they feel the business has performed over the last accounting period. The auditor will find among his or her clients that the bulk of them has a reasonable idea as to how they have fared in the last 12 months. It is, however, important that the discussion is undertaken close to the year-end so that any relevant events are still fresh in the minds of the directors and management of the entity.

When conducting this discussion with the directors, the auditor needs to ensure that he or she collects as much information as possible in respect of significant changes in the business. This is so that he or she can obtain from the directors the changes to the figures that they would expect to see in this year's accounts.

It may well be sufficient for the auditor to include narrative notes of his or her discussions with the directors as to what their expectations are and what the accounts will show for the year in question.

This actually achieves two things, not only does it help the efficiency and effectiveness of the audit but it will also help client relations if the auditor shows willingness to discuss their results with them before his or work starts.

However, the preliminary analytical review still needs to be reviewed on an ongoing basis as detailed audit procedures may result in original ratios being changed as errors/adjustments from the exercise of judgement are corrected during the audit.

Once the preliminary analytical review is carried out, it will have to be repeated at the final analytical review stage if the figures have changed significantly. In other cases, the final ratios of the current year should be compared to the preliminary ones, with explanation being given on changes arising during the course of the audit.

Preliminary analytical review will not always provide audit assurance of itself, but may be used as an introduction to extensive analytical review, which forms part of substantive audit testing.

The most important point to note is that a conclusion to the work is required. This will normally be expressed in terms of whether any particular problems have been identified or there are any particular areas of the audit that require more detailed investigation.

C8 Materiality summary

This is the third of the planning schedules that affects the level of sampling during an audit. Guidance on the various factors which will determine materiality on an individual audit is given in Chapter 6 of these Guidance Notes.

Since this is a planning document, figures for the accounts being audited will on occasions not be available. Where this is the case the anticipated figures for the current year (perhaps based on bank statements or sales records), and, if appropriate, the figures for the previous years should be used.

The materiality figure established sets the overall materiality to apply to the audit as a whole. It must be emphasised that setting the materiality level is a matter of professional judgement. The ranges given on C8 are for guidance only and there will be occasions when materiality is determined to fall outside these ranges. Under no circumstances should the ranges be treated as a formula and materiality calculated as an average of the three.

SLAuS 320: *Audit materiality* requires the auditor to consider the level of materiality throughout the audit.

There is a question in each section asking the auditor to consider whether there is any need to revise the level. At the end of the job you are asked to record the final level on the ***C8*** form. In the case of materiality being reduced, you should reconsider the adequacy of the audit work done in earlier sections.

C9 Other planning schedules

A number of optional planning schedules are included for use where appropriate. Many users prefer to deal with such matters in the detailed planning memorandum.

C9.1 Accountancy work planning form

This form allows you to set a level of acceptable accounting differences for use when the accountancy work is being undertaken by the practice. It should also be used to plan the analysis work required for audit, tax or other statutory purposes.

The form includes a prompt to consider the ethical implications of providing accounting services to an audit client.

C9.2 Sample size planning

The form provides a convenient summary of the sample sizes in each area.

C9.3 Assignment planning timetable

This schedule may be useful if there are a number of organisational points arising on the audit.

It will help to ensure that both the firm and the client are aware of key dates, which may reduce the risk of misunderstandings.

C9.4 Budget and performance summary

It is increasingly likely that a formal estimate of the cost of the audit work will be agreed with the client in advance.

Regardless of this, audit quality must never be compromised. If the audit is to be carried out efficiently, it is necessary to know how best the time should be allocated. It is normally the case that the smaller the audit the more precisely the time can be budgeted.

Although not considered compulsory, it is highly recommended that this form be completed.

If time increases over budget, it will be essential to be able to explain to the client where costs increased and why.

In any debriefing at the end of the audit, the budget to actual comparison can provide evidence of how the time was spent, whether it was wisely spent, and can provide a basis for planning next years' audit in terms of staffing and audit focus, in order to minimise the risk of recurrence.

C9.5 Job progress report

This form allows progress to be tracked of work on the main file sections. Tracking progress against budget both in terms of timings and time spent is a good way to identify problems early.

4 AUDIT EVIDENCE

This chapter explains the use of the audit programmes within the manual.

Particular reference is made to the summary sheets, on which conclusions on individual audit areas are required.

4.1 Section D - analytical procedures

Section D is devoted to analytical procedures which may be carried out on the accounts as a whole or in respect of particular aspects of the accounts.

Where it is considered that useful audit evidence can be derived from the use of analytical procedures, this approach can be adopted. It is often very cost effective. For analytical procedures to be effective they must be targeted, you must be able to corroborate the results and it must be undertaken by a suitably senior individual.

Remember that the extent to which the results of analytical review can be used to reduce the level of substantive testing will depend on the results of the analysis.

It may be, for example, that analytical procedures undertaken lead to the belief that there is a particular problem in the valuation of inventories. It would obviously be wrong to blindly accept the results of the analytical procedures in such circumstances. Analytical procedures may, therefore, help concentrate the audit on significant aspects of the company's accounts for maximum audit efficiency.

To continue the inventories analogy, it may be that audit tests indicate that inventories has been overvalued, throwing the problem back onto the rate of gross profit, which will have been affected by the required reduction in inventories values. This new area of apparent difficulty would now need to be investigated.

Analytical review is ongoing throughout the audit. At any stage the results of audit tests may cause a rethink of the view apparently presented by preliminary analytical review. This continuous process of analysis is an essential theme of any audit, where analytical procedures are being used.

If the results of extensive analytical review indicate that the nature and/or extent of detailed testing may be reduced or in some cases it may not be necessary to do any further testing, this should be recorded on the 'Sample selection planning form'. This form may be found useful as a means of linking assessment of risk, materiality and, where appropriate, the results of extensive analytical review to provide an objective sample size.

Blank 'Sample selection planning' forms for the balance sheet and profit or loss account are included in each section of the file. In addition there is a form within the planning (***C9.2***) section that allows you to record the different methods of obtaining audit evidence and the anticipated sample sizes for each of the audit sections.

4.2 Summary sheets

Audit objectives

SLAuS 500.2 requires that the auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion. SLAuS 500.16 goes on to state that the auditor should use assertions for classes of transactions, account balances, and presentation and disclosures in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures. The auditor uses assertions in assessing risks by considering the different types of potential misstatements that may occur, and thereby designing audit procedures that are responsive to the assessed risks.

The assertions referred to above are set out in SLAuS 500.17, which is reproduced below.

Assertions used by the auditor fall into the following categories:

a) Assertions about classes of transactions and events for the period under audit:

   (i) Occurrence— transactions and events that have been recorded have occurred and pertain to the entity.

   (ii) Completeness— all transactions and events that should have been recorded have been recorded.

   (iii) Accuracy— amounts and other data relating to recorded transactions and events have been recorded appropriately.

   (iv) Cut-off— transactions and events have been recorded in the correct accounting period.

