

EXTERNAL AUDIT

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What is an audit?

Assurance services

The purpose of assurance services is to:

- increase the confidence
- reduce the risk of the users of those services.

The *International Framework for Assurance Engagements* gives the overall guidance for carrying out assurance engagements.

3 parties involved

User

Expresses a **conclusion** that provides the user with a **level of assurance** about that subject matter

Responsible party

Responsible for the subject matter

The practitioner:
Is offering a professional service and expects to be paid
Must be competent, objective and independent
Work must be carried out to expected standards.

Practitioner

Evaluates or measures a **subject matter**

Against identified suitable **criteria**

Reasonable assurance engagements

The practitioner:

- gathers sufficient appropriate evidence
- does enough work to be able to draw reasonable, but not absolute, conclusions
- concludes that the subject matter conforms in all material respects with identified suitable criteria
- gives a report in the form of a **positive statement of opinion**

EXAMPLE

- Statutory audit.

The Rules

Who may or may not act as an auditor

MAY ACT ✓

INDIVIDUALS

- A member of a Recognised Supervisory Body (RSB) e.g. ACCA
- and
- Allowed by the rules of that body to be an auditor
- or
- Someone directly authorised by the state.

FIRMS

- Controlled by members of a suitably authorised supervisory body
- Or
- A firm directly authorised by the state

MAY NOT ACT ✓

EXCLUDED BY LAW

In Britain

- An officer (Director or secretary) of the company
 - an employee of the company
 - a business partner or employee of the above.

EXCLUDED BY ETHICS

- Due to lack of objectivity or independence, for example, due to:
 - close business relationships
 - personal relationships
 - long association with the client
 - fee dependency
 - non audit services provided.

Risk

Audit risk

Audit risk (AR)

Definition

The risk of issuing an inappropriate audit opinion.

Inherent risk (IR)

The risk of misstatement occurring in the first instance.
Caused by client's unique internal and external operating environment.

Example

Higher risk:

- A client in a volatile industry.
- Engaging in foreign transactions.
- Rapidly changing technology

Control risk (CR)

The risk that the client's controls fail to prevent and detect misstatement.

Example

Higher risk:

- Old or ineffective accounting software.
- Lack of segregation of accounting duties;
- Lack of authorisation procedures.

Detection risk (DR)

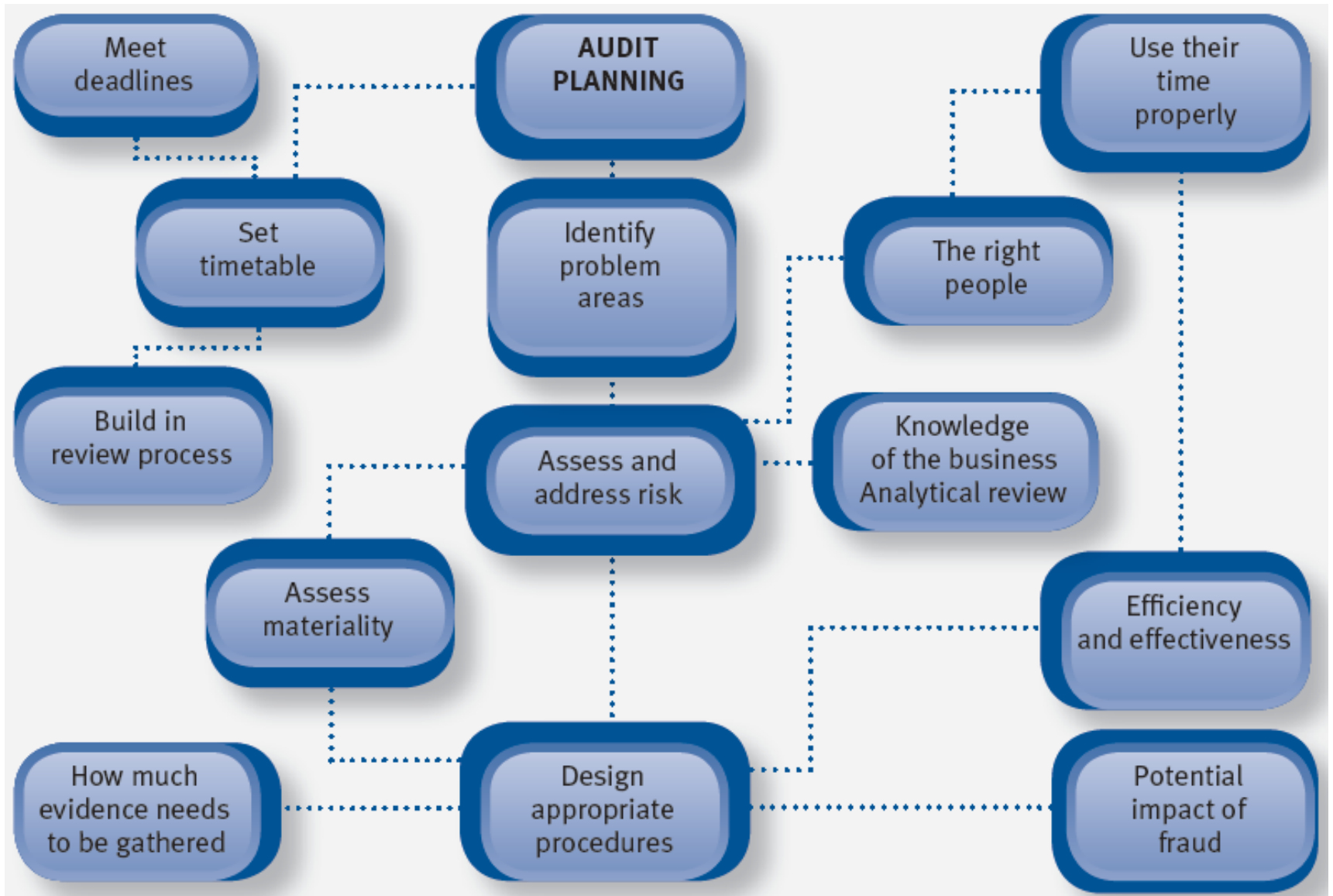
The risk that the auditor fails to detect material misstatement

