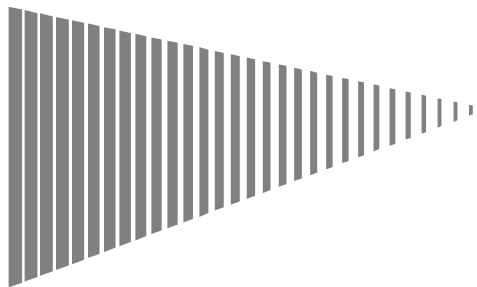


# ICAJ - Improving Compliance with International Standards on Auditing

## Workshop 3

November 22, 2014



Building a better  
working world

Presenters today:

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# Agenda

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- ▶ Refresher
- ▶ ISA 500 – Audit Evidence
- ▶ Audit assertions and substantive procedures
  - ▶ Inventory
  - ▶ Revenue
- ▶ Completion of audit

# Objectives

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- ▶ Reinforce lessons learnt in sessions 1 and 2
- ▶ Identify the audit assertions associated to the relevant accounts
- ▶ Understand the extent of documentation or audit evidence required to support the procedures completed and conclusion reached
- ▶ Understand impact of audit procedures on audit report and conclusion documentation

# Exercise 1 - Refresher

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▶ **Objective:**

- ▶ Describe the procedures and documents that should be on your file prior to beginning the audit

▶ **Time:**

- ▶ Ten minutes

▶ **Instructions:**

- ▶ Refer to PM 1.1 for details.
- ▶ Read background and describe procedures and documents to be completed during the planning phase of the audit

# ISA 500 – Audit Evidence



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# Audit evidence

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- ▶ **ISA 500 – 31 December 2009**
- ▶ Addresses auditor's responsibility to design and perform audit procedures to obtain **sufficient appropriate audit evidence** to be able to draw reasonable conclusions on which to base the auditor's opinion
- ▶ Is cumulative in nature and is primarily obtained from audit procedures performed during the course of the audit. It may, however, also include information obtained from other sources such as previous audits or a firm's quality control procedures for client acceptance and continuance.

# Audit evidence

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- ▶ In addition to other sources inside and outside the entity, the entity's accounting records are an important source of audit evidence. Also, information that may be used as audit evidence may have been prepared using the work of a management's expert. Audit evidence comprises both information that supports and corroborates management's assertions, and any information that contradicts such assertions.
- ▶ Audit procedures to obtain audit evidence can include **inspection, observation, recalculation and reperformance and analytical procedures**, often in some combination, in addition to **enquiry/confirmation**.

# Audit evidence

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- ▶ Sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated) to an acceptably low level
- ▶ Performance of risk assessment procedures, tests of controls and substantive procedures provide audit evidence



# Audit evidence

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- ▶ Reminder – audit evidence must be relevant eg.
  - ▶ Inspection of documents related to the collection of receivables after the period end may provide audit evidence regarding existence and valuation, but not necessarily cutoff
  - ▶ Obtaining audit evidence regarding a particular assertion, such as, the existence of inventory, is not a substitute for obtaining audit evidence regarding another assertion, for example, the valuation of that inventory
  - ▶ An audit procedure is to test for overstatement in the existence or valuation of accounts payable, testing the recorded accounts payable may be a relevant audit procedure. On the other hand, when testing for understatement in the existence or valuation of accounts payable, testing the recorded accounts payable would not be relevant, but testing such information as subsequent disbursements, unpaid invoices, suppliers' statements would be relevant

# Exercise 2

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▶ **Objective:**

- ▶ Identify the assertions relevant to the inventory account and what audit procedures would be executed

▶ **Time:**

- ▶ 15 minutes

▶ **Instructions:**

- ▶ Based on background in PM 1.1, describe risks that could arise in the inventory process related to the assertions relevant to the inventory account

# Exercise 2

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## ▶ Instructions:

- ▶ Write substantive procedures that you believe can be used to address these risks. You have in your materials:
  - ▶ PM 2.1 – Trial balance
  - ▶ PM 2.2 - Inventory lead schedule,
  - ▶ PM 2.3 – Inventory compilation,
  - ▶ PM 2.4 – Inventory sample,
  - ▶ PM 2.5 - Extract Inventory movement report

Use these in describing the procedures you will perform to address the assertions

- ▶ What documentation would be expected?