   (v) Classification— transactions and events have been recorded in the proper accounts.

b) Assertions about account balances at the period end:

   (i) Existence— assets, liabilities, and equity interests exist.

   (ii) Rights and obligations— the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

(iii) Completeness—all assets, liabilities and equity interests that should have been recorded have been recorded.

(iv) Valuation and allocation—assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

c) Assertions about presentation and disclosure:

(i) Occurrence and rights and obligations—disclosed events, transactions, and other matters have occurred and pertain to the entity.

(ii) Completeness—all disclosures that should have been included in the financial statements have been included.

(iii) Classification and understandability—financial information is appropriately presented and described, and disclosures are clearly expressed.

(iv) Accuracy and valuation—financial and other information are disclosed fairly and at appropriate amounts.

Audit objectives are the auditor’s method of defining and testing those assertions. Audit tests must be designed to meet each of these financial statement assertions.

Some of these assertions are often more inherently risky than others. For example, it is often the case that the 'Completeness' and 'Valuation' assertions are more risky from an auditing point of view than (say) the 'Existence' assertion. Accordingly, specific risk assessments should not be restricted to just considering the balance as a whole. The key to an efficient audit lies in appreciating where the risks truly lie in terms of the underlying assertions within a particular balance and focusing the audit work accordingly.

At the commencement of each audit programme section there is a summary sheet setting out the audit objectives for that audit area and how the audit tests are assigned to meet those objectives.

By keeping specific audit objectives in mind, audit tests can be efficiently directed to meet them.

If any tailoring of the programme is done, the audit objectives should be cross-referenced to the tailored programme to ensure that they continue to be met by the revised/new programme.

If additional or alternative tests are carried out, these should likewise be cross-referenced to the audit objectives.

This should ensure that these tests also meet the objectives set.

Space is available for comments and for initialing by whoever has planned the audit programme.

Audit conclusion

A conclusion should be drawn for each audit area. This is vitally important. Not only should the summary sheet be concluded upon, but for each main test within each area there should be stated:

- the aim of the tests;
- the work performed;

- the results obtained; and
- the conclusion reached.

The conclusion section provides the following options:

Planning

Particularly where there has been significant tailoring of the audit approach it is essential that there is evidence to show that the partner has approved the approach being taken to the audit of the particular section before the work is commenced. This will also serve to improve the efficiency of the audit.

Final

Conclusion

The conclusion requires confirmation of a number of different things. This includes confirmation that:

- the work detailed in the audit programme has been carried out;
- the results have been adequately recorded;
- all necessary information has been collected for the preparation of the statutory accounts; and
- subject to any minor matters highlighted on ***B5*** or ***B8*** the objectives have been met.

Alternative conclusion

The summary sheet should state clearly the alternative conclusion reached, with adequate explanation for the conclusion to be understood.

The alternative conclusion must be brought to the attention of the partner on schedule ***B5*** or ***B8***.

Before reaching an alternative conclusion, consideration should be given to whether or not there are any additional audit procedures that could be carried out to enable an unqualified confirmation of the audit objectives to be given.

4.3 Audit programmes

The audit programmes contain the main tests that would normally need to be undertaken when carrying out an audit. However, the programmes should always be considered in the light of the specific needs of the client. The programmes must be amended to include any additional tests required to meet specific aspects of the client. In many cases, certain tests may be inappropriate.

The first column asks 'Test required?' This column should be completed at the planning stage of the audit, by entering a 'Y' against those tests to be undertaken. Conversely, enter 'N' for those tests which are not required.

Where specific tests are not being performed, ensure that sufficient other audit work is being performed adequately to satisfy the audit objectives. Cross referencing any amendments to the audit programme with the objectives on the Summary sheet ensures that this occurs.
The second column should state whether the results of the test were satisfactory. A 'no' answer here means that audit objectives have not been satisfied. This therefore represents an 'audit problem' and should be referred to on schedule ***B5*** or ***B8***, 'Points for partner/audit highlights'. This should include a

note of any alternative procedures that have been applied that may have helped to demonstrate that the objectives have in fact been met.

Any 'N' on the second column of the programme identifies an audit problem. If the programmes are completed properly, then it should be relatively straightforward for the manager or partner to review the programmes and quickly spot any problems.

Any comments relating to a test can be noted in the fourth column. For example, where a planned test is not applicable the reason should be noted rather than simply stating that it is not applicable.

4.4 Permanent audit file index

The Permanent audit file index provides a detailed list of various matters that are often of ongoing relevance and that should be maintained on the Permanent audit file. Tick the boxes on the Index to identify what information is actually on the file.

The purpose of the Permanent audit file is to maintain documentation and information of continuing relevance to the audit. The file must be reviewed at least annually, with material that is no longer of use being removed from the file, and archived. The file should not be considered to be a permanent repository for all documentation that may once have been pertinent.

Forms have been provided to allow recording of the basic information, which should be contained on the Permanent audit file. These include:

- Background information (PAF02)
- Details of bankers and professional advisors (PAF03)
- Know Your Client Checklist (PAF04)
- Register of laws and regulations (PAF05)
- Details of related parties (PAF06)
- Significant accounting policies (PAF07)

Know Your Client Checklist

The Know Your Client Checklist is an aide memoir of the sort of information that should be recorded in order to comply with the requirements of SLAuS 315: *Understanding the entity and its environment and assessing the risks of material misstatement.*

Register of Laws and Regulations

The ***Register of Laws and Regulations*** is, as the name suggests, a form for recording all the significant laws and regulations which affect the client company. SLAuS 250:*Consideration of laws and regulations in an audit of financial statements* requires the auditor to:

- obtain a general understanding of the legal and regulatory framework applicable to the entity and the industry and how the entity is complying with that framework (SLAuS 250.15);
- obtain a general understanding of the procedures followed by the entity to ensure compliance with that framework (SLAuS 250.15.1) and

- perform further audit procedures to help identify instances of non-compliance with those laws and regulations where non-compliance should be considered when preparing financial statements (SLAuS 250.18).

The form must therefore be tailored to suit the client: this requires more than a vague note about the applicability of the Companies Act and employment legislation. It requires specific comment on:

- the procedures the client has in place to ensure compliance with each requirement; and

- the audit approach for determining compliance.

The form has been split to consider those laws and regulations which relate to the accounts, those which relate to business in general, and those which are specific to the client. Particular regard should be given to those laws and regulations that provide a framework within which the entity operates, as well as those whose infringement could threaten the entity's ability to continue to trade.

5 THE ICASL AUDIT MANUAL: AN OVERVIEW

5.1 Introduction

The manual is intended for use whenever an audit is carried out in accordance with Sri Lanka Auditing Standards.

Sri Lanka Manual of Audit Procedures is mainly for audits of Specified Business Enterprises (as described in Sri Lanka Accounting and Auditing Standards Act No 15 of 1995). However, it can be used for others as well. The manual audit approach may be summarised as follows:

1. planning;

2. collection of evidence;

3. controlling and recording and

4. review and opinion.