Example

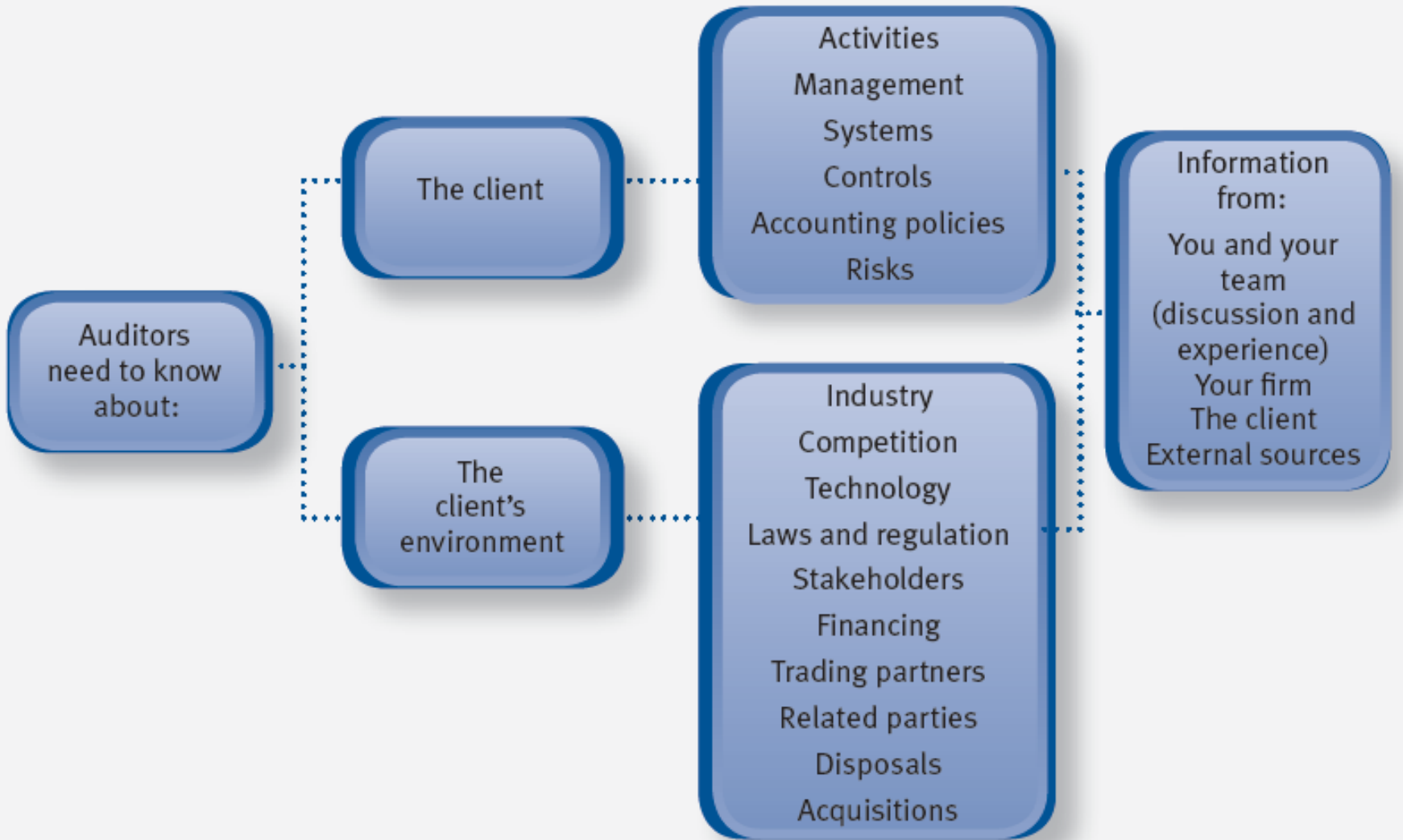
Higher risk:

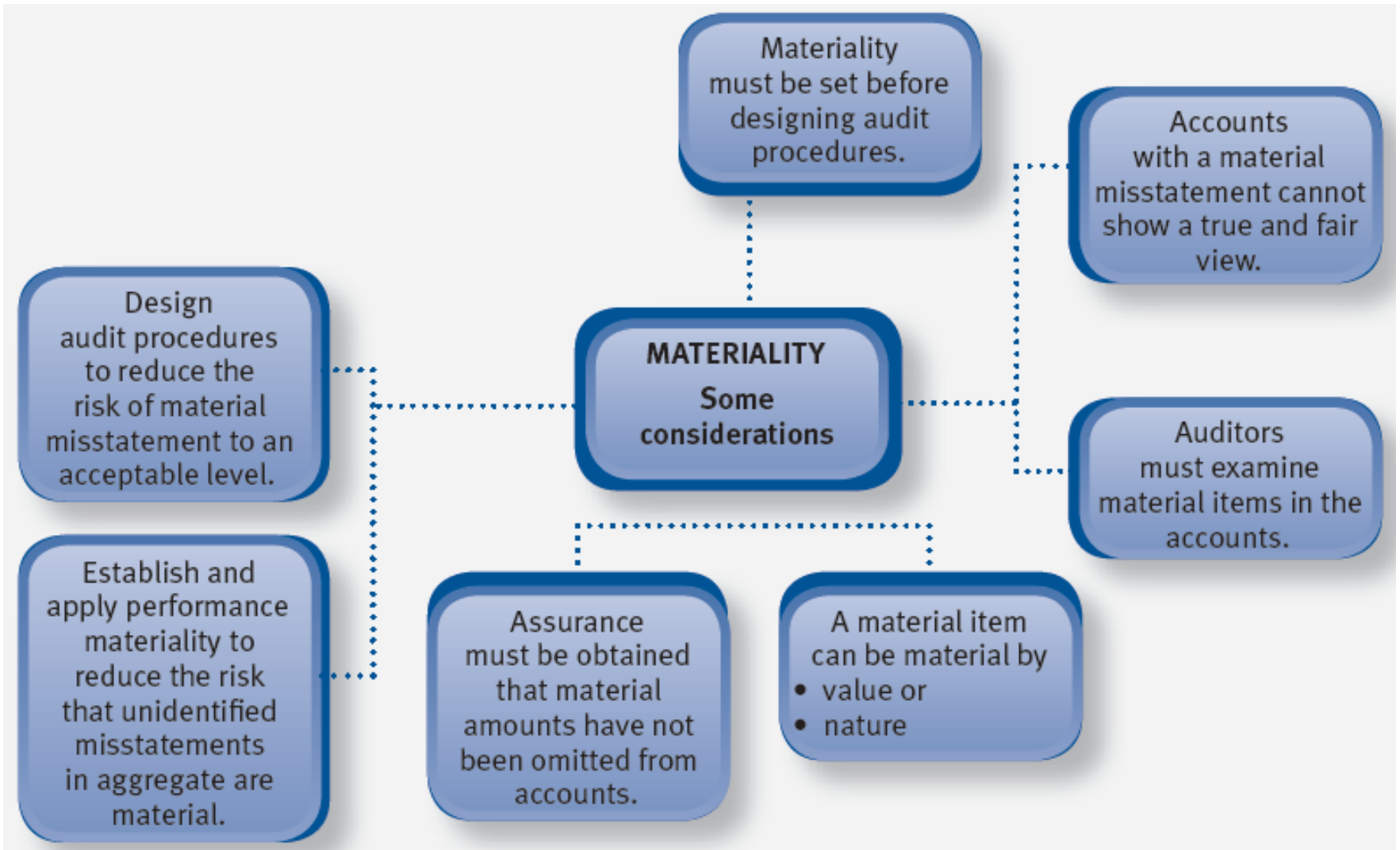
- Using inappropriate procedures.
- Misinterpreting results.