## DOCUMENT RESPONSES ON PM 2.0

# Learning objectives

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- ▶ Recognize and describe the risks associated with auditing inventory
- ▶ Identify the substantive procedures performed on inventory balances
- ▶ Describe the purpose and procedures for observing physical counts, inventory compilation, cutoff testing and valuation of inventory

# Inventory: production companies

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Raw materials



Work-in-progress



Finished goods

# Mathematical components of inventory balance

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Inventory balance = Quantities x Unit costs - Allowances

# Unit costs

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Unit costs generally consist of:

- ▶ Material (included in all types of inventory)
- ▶ Labor (included in WIP and finished goods)
- ▶ Overhead (included in WIP and finished goods)

# Measurement of inventory

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- ▶ Inventory costs should include:
  - ▶ Costs of purchase
  - ▶ Costs of conversion
  - ▶ Other costs incurred in bringing the inventories to their present location and condition
- ▶ Costs that should be excluded from the cost of inventories:
  - ▶ Abnormal waste
  - ▶ Storage costs
  - ▶ Administrative overhead unrelated to production
  - ▶ Selling costs
  - ▶ Foreign exchange differences arising directly from the recent acquisition of inventories in a foreign currency



# Cost formulas

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- ▶ Specific cost
- ▶ Weighted average cost
- ▶ FIFO

# Net realizable value (NRV)

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- ▶ Inventory should be measured at the lower of cost or NRV.

# Auditing inventory: assertions

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- ▶ Our audit procedures are designed to provide support for these financial statement assertions:
  - ▶ Existence
  - ▶ Completeness
  - ▶ Valuation
  - ▶ Rights and obligations
  - ▶ Presentation and disclosure

# Substantive procedures for inventories

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## Types of audit procedures:

- ▶ Observing inventory counts
  - ▶ Compilation
  - ▶ Cutoff
  - ▶ Valuation
- ▶ Appropriate planning and evaluation of the results of these procedures are essential.

# Observing physical inventory counts: objectives

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- ▶ Inventory that has been recorded by the entity physically exists.
- ▶ The entity has recorded all of the inventories it owns and only that which is its property.
- ▶ Inventory is in a useable or saleable condition, that is not damaged or obsolete.

# Exercise 3 - Guide to inventory physical observations

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▶ **Objective:**

- ▶ What procedures should be performed at the inventory physical observation and what are the relevant considerations?

▶ **Time:**

- ▶ Five minutes to discuss at table groups
- ▶ Document your responses on PM 3.0

▶ **Debrief**

- ▶ PM 3.1 , PM 3.2

# Compilation: objectives in testing

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- ▶ Inventory count records are summarized properly
- ▶ Compilation agrees with inventory count records
- ▶ General ledger agrees with the compilation of physical inventory results

# Compilation: audit procedures

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- ▶ Agree the compilation to the general ledger or review the reconciliation, if it is prepared.
- ▶ Test the clerical accuracy of the compilation.
- ▶ Trace test counts taken at the physical observation to the compilation.
- ▶ Verify the tag control schedule (or equivalent).



# Compilation: audit procedures (cont.)

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- ▶ Review inventory compilation for unusual items:
  - ▶ Items with zero or negative quantities, unit prices or extended values
  - ▶ Quantities that seem extremely large compared to others
  - ▶ Large or small extended values in light of quantities and unit costs
  - ▶ Unusual unit costs
  - ▶ Descriptions that appear inconsistent with the entity's business
  - ▶ Page totals or extended values that make no sense
- ▶ Follow up on any other items noted during the observation.

# Cutoff: objectives in testing and main characteristics

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- ▶ The purpose of cutoff testing is to determine whether transactions are recorded in the proper period.
- ▶ Cutoff:
  - ▶ Affects assertions related to various accounts
  - ▶ Requires cross-referencing to various accounting records
  - ▶ Can be tested in various ways

# Cutoff: audit procedures when testing individual transactions

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For shipping cutoff, test that:

- ▶ Items shipped *before* physical inventory were excluded from count and included in sales and trade receivables
- ▶ Items shipped *after* physical inventory were included in count and excluded from sales and trade receivables

# Cutoff: audit procedures when testing individual transactions (cont.)

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For receiving cutoff, test that:

- ▶ Items received *before* physical inventory should be included in inventory count, inventory balance and trade payables
- ▶ Items received *after* physical inventory should be excluded from inventory count, inventory balance and trade payables

# Shipping cutoff

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- ▶ To test proper cutoff in recording shipments, we generally agree information among the following records:
  - ▶ Invoice
  - ▶ Shipping documents
  - ▶ Inventory records
  - ▶ Sales journal
  - ▶ General ledger/accounts receivable subledger
- ▶ Records available for our cutoff testing depend on the entity.

# Receiving cutoff

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- ▶ To test proper cutoff when recording inventory receipts, we generally agree information among the following records:
  - ▶ Vendor invoice
  - ▶ Receiving document
  - ▶ Inventory records
  - ▶ General ledger/accounts payable subledger
- ▶ Records available for our cutoff testing depend on the entity.