The manual uses an approach that ensures compliance with Sri Lanka Auditing Standards in an economical timescale.

5.2 Planning

Planning is essential for two reasons:

1. It is a requirement of Sri Lanka Auditing Standards; and

2. It is the key to successful auditing and would be part of the manual approach even if there were no requirement for it in Sri Lanka Auditing Standards.

In order to assist in a disciplined approach to planning and to ensure compliance with Sri Lanka Auditing Standards, the manual provides documentation enabling a record of planning to be kept, demonstrating the approach adopted for each audit and the reasons for that approach.

Guidance on the manual audit planning is set out in Chapter 3.

In addition to the standard documentation there should always be a client-specific planning memorandum setting out:

- what the entity does;
- how it conducts its business;
- where the risks and issues are and
- how these will be audited.

5.3 Assessment of risk and materiality

The assessment of risk and materiality are two of the principal planning procedures. The assessment of risk in particular is at the core of the approach to audit set out in the Sri Lanka Auditing Standards. A more detailed discussion of the assessment of risk and materiality is contained in Chapters 6 and 7 respectively.
In the manual approach audit risk interacts with materiality and population value to determine sample sizes.

5.4 Analytical procedures

Analytical procedures can be a useful source of audit evidence.

It may include:

a) a preliminary analytical review;

b) an extensive analytical review;

c) a final analytical review.

These separate stages should not be considered to be mutually exclusive, but part of a continuous process of review.

It is probably fair to suggest that analytical review is not as widely used as it could be in the audits of small companies. Some form of final analytical review is generally carried out, but, by that stage, it may be of little use in directing the audit towards areas of need.

More detailed guidance on analytical review procedures is set out in Chapter 8.

5.5 Tests of controls

Sri Lanka Auditing Standards require a much greater consideration of the client's system of internal control than was the case under the old standards. Under the old regime the testing of internal controls was entirely optional. This is not the case under the SLAuSs.

- As part of understanding the entity and its environment it is a requirement to evaluate the design and implementation of all controls relevant to the audit.
- Evaluating the design and implementation of controls requires more than just enquiry; further work such as inspecting documents or tracing transactions through the system is required.

- Testing of the operational effectiveness of internal controls (that is compliance testing) is mandatory where:
  - the risk assessment includes an expectation that controls are operating effectively; or
  - substantive tests alone do not provide sufficient evidence of operation.

In addition, as before, the auditor may choose to test the effectiveness of controls where this is more effective than relying solely on substantive procedures.

Review of the design and implementation of controls is considered as part of the planning process (***C5.1***). Testing the effectiveness of controls is dealt with in Section S.

The initial stage is to complete the Internal Control Questionnaire (***S4***) in order to determine the controls that operate over the main business cycles. Where controls have been identified these should be recorded on ***C5.1*** to evaluate the design and implementation of those controls.

Where there is a requirement to test controls or where a decision is made to do so the Internal Control Evaluation (***S3***) allows you to record how operation of the controls will be tested. The results and consideration of the impact that the results will have on the detailed audit testing should also be recorded here.

Where reliance is placed on testing the effectiveness of internal controls it is still necessary to undertake some substantive testing.

> *Irrespective of the assessed risk of material misstatement, the auditor should design and perform substantive procedures for each material class of transactions, account balance, and disclosure. This requirement reflects the fact that the auditor's assessment of risk is judgmental and may not be sufficiently precise to identify all risks of material misstatement. Further, there are inherent limitations to internal control including management override. Accordingly, while the auditor may determine that the risk of material misstatement may be reduced to an acceptably low level by performing only tests of controls for a particular assertion related to a class of transactions, account balance or disclosure, the auditor always performs substantive procedures for each material class of transactions, account balance, and disclosure.*(SLAuS 330.49)

Therefore, whilst it is not appropriate to abandon substantive testing completely, where an effective control has been identified, the nature of the substantive tests can be altered or the sample size can be reduced in line with the guidance on the sample selection planning form. This can be extended to show that the greater the reliance that can be placed on controls, the lower the level of substantive work needed.

Operation of controls implicit in a low risk assessment

SLAuS 330.23 states that when the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that controls are operating effectively, the auditor should perform tests of controls to obtain sufficient appropriate audit evidence that the controls were operating effectively at relevant times during the period under audit.

When calculating the sample size in these circumstances it will be appropriate, based on knowledge of the client and the review of the design and implementation of controls, to assume that the risk will be low and that internal controls are operating when calculating any relevant sample size. Clearly if the controls prove not to be operating effectively and/or the risk assessment is revised: then it will be necessary to consider increasing the relevant sample sizes.

However, users should note that it is not compulsory to test controls. It is perfectly acceptable to conclude that it is more effective to follow a substantive approach and accept a higher level of risk. For example, based on our past experience of the client's systems and the fact that those systems appear to be unchanged we may conclude that risk can be reduced from high to medium. Our samples for substantive testing would be calculated accordingly.

In some areas of the audit that are material, but not critical it may be possible to argue that the risk assessment is low without any need for reliance on controls. However, this is unlikely to be true for any of the main transaction cycles.

5.6 Collection of audit evidence

The manual audit programmes are comprehensive and designed to deal with most eventualities; however, it is crucial that the programmes be tailored to meet particular circumstances.

Detailed guidance on their use is set out in Chapter 4.

5.7 Audit sampling

The question of how many items to test has always been a debatable subject. It is far better to design tests directly relevant to the client rather than to merely 'fill the forms'. Tailoring or drafting of programmes using the manual as an aide memoir is therefore encouraged. Clearly, any sample must be representative of the whole population and it must be sufficiently large to enable creditable conclusions to be formed.

The exercise of judgement must ultimately determine the sufficiency of sample sizes. The use of inherent risk factors, materiality and population characteristics may give a useful theoretical starting point but ultimately judgement must prevail. The standard risk model does at least provide a benchmark against which to assess the reasonableness of your judgement. More detailed guidance on audit sampling is set out in Chapter 9.

5.8 Evaluation of errors

Errors found in the performance of audit tests must be evaluated to determine their impact on the population being tested and on the accounts as a whole.

Evidence suggests that, at times, auditors have difficulty with this evaluation and what to do next. More detailed guidance on the evaluation of errors is set out in Chapter 10.

6 ASSESSMENT OF RISK

6.1 Introduction

The biggest impact of the change to Sri Lanka Auditing Standards is in the approach to risk. There are two risk SLAuSs:

- SLAuS 315: *Understanding the entity and its environment and assessing the risks of material misstatement*
- SLAuS 330: *The auditor's procedures in response to assessed risks*

These SLAuSs are significantly more demanding than the previous standards in the depth of understanding of the client's systems and operations that is required and also the extent of the linkage of work undertaken to the assessed risks.

The nature of risk

Audit risk is present in the giving of any audit opinion on financial statements. Elements of audit risk include those arising:

a) from the business environment in which the entity operates;

b) from the operation of the entity's control systems;

c) from the failure of auditing procedures, including 'sampling risk'.