Planning



KOB is the key to assessing risk.





Systems and controls

More reliable systems of control mean lower risk of material misstatement. Reliable systems contain stronger controls.

The auditor must:
Understand the system.
Understand the controls within the system.
Test whether the controls work.

The more effective and reliable the system the lower the audit risk and the greater the reliance the auditor can seek to place upon the system.

Control Procedures:

Authorisation

Comparison

Computer controls

Arithmetical checks

Maintaining control accounts/records

Accounting reconciliations

Physical controls

Segregations of duties

- The auditor needs to:

ASCERTAIN THE SYSTEM

Possible methods:

- examine previous audit work
- client's own documentation of the system
- interview client staff
- trace a transaction through the system (walkthrough test)
- observe procedures.

DOCUMENT THE SYSTEM

Possible methods:

- narrative notes
- organisation chart
- complete an Internal Control Questionnaire (ICQ)
- flowcharts.

EVALUATE THE SYSTEM

Use an Internal Control Evaluation Questionnaire (ICEQ or ICE).

Audit Evidence

4 Key Auditing Questions:

Questions	Assertions
Should it be in the accounts at all?	Occurrence
	Existence
	Rights and obligations
	Cut-off
Is it included at the right value?	Accuracy
	Valuation
Is there any more?	Completeness
Is it properly disclosed?	Allocation
	Understandability