The third component can only rarely be eliminated completely. It is almost certain that some risk will remain. The purpose of this manual is to ensure that the risk is minimised and that, even in the event of auditing procedures failing to detect misstatements in the accounts, the auditors can nevertheless be shown to have undertaken adequate auditing procedures.

For these reasons, an assessment of audit risk is essential on all audits, no matter how small the company may be.

Even in the small company audit, it is necessary to consider the business environment in which the company operates. This will include an assessment of its regulatory environment, the markets it serves, the risks it faces, its strategic objectives, the threats to those objectives and any related pressures on management. Consideration should also be had, for example, to whether or not the view presented by the company's accounts is consistent with the lifestyle of its directors and shareholders. To a large extent, this is why it is considered necessary in any audit to see the company at its own premises. If the company operates from the director's home, then go and see him at home. It is not easy to satisfactorily assess audit risk from a completely office-bound perspective. You cannot get a 'feel' for a company by sitting behind a desk!

Business risk

The idea of business risk has been around for some time and many firms already incorporate this into their audit systems. However, this is now a requirement of Sri Lanka Auditing Standards. SLAuS 315.76 states:

> *The auditor should obtain an understanding of the entity's process for identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks, and the results thereof.*

The detailed risk assessment (***C6.4***) includes a section on business objectives to assist firms in identifying such risks.

Audit risk

Audit risk is defined as the risk that the auditors will give an inappropriate audit opinion. This can arise by either:

- an audit report being qualified when it should not have been; or
- an unqualified audit opinion being issued when a qualification was appropriate.

6.2 General risk assessment

General risk relates to the commercial and regulatory environment in which the audit client operates. It is also affected by the business risks the entity faces and an assessment of the integrity of management.

This assessment should assist in determining the riskiness of the engagement as a whole. The higher the perceived risk, the lower the audit risk that the auditor is willing to take, the greater the audit assurance needed.

The overall assessment of risk for a client is determined after completion of the detailed risk assessment at ***C6.4***.

6.3 Specific risk assessment

The assessment of specific risk achieves two objectives:

- It may be used in the context of the very small company to assess the extent to which the full audit programme approach can be foregone in the particular circumstances of the audit in question.

  This approach must always be documented and justified, not simply applied without reason.

- It may be used to pull together the various risks identified on ***C6.4*** and ***C6.3*** and consider their overall impact on a particular area of the financial statements.

This helps to concentrate the audit work on areas of audit significance, ensuring that the bigger picture is not lost through concentration on individual risks identified on ***C6.3***.

6.4 Reliability factors

The sampling model can be expressed as used in this manual can be expressed as:

$$\text{Sample size} = \frac{\text{Population value - Items above Tolerable error - Key items}}{\text{Tolerable Error}}$$

i.e.,

$$\text{Sample size} = \frac{\text{Adjusted Population Value}}{\text{Tolerable Error}}$$

By using the normal distribution it is possible express confidence in sampling results in the form of risk factors. The reciprocal of a risk factor is a reliability factor and these form the basis of the sampling method.

A table of reliability factors can be found on schedule ***C6.2 Risk Response Summary***. When sampling is under-taken, the factor relevant to the particular audit test should be recorded on the relevant sample selection planning form. The reliability factor will then be multiplied by a quotient dependent upon whether tests of detail only or tests of detail plus analytical review and/or compliance tests are to be undertaken. The multiple is also different for balance sheet and profit and loss account testing. Details of the multiplier that affect the reliability factor are given on the sample selection planning forms.

6.5 Vouching the total population

It may be that a total population is tested in the audit of very small companies. For example, it may be that the flat management company has 12 invoices a year and that it is decided to vouch all 12.

Inherent risk assessment will not be applied, and would make no difference, in these circumstances.

General risk assessment must still be considered because the vouching of all 12 invoices cannot, on its own, provide all the audit evidence that we require to form a reasonable conclusion that all income has been completely and accurately recorded in the company's accounting records.

6.6 Accountancy work and audit testing

The ethical issues concerned with providing accounting services to audit clients are outside the scope of the manual. However, assuming that the ethical issues have been properly addressed it may be possible to use audit evidence derived from work carried out in the preparation of the accounts.

Such accounting work must have been properly planned with specific audit objectives in mind, be properly controlled and recorded and subject to adequate review.

In such circumstances it may be that sufficient audit evidence can in respect of certain assertions be obtained to obviate the need for further testing of transaction details.

Remember, however, that such audit evidence will not provide evidence of, for example, completeness, continued existence or title, thus still requiring top up audit work to be done.

6.7 Conclusion

The assessment of risk and the response to those risks is the central plank of the audit approach implicit within Sri Lanka Auditing Standards. The response to assessed risks affects all parts of the audit so it must therefore be an integral part of the audit planning. This will enable the auditor to direct resources to key areas of the audit.

7 MATERIALITY

7.1 Introduction

SLAuS 320.3 reiterates the following definition of materiality which is taken from the ICASL ‘Framework for the Preparation and Presentation of Financial Statements’.

> *Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.*

Materiality impacts on audit work in two respects:

a) It is one of the factors which influences the nature and extent of the tests of detail.

b) It influences decisions as to whether or not an auditor should seek adjustment for errors found in assessing projected errors and for assessing the significance of areas of disagreement on judgemental values presented by the client.

'True and fair' accounts are those free of 'material' misstatement. For this reason above all others, an assessment of materiality should always be made, even on the very smallest of companies.

7.2 Basis of determining materiality

Any basis of determining materiality is necessarily judgemental. No basis should be applied blindly. In general, the level of materiality is relative to the size of the business. However, some items might be material by their nature, regardless of magnitude (e.g., statutory disclosures such as directors' emoluments).

Turnover is normally used as the principal yardstick in determining the level of materiality because it is indicative of the level of business and transactions undertaken in the year. Total assets are also indicative of size and, therefore, should be taken into account. A trading entity would usually be audited to turnover-based materiality. An investment company would normally be audited on an asset-based materiality.

Profit before tax on ordinary activities is determined after directors' remuneration. In most smaller businesses the impact of such remuneration on profit will be significant. Where exceptional salaries, including bonuses, or other exceptional items have been charged in arriving at profit before tax, the exceptional element of such costs should be added back when calculating profit-based materiality to the extent these costs are discretionary.

The following notes are a guide only to determining materiality in particular circumstances. Wherever the figure of materiality appears to be more appropriately calculated by other means, use an alternative basis, but the reasons for doing so must be documented.

7.3 The smaller company

When the materiality ranges based on the guidelines have been established, the overall materiality must be determined. This is not an arithmetic average but a matter of professional judgement. In most small businesses it may be close to the turnover parameter; however, in an asset-based business, such as a property investment company, it may be closer to the gross asset parameter. Materiality will not usually be set at the profit parameter. This figure should be used to help decide what level is most appropriate, somewhere between the turnover and gross asset parameters. Once a materiality has been set, it might be appropriate to consider differing levels of tolerable error within different account balances.

For example, auditors could normally be prepared to tolerate a greater error in inventories than in banks and cash. However, tolerable error should not exceed materiality.

Where total liabilities are significant, it may be necessary to calculate a parameter for total liabilities, introducing this into the overall equation. This may be particularly relevant where the company is making a loss.

Where the company is close to break even, such that a relatively small error could turn a profit into a loss (or vice versa), greater emphasis should be placed on trends over a period of years. Remember that materiality should remain broadly constant from year to year (subject to inflation and significant changes in the level of business carried on). However, many choose to revise materiality downwards where a company is near break even, either in terms of its results for the period or in terms of the net assets.

7.4 Determining materiality

A guide for determining the level of materiality is set out below. If must be emphasised that this is guidance only. The level of materiality is a matter for professional judgement. Under no circumstances should materiality be 'calculated' as an average of the parameters!

Profit before Tax 5% - 10% (Circumstances of the entity should be taken in to account if Profit before Tax criteria is used for materiality and the given threshold is only guidance)

Turnover/Total Assets/Net Assets 1% - 3%

7.5 Conclusion

Firms are free to set their own levels of materiality, but, in doing so, should take care not to set levels of materiality which are either too high or too low. In the very small company audit, experience indicates that there may be a tendency to set materiality at too low a figure, probably as a result of confusion of audit and accounting materiality.

Setting materiality too low will affect sample sizes: they will increase. This may cause time problems without necessarily increasing audit efficiency. Too low a materiality figure could also pose problems if an audit firm's work is called into question. By defining materiality at too low a level, the firm is defining 'truth and fairness' in too precise terms. Its work could be found wanting when judged in terms of too precise a definition of 'truth and fairness'. By opining that accounts are 'not materially misstated', auditors do themselves no favours by setting materiality at too low a level.

8 ANALYTICAL REVIEW

8.1 Introduction

SLAuS 520.2 states that the auditor should apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment and in the overall review at the end of the audit. This paragraph also states that analytical procedures may be applied as substantive procedures.

In the context of the smaller company, the extent to which analytical review procedures are effective or even possible will vary widely. It would, however, be quite wrong to suggest, as a matter of principle that analytical review need not be carried out for smaller companies.

In many smaller companies, analytical review may form an effective part of substantive procedures. They can be particularly useful in circumstances in which tests of transactions cannot provide adequate evidence of completeness.

Extensive analytical review procedures may highlight fluctuations in ratios. These may be normal fluctuations (business trends, seasonal changes, trade cycles, cost/selling price relationships) or abnormal fluctuations (exceptional transactions, bad debts, loss of assets by fire or theft, bases of valuation of inventories and cut-off errors).

In analysing the cause of the fluctuations, there is a tendency in smaller company audits for the auditor to accept too readily the explanation given by management. Care must be taken to check that the facts given by management are valid and complete and that their effect is sufficient to explain the fluctuation. The recording of such explanations and corroborating their validity in the working papers will be as important as the identification of the fluctuation itself. Only corroborated commentary provides valid audit evidence.

This same problem would arise in the audit of, for example, a bar. Audit tests on till rolls can never provide total audit assurance that all sales have been rung up on the till. Analytical procedures may, in such circumstances, provide the only practicable alternative procedures to verify completeness of sales.
Analytical procedures in this last example would involve analysis of margins, analysis of inventory reports, brewery statistics of barrelage, etc. This should provide the additional audit evidence necessary to avoid the possibility of a qualification on grounds of lack of control over cash income.

It is the importance of this aspect of analytical procedures that the manual hopes to emphasise. Experience indicates that many auditors of smaller companies do not adequately appreciate the extent to which analytical review procedures can help, believing erroneously that such procedures are only applicable to the larger audit.

8.2 Timing and objectives of analytical procedures

Analytical procedures may be relevant to three distinct but interrelated stages of the audit:

a) the planning stage;

b) extensive analytical review as a substantive test; and

c) critical review of accounts.

The planning stage

A preliminary analytical review should be carried out as required by SLAuS 520.8. These states:

> *The auditor should apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment.*

Where draft accounts are not available, information should be extracted from available records such as daybooks or expected changes from previous years should be discussed with the directors. If management accounts or draft accounts are available at an early stage in the audit it may be appropriate to carry out a more detailed preliminary analytical review as soon as they are available.

Preliminary analytical review procedures should assist in identifying significant matters that require consideration during the audit. This suggests that wherever possible, preliminary analytical review should be carried out before completing the assessment of general and specific risk. Risk assessments should be reconsidered as further evidence comes to light.

Preliminary analytical review procedures do not, of themselves, provide audit assurance, although they should contribute to effective auditing by minimising the risk of over- and under-auditing.

The purpose of preliminary analytical review is to identify areas of the audit where there are greater risks or areas that may, for other reasons, require more detailed investigation. It is therefore vital that there is some commentary on the variances and ratios calculated together with a conclusion identifying any matters that require further investigation, or noting that there are none.

Extensive analytical review

During the course of the audit, extensive analytical review procedures may be carried out on specific areas of the accounts, or on the accounts as a whole, as a means of providing formal audit assurance as already discussed in section **3.1** above, to which readers are referred.

Care must, however, be taken in the analysis of the results of extensive analytical review procedures. It would be wrong to assume that extensive analytical review procedures can result in an automatic reduction in the extent of detailed testing. Only if the results of the procedures are satisfactory, can the extent of substantive testing be reduced. If, as may often be the case, extensive analytical review indicates unexpected variations in ratios, this would require investigation of the variations, directing audit attention accordingly. In such circumstances, it might be inappropriate to reduce the level of substantive testing. Where exceptionally good quality evidence has been gained it may be that no further work is required on an area once the detailed analytical review has been undertaken.

This can be evidenced through the forms in the D section of the working papers.

In other instances, extensive analytical review procedures may bridge the gap in the audit trail where, for example, detailed inventories records are not maintained. This will arise in the retail trade, where detailed inventories movements will tend not to be recorded. If audit tests are based on copy sales invoices, these may not contain details of all sales. What of the 'sale' that was not recorded on a sales invoice? Transaction testing will never pick this up; no such transaction test can in cases where there is no complete population of despatches. Extensive analytical review procedures may, however, provide alternative audit procedures. These may enable appropriate reliable audit evidence to be derived from a combination of transaction testing and analytical review, from which it can be concluded that all sales have been properly recorded in the accounting records, or at least have not been materially understated.

Critical review of accounts

A final analytical review should always be carried out. The procedures for final analytical review will be similar to those of preliminary analytical review. Both are mandatory procedures under the SLAuSs.

SLAuS 520.13 states:

> *The auditor should 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.*

Final analytical review will, therefore, compare current year final figures and ratios with those of previous years and with the findings of the audit tests. Where preliminary analytical review has been carried out, it will nevertheless be necessary to re-perform this work at the final stage unless the figures have not altered significantly.