5 key methods of obtaining evidence

A nalytical review

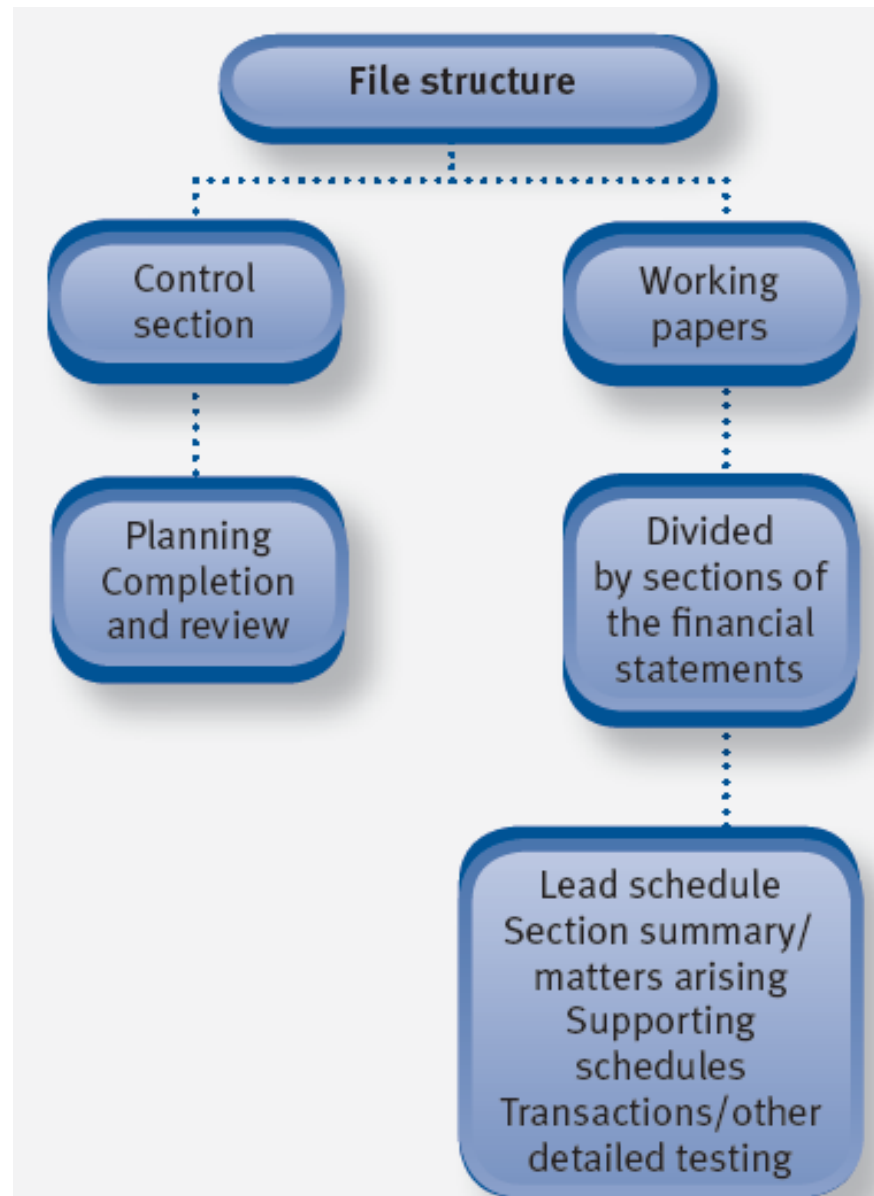
E nquiry and confirmation

I nspection of documents and assets

O bservation

recalc **U** lation and recomputation

Audit procedures



Using the work of an auditor's expert (ISA 620)

EXPERT = Person/Firm providing special skill, knowledge and experience other than auditing

Auditors need to obtain **sufficient appropriate** evidence that the work performed by expert is adequate for audit purposes

Auditor must assess whether expert is competent and independent of client.

1. Nature and scope of work agreed with expert

2. Auditors must evaluate findings of expert (e.g. review assumptions....)

Assess appropriateness of their assumptions

Assess consistency of conclusions with evidence obtained.

Consider reliability of source data

ISA 610 - Using the work of Internal Audit

- Although the objectives of internal and external audit differ, the objectives are often similar.
- External auditors must obtain a sufficient understanding of the IA function to assist in the planning and developing of an effective audit approach and to determine whether it is possible to rely on Internal audit work.

Factors to consider include:

- The organisational status of IA
- The scope of the IA function
- The technical competence of the IAs
- Due professional care

Computer assisted audit techniques

Test data

Test data is data generated by the auditor which is then processed using the client's computer systems.