As with preliminary analytical review it is the commentary and conclusion that are important rather than the number crunching. In this case the conclusion should be expressed in terms of the overall truth and fairness of the figures.

8.3 Conclusion

Carry out preliminary analytical review procedures, with a final review on completion of the audit, without repetition of the earlier work. Repetition might be unavoidable where the figures are materially different.

Wherever effective, carry out extensive analytical review procedures, corroborate and explain the findings and rely on the assurance provided to reduce the extent of transaction testing or to refocus audit work.

Always carry out a final critical review of the accounts. This should involve primarily a review of the financial statements but auditors must also read other information to be issued with the financial statements. The critical review should help auditors to form a final overall view on the truth and fairness of the financial statements as well as ensuring that the other information is not inconsistent with them.

9 AUDIT SAMPLING

9.1 Introduction

The sampling method in the manual is designed to provide a reasonable guide to the level of testing that should be applied to individual populations. However, always consider whether the sample size produced is appropriate. The sample size must ultimately be a matter of reasoned professional judgement. Accordingly the suggested sample size may be adjusted, but the reasons for the adjustment must be given on the relevant audit working papers and must be justifiable.

9.2 Determining sample sizes

The proposed basis of determining sample sizes uses the following figures:

- the monetary value of the population;
- the overall level of materiality set for the audit;
- the calculated reliability factor (i.e., a converse measure of risk);
- the identification of high value and key items.

By basing the sample size on a combination of monetary value of the population, materiality and risk, the auditor is using the data determined at the planning stage of the audit in determining the size of the audit sample. The lower the figure of materiality and the lower the sampling risk the auditor is willing to accept (i.e., the higher the risk factor), the larger the sample will be. Following the manual sampling method therefore ensures that work undertaken is responsive to the level of assessed risk in that area.

High value items and key items have been stratified separately for testing. These are considered sufficiently important to justify selecting all such items. In an overstatement test, high value items are those transactions or balances that are higher than the figure of tolerable error (materiality divided by the inherent risk factor). In an understatement test, of say creditors, 'high value items' are those balances, of whatever magnitude, with major suppliers. Key items are other balances or transactions that are identified as significant in the particular circumstances of the test being carried out.

Judgement is required in assessing whether or not an item is a 'key' item for these purposes. For example, in the context of debtors, this might be by reference to ageing or known risk sectors of debtor balances, suggesting that greater audit attention should be given to such balances. No absolute definition of key items is suggested or possible. Judgement must be exercised as necessary.

Once an understatement test has been completed, any balances over materiality remaining unaudited should be verified. It is wrong to single out high value items first in an understatement test.

The value of the population should relate specifically to the test being carried out. For example, a test designed to verify the provision for obsolete inventories should not be based on the value of the provisions made by the client. The main concern is to ensure that all items of obsolete inventories have been identified. In these circumstances, the population should be the total value of inventories. Of course, it would be in order to concentrate testing on high-risk items, such as those with no sales over the past few months. The remainder of the population cannot, however, be ignored. Tests must cover some apparently low risk items, hence the value of the residual population forming the basis for this sample.

9.3 Sample selection planning form

Sample selection planning forms may be used to determine sample sizes in all the examples referred to in **9.2** above and are included in each of the main file sections.

Sample sizes may be determined without using the form, but, in such circumstances, the basis should be explained.

The form takes you step-by-step through the data determined in the planning stage to provide an objective means of determining the sample size. Reference to the inherent risk factors should be made as necessary.

Remember that a different risk factor is used for balance sheet sample selection to that used in the profit and loss.

Where the sample size has been determined by means of the form, it may, nevertheless, not be considered appropriate. Be careful: do not simply override the form and select a different figure; think about whether the information derived from the planning forms is fair in all the circumstances. If a different sample size is selected, the reason for having done so must be explained in the working papers. The form is not, therefore, intended to provide an absolutely rigid approach to sample selection. Judgement must be used.

An example of difficulty quite commonly encountered in sample selection is the determination of a very high sample size. While it may be that in circumstances of high-risk areas of high risk audits, high sample sizes are selected, the sample selected must be capable of proper testing in an appropriate time scale. It is generally not efficient in the smaller company to test such samples, suggesting that a rethink of audit strategy is necessary. It is likely that alternative audit tests should be considered as a means of obtaining sufficient audit evidence, reducing the tests of detail accordingly.

Care should also be taken where the calculated sample size is small, say below 10, as any sample is unlikely to be representative. This might be because the population has a low value or because assurance has been gained from tests of control or detailed analytical review. In these circumstances an alternative test such as a scrutiny for material/unusual items or a proof in total may be more suitable.

9.4 Selecting the sample from the population

Various means are available for selecting the chosen sample from the population. High value and key items will already have been identified. The sample from the residual population should be selected so as to cover fairly the whole of the population being selected.

This involves the use of either random, systematic or judgemental means of selection. Try to avoid the selection of a block of items as this is prone to bias and fails adequately to consider the whole population.

If using a random selection, start with a random number (the serial number of a bank note, for example), selecting every *n*th item thereafter where *n* equals the residual population value divided by the sample size. Again, ignore high value items and key items as these will already have been selected for testing.

Regardless of the basis used, state the basis and, if necessary, why it was chosen.

9.5 Samples for compliance testing

No specific guidance is given on the size of samples for compliance testing, as this is essentially a judgemental area. The standard sampling approach does not apply, as the population for many controls will be monthly, weekly or daily. In these circumstances it is a matter of judgement as to how many should be tested.

Where a control operates at a transaction level then dual purpose testing is normally the most effective approach. This means that a substantive sample is selected, based on the assumption that the control is operating, and is tested substantively (for example that a purchase invoice exists to support a nominal ledger debit) and also for the operation of the control (perhaps that the invoices is agreed to a goods received note).

9.6 Conclusion

Sample sizes should feel right, judgementally. It is not, however, sufficient to determine the size of a sample without recording the logical thought used in its selection.

The sample selected should be capable of being properly tested. If this cannot be done, it is nearly certain that the work will not be carried out well.

Finally, once a sample size has been selected, it is essential to stick to it. To test, say, half the chosen sample is positively dangerous.

10 EVALUATION OF ERRORS

10.1 Introduction

The investigation and evaluation of errors encountered during audit tests is a vital part of the audit. Errors should always be followed up. In no circumstances should they simply be ignored.

10.2 Extrapolation of errors

When an error is encountered, the questions which must be addressed are:

1. Could other errors exist elsewhere within the population?

2. Is it possible that those errors could be material to the accounts?

If the answers to these questions are both 'yes', then some additional audit work must be carried out. Remember, the second question is asking whether it is possible, not whether it is likely. In normal circumstances, therefore, some additional work must be carried out whenever an error is encountered.

Having considered the nature of an error, it may well be possible to devise an alternative test which can more effectively and efficiently identify the likely impact. This may involve detailed analytical review or some other test altogether. In the absence of this, it will be appropriate to extend the sample size in order to determine whether the level of error encountered is typical of the population as a whole.

Since the method of sampling has already identified all high value items and tested these individually, any errors within these items will have already been fully evaluated. Increased audit work will, therefore, be within the 'residual population'.

Where the increased work identifies a certain level of error within the population, it will usually be appropriate to extrapolate that level of error over the residual population. This, combined with the errors found in the high value items tested, will give us the most likely level of error in the population as a whole. Consideration must be given to whether this level of error is likely to produce a material misstatement within the accounts.

Errors are not always most effectively dealt with by simply increasing the sample size. The nature of the error, and why it may have arisen must be considered. For example, if posting errors arise during the period when a particular member of staff was on holiday, it would clearly be sensible to extend tests to concentrate on that period of absence, rather than the year as a whole. Similarly, if errors are coming out of one particular branch or depot, additional testing should concentrate on these.

10.3 Projecting the value of errors

Two non-statistical methods of projecting errors in a population are set out below.

The ratio method may be more appropriate where the amount of error in a transaction relates closely to its size, i.e., the bigger the transaction, the bigger the error.

The difference method may be more appropriate where the size of the transaction would make no difference to the amount of the error, i.e., the error is of a constant amount.

Both bases of calculation are able only to project an error in the population as a whole.

The ratio method

$$\text{Projected error in population} = \text{Error found} \times \frac{\text{Population value}}{\text{Sample values}}$$

Example

Total value of population	Rs. 250,000
Total value of high value key items	Rs. 100,000 (errors – Rs. 4,000)
Sample value	Rs. 45,000 (errors – Rs. 2,000)

Projected error in the residual population: Rs. 2,000 x $\frac{150,000}{45,000}$ = Rs. 6,667

Overall projected error: Rs. 10,667 (Rs. 6,667 + Rs. 4,000)

Known error: Rs. 6,000 (Rs. 4,000 + Rs.2,000)

The difference method

$$\text{Projected error in population} = \text{Error found in sample} \times \frac{\text{Number of items in population}}{\text{Number of items in sample}}$$

Example

Total number of items in population	300	
Number of items examined 100%	20	(errors – Rs. 1,000)
Number of items in sample	25	(errors – Rs. 1,200)

Projected error in the residual population: Rs. 1,200 x $\frac{280}{25}$ = Rs. 13,440

Overall projected error: Rs. 14,400 (Rs. 13,400 + Rs. 1,000)

Known error: Rs. 2,200 (Rs. 1,000 + Rs. 1,200)

Where information about the nature of errors is not known, the ratio method should normally be used.

10.4 Errors and materiality

The total value of all projected errors must be accumulated to determine whether or not this value could give rise to material error in the accounts. Any such errors should be recorded on the ***B7*** schedule of unadjusted errors.

The nature of the errors, their amount and the accounts areas on which they impact will all affect the auditor's judgement in evaluating their effect on the truth and fairness of the accounts.

10.5 Conclusion

Because projected error is unlikely to be the same as actual error in a population, it will be necessary to evaluate judgementally whether or not material error in the accounts is considered likely. If considered material, the choice of options open are:

a) to request the client to investigate the errors and the potential for further errors; or

b) to extend the audit tests to gain a more precise conclusion; or

c) to perform alternative procedures (if possible); or

d) to qualify the audit opinion on grounds of uncertainty.

The effect of errors found in audit tests must be resolved. It is not acceptable to leave an error position 'open'. A conclusion about its impact on the area being tested and the accounts as a whole must be drawn.

11 PRACTICAL POINTS ON REVIEWING THE MANUAL FILES

Knowing where to look in an audit file can be a valuable skill when it comes to reviewing files. The top twenty problems we find on the review of audit files are set out below.

20. Too much photocopying

There is generally too much photocopying on audit files. Typically a file will contain copies of all or some of the clients entire nominal ledger, aged listings for trade receivables & payables, rough inventory sheets, final inventory sheets and all invoices and supplier statements examined! If details from a report are extracted for testing it is not necessary to copy the entire report as well. Unless the report is short normally only the first and last pages are required to identify the version of the report tested. Similarly it is not necessary to copy invoices or statements unless there is something contentious. If it is really felt necessary to copy huge swathes of the client's records then these should be placed on a separate file so that they do not make the audit file unmanageable.

19. Analytical procedures as a substantive test

There is often confusion over use of D section, analytical procedures. This section is intended for the use where analytical procedures are used as substantive tests to reduce other detailed testing. This is distinct from analytical procedures undertaken at the planning (***C7***) and final (***B9***) stages.

18. Completion of programmes

Audit programme tests are completed with "Yes"or "OK", but there is no evidence of the work undertaken to support that result. In these circumstances the only conclusion available is that there is insufficient audit evidence on the file. At the very least there should be some comment on the programme as to what was done and ideally a reference to a schedule.

17. Subsequent events review

The subsequent events review is signed off at the date the fieldwork was completed and is not updated to the date of approval of the audit report. In particular there is some confusion concerning the use of the two post balance sheet events programmes. The programme ***T2*** is intended to be completed at the fieldwork stage by the senior or manager. The partner or manager should complete the programme ***T4*** just prior to the approval of the audit report if there has been a significant delay from the completion of the fieldwork or where there are indications of material post balance sheet events. If the audit is signed off very quickly after completion of the fieldwork and there are no indications of any post balance sheet events it is not necessary to complete ***T4***, a simple note on file to that effect will suffice.

16. Permanent files

Permanent files are not complete or up to date and often consist only of copies of contracts, agreements and past accounts. Matters such as the clients accounting system or a register of relevant laws and regulations are not included. It is difficult to see how the auditor will be able to demonstrate compliance with SLAuSs 240 and 315 in such circumstances.

15. Engagement letters

The engagement letter is out of date! This may be either in respect of the services offered or a technical issue such as a reference to out dated standards.

14. Disclosure checklists

A disclosure checklist is not completed in the year; there is no annual review of changes or a copy of a completed disclosure checklist on the permanent file. In these circumstances it is hard to evidence that the assertions concerning correctness of disclosure have been considered, particularly when we find disclosure errors in the accounts! It is important to have a clear policy as to how often a full checklist will be completed and how disclosure will be considered in the intervening years.

13. Accounting policies

Files rarely include any discussion of key or unusual accounting treatments, the client's policy being simply accepted. For example, it is common to see the calculation of depreciation charges being checked but no consideration of whether the rates used are appropriate. Justification for non-depreciation of buildings is also often accepted without any evidence of consideration of the reasonableness of the arguments for the building having a high residual value and or long economic life.

12. Title to properties

There will often be a note to the effect that the company's premises were physically verified during the audit. However, the issue of ownership will not have been considered. Whilst the bank letter may refer to the title deeds, this only confirms that the bank holds them, it does not confirm the beneficial owner.

11. Testing inventories

Inventories often present problems with directional testing since they must be tested for both under and overstatement. We frequently see that inventories are only tested for overstatement or where understatement is considered only half the sample is tested each way. In addition, when testing the net realisable value it is common to see an inventory line checked to a single after date invoice to confirm that the selling price is higher than cost. No consideration is given to the quantities held and the quantities sold at that price since the year-end.