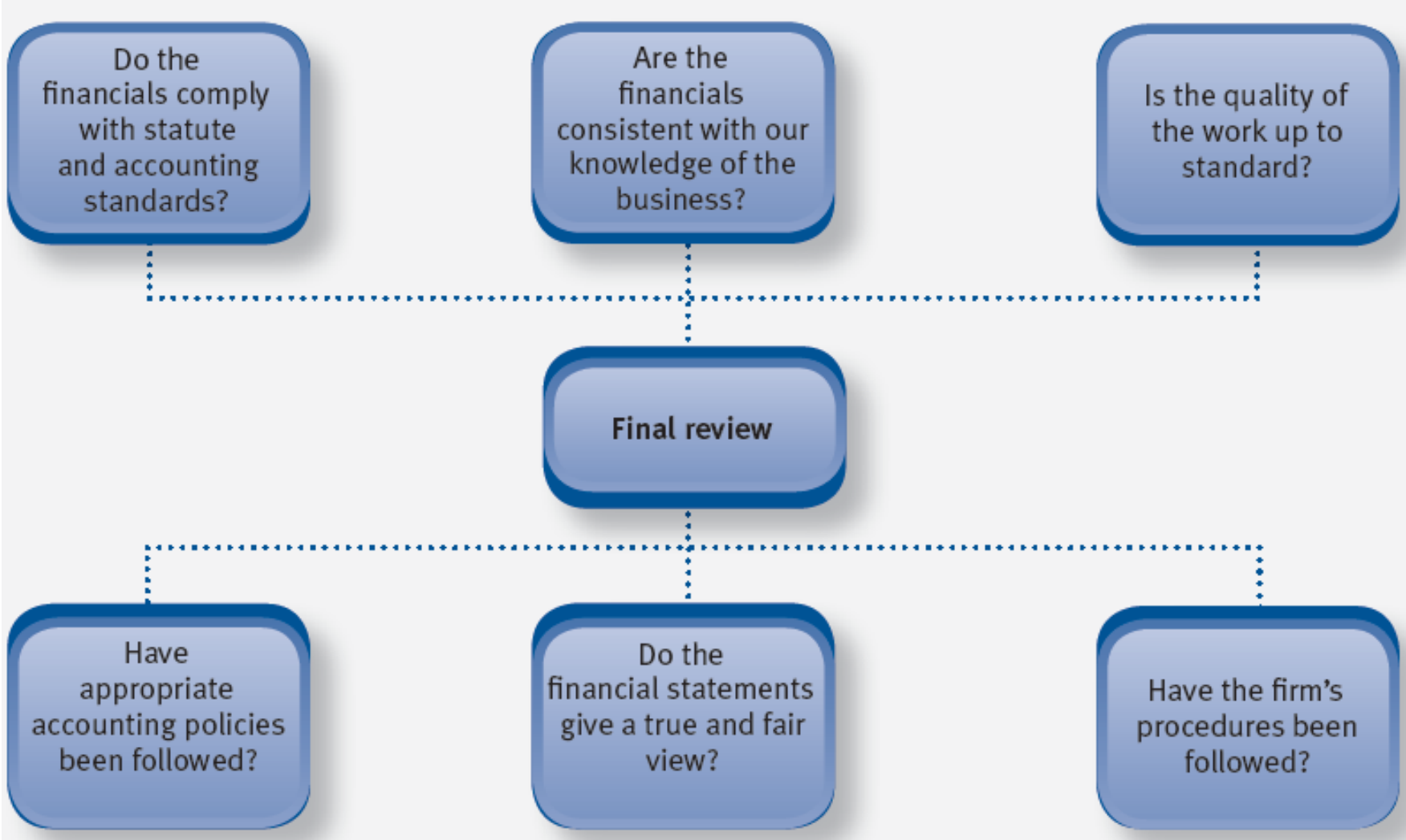
It is used for:
Reasonableness checks.
Confirming exception reporting (therefore test data should include incorrect items).

Audit software

Software specially designed for audit purposes.

It is used for:
Selecting samples.
Checking computations and calculations by reperformance.
Comparing two or more different files.
Performing detailed analytical review.

Completion and review



Subsequent Events (ISA 560)

Up to the date of
the audit report



Auditors should perform procedures **designed to obtain sufficient appropriate audit evidence that all events up** to the date of the auditor's report that may require adjustment or disclosure have been identified.

After the date of the audit
report but before the
FS are issued



Auditor **has no responsibility** to perform procedures or make enquiry regarding FS after audit report date. If auditor becomes aware of amendment should discuss with management and consider implications for audit report.

Going Concern (ISA 570)

Fundamental principle: When **planning** and performing auditing procedures and in **evaluating** the results, the auditor should consider the appropriateness of **management's** use of the going concern assumption in the preparation of the FS.

Management is required to make an assessment of the enterprise's ability to continue for the foreseeable future considering the following factors:

Financial eg

- BS position
- Budgeted negative cash flows
- Maturing debts without realistic prospect of repayment

Operating eg

- Loss of key management without replacement
- Loss of major market

Other eg

- Non-compliance with capital or other statutory requirements

Auditors must review management's going concern assessment, gather sufficient appropriate evidence to confirm/dispel whether a material uncertainty exists and seek management representations regarding future plans. In carrying out evaluation, procedures should include:

- * Analysing and discussing latest and budgeted financial information
- * Reading board minutes for reference to financial difficulties and future plans
- * Review loan agreement terms and determining whether there has been or will likely be any breach

Reporting

Types of Modification

	<u>Material but NOT Pervasive</u>	<u>Material AND Pervasive</u>
Material Misstatement	Qualified Opinion	Adverse Opinion
Inability to Obtain Sufficient Appropriate Evidence	Qualified Opinion	Disclaimer of Opinion