10. Representations from directors

There is often an over-reliance on representations from directors for matters such as bad debts or inventory provisions without any attempt to substantiate them. However, these representations are all too often missing from the letter of representation, which is just a standard letter.

9. Cut-off testing

Cut-off testing is either not performed or is performed in a mechanical manner without any consideration of the materiality of the transactions involved. Where testing is performed it appears to be almost standard to test the first and last 5 sales and purchases. There are two problems with this approach:

- It does not consider receipts or despatches of goods and the last 5 sales in the year may not correspond with the last 5 despatches, similarly for purchases.

- It takes no account of the materiality of the transactions involved. As auditors we are interested in material cut-off errors. How will testing the last 5 items at the end of the year achieve this if they are immaterial? Particularly when any errors that do arise are likely to be dismissed as isolated even though there are no grounds for doing so!
  (See 8.)

Surely it is more effective to identify higher value transactions around the year-end and test these. The period around the year-end that needs to be reviewed will depend on the specific transaction timescale for the company concerned; however, this will mean that sales and despatches and purchases and receipts can be considered together.

8. Unadjusted errors

Errors identified during testing are not always recorded on ***B7*** or extrapolated to consider the overall potential effect; and as noted in point 9, too many are dismissed as being one-offs when there is little or no justification for doing so. Where errors are recorded on ***B7*** the requirements of SLAuS 260 in relation to determining which errors are trivial and requesting that the client adjusts for non-trivial errors are not always complied with.

7. Testing completeness

The ICASL Audit manual applies directional testing and most audits are planned on this basis. This means that debits should be tested for overstatement and credits for under statement. Testing for overstatement is more straightforward as the auditor is checking what is already recorded. As a result such tests are usually performed well (If not too well! The problem here is often over-auditing; staff find these tests easy so they will do more of them!) Testing for understatement is not so straightforward as the auditor is looking for what is not already recorded. Problems arise in two areas: completeness of income and completeness of creditors.

It is common to see that the list of recorded creditors has been checked to supporting invoices and after date payments. These tests confirm the existence of the recorded balance; they do not confirm completeness. The best test for completeness is reconciliation of supplier statements with proper follow-up of reconciling items. If supplier statements are not available then a review of invoices processed after the year-end should be performed.

Similarly when testing sales, checking recorded sales to despatch notes confirms the genuineness of the sale, not completeness. To test completeness the test must start outside the accounting records, for example testing from despatch notes, job numbers or an order file to the corresponding sales invoice.

6. Existence of fixed assets

The approach to confirming existence of assets often consists of noting those assets seen during the fieldwork or inventories take. This test does not confirm the existence of recorded assets since the sample is taken from the assets themselves rather than the nominal ledger or fixed assets register. Also no consideration is given to the existence of the assets that were not checked.

5. Preliminary analytical review

SLAuS 520 requires the auditors to apply analytical procedures at the planning stage to assist in understanding the entity's business, in identifying areas of potential audit risk and in planning the nature, timing and extent of other audit procedures. Most files now include a schedule entitled preliminary analytical review. However, the work on the schedule is usually of little value.

As stated above the purpose of preliminary analytical review is to identify areas of the audit that may require more detailed investigation. It is therefore important that there is some commentary on the variances and ratios calculated together with a conclusion identifying any matters that require further investigation, or noting that there are none.

It is also common to see a note to the effect that preliminary analytical review is not possible as there are no figures available. Such a statement does not comply with the SLAuS and in any event is not correct. Whilst there may not be management accounts or a trial balance available there will almost certainly be bank statements. A review of the level of sales, how close the company is to its overdraft facility and a discussion with the directors may well identify significant changes in the level of activity or cash flow problems that need to be investigated during the audit.

4. Final analytical review

Similar comments to those for preliminary analytical review apply to final analytical review. SLAuS 520 requires the auditor to apply analytical procedures in forming an overall conclusion as to whether the financial statements as a whole are consistent with their knowledge of the entity's business. As with preliminary analytical review it is the commentary and conclusion that are important rather than the number crunching. In this case the conclusion should be expressed in terms of the overall truth and fairness of the figures.

3. Evidence of partner review

There is little or no evidence of partner involvement in the audit. Signatures on the partner completion schedules alone are unlikely to be sufficient. If a detailed audit highlights memorandum (see 2) were prepared then comments against the matters discussed would suffice. However, it will normally best to include a schedule headed partner review. If there are no review points required then the schedule could be used to compliment the staff on a good file!

2. Audit highlights memorandum

There is often no audit highlights memorandum or if a memorandum is prepared it will only list outstanding points that tend to be of an accounting nature. An audit highlights memorandum is effectively a summary of the audit. It should record the results of the audit tests in all the key areas identified at the planning stage. In addition any problems or outstanding points should also be listed. This will help ensure compliance with SLAuS 330.73 which requires that:

> *The auditor should document the overall responses to address the assessed risks of material misstatement at the financial statement level and the nature, timing, and extent of the further audit procedures, the linkage of those procedures with the assessed risks at the assertion level, and the results of the audit procedures. In addition, if the auditor plans to use audit evidence about the operating effectiveness of controls obtained in prior audits, the auditor should document the conclusions reached with regard to relying on such controls that were tested in a prior audit.*

Preparation of the memorandum is a good discipline for the senior and manager as it helps ensure that all key areas identified at the planning stage have been addressed. If the audit highlights memorandum is properly drafted it will save partner time at the review stage as the partner will be able to review the file selectively concentrating on key and problem areas.

1. Planning memorandum

It is common for the planning section to consist only of the manual forms that have been completed in a fairly superficial manner. For example, on a number of files reviewed the only indication of the business of the company was the principal activity noted in the directors' report. The permanent file (see 16) and planning section being silent on the issue. Other problems commonly seen with planning include the following.

- Insufficient justification of general risk, in particular apparent higher risk factors are ignored or dismissed without adequate explanation.

- All specific risks are assessed as low when there are quite clearly higher risks in some areas, and in some cases a conclusion to this effect on the general risk assessment!

- The example form ***C3*** in the manual is included on file, and either left blank, or filled out, but with nothing of relevance to the client. In fact this form is an example of the layout of a planning memorandum, and it was not intended that the example itself should appear on file.

- The planning is signed by the partner at the completion stage.

- All programmes are completed in full when not required at all or where only specific tests on the programmes were needed.

- Failure to properly test the implementation of controls at the planning stage or alternatively treating checks on the implementation of controls as compliance tests.

For most audits the completion of only the manual forms will not normally be sufficient evidence of planning. A detailed planning memorandum should be prepared that pulls together the matters addressed on the planning forms and sets out the key areas for the particular audit and the detailed tests that will be performed in these areas. This will help ensure that audit work is directed to the right areas. If this memorandum is word-processed then it can evolve each year as different issues arise.