# Valuation: objectives of testing

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- ▶ Costs assigned to inventory are in accordance with the stated valuation/costing method and consistent with the prior period.
- ▶ Materials, labor and overhead balances included in ending inventory are reasonable.
- ▶ Necessary valuation allowances are recorded properly.

# Valuation: audit procedures

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- ▶ Test the unit costs of RM and materials in WIP and FG by reference to vendor invoices (such as Price Test Procedures).
- ▶ Vouch the costs and agree the quantities of materials in WIP and FG to supporting documentation.
- ▶ Test the labor and overhead components in WIP and FG.



# Valuation: audit procedures (cont.)

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- ▶ Determine that the costing method used is consistent with the entity's policy and with the method used in the prior period.
- ▶ Compare unit prices for inventory items with those of prior periods and investigate significant changes and/or unusual trends in pricing.
- ▶ Perform analytical procedures to test the reasonableness of inventory value, in total or per component and of the entity's gross and operational margins.

# Price tests

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- ▶ Verify the unit costs of raw materials and goods purchased for resale:
  - ▶ Select statistical samples, if considered necessary
  - ▶ Compare unit cost with external prices
  - ▶ Evaluate and document results

# Valuation allowances

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- ▶ Some common allowances and adjustments are:
  - ▶ Excess or obsolescence
  - ▶ Lower of cost or NRV
  - ▶ Standard to actual
  - ▶ Other adjustments
- ▶ Calculation might be a complicated process and often involves assumptions and subjectivity.

# Analytical procedures and other substantive procedures

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- ▶ Depending on our risk assessment, we might perform additional substantive procedures for inventory accounts.
- ▶ Analytical procedures:
  - ▶ Compare inventory turnover and age with prior periods and budget.
  - ▶ Compare gross margin by product group/line.
  - ▶ Compare quantities and/or costs by location/type with prior periods.
- ▶ Other substantive procedures:
  - ▶ Review minutes, contracts and other documents for evidence of restrictions and determine that the necessary disclosures are made.

# Fraud considerations

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- ▶ Empty containers
- ▶ Bill-and-hold inventory
- ▶ Incorrectly valued WIP
- ▶ Improperly increasing physical counts
- ▶ Recording fictitious in-transit inventories
- ▶ Inappropriate capitalization of inventory components

# Summary

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Now you should be able to:

- ▶ Recognize and describe the risks associated with auditing inventory
- ▶ Identify the substantive procedures to be performed on inventory balances
- ▶ Describe the purpose and procedures for observing physical counts, inventory compilation, cutoff testing and valuation of inventory

# Exercise 4

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▶ **Objective:**

- ▶ Identify the assertions relevant to the revenue account and what audit procedures would you execute

▶ **Time:**

- ▶ 15 minutes

▶ **Instructions:**

- ▶ Based on background in PM 1.1, describe risks that could arise in the revenue process related to the assertions relevant to the revenue account
- ▶ Document the substantive procedures that you believe can be used to address these risks using PM 4.0

# Revenue accounts

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- ▶ Revenue and Income
  - ▶ Sales of goods
  - ▶ Rendering of services
  - ▶ Rental income
  - ▶ Finance income/revenue
  - ▶ Other income e.g. Gains on sales of fixed assets



# Assertions

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- ▶ Assertions relevant to revenue accounts:
  - ▶ Occurrence
  - ▶ Completeness
  - ▶ Measurement
  - ▶ Presentation and disclosure

# Substantive procedures

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- ▶ Substantive procedures
  - ▶ Completeness – subledger to GL reconciliation
  - ▶ Tests of details
    - ▶ Confirmation
    - ▶ Inspection of sample of transactions to source documents – could be statistically determined
  - ▶ Substantive analytical procedures – trends/relationships

# Link between revenues and trade receivables

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- ▶ Testing of balance sheet account
  - ▶ Trade receivables also provides assurance over revenue assertions
  - ▶ For example, cutoff testing

# Example: sales cutoff

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- ▶ In testing trade receivables, we:
  - ▶ Checked that the receivable was recorded in the correct period around period-end
  - ▶ Checked that the sale was recorded in the same period and was in line with the accounting policy
  - ▶ Considered the occurrence of sales around period-end

# Substantive analytical procedures: definition

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- ▶ Comparison of various pieces of information, sometimes all financial (such as account balances) and sometimes a mixture of financial and non-financial (such as account balance movements, consumer trends and demographic changes)
- ▶ Involves evaluation of financial information through the analysis of plausible relationships among financial and/or non-financial data

# Data analysis

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Analyze each item in the population to identify higher-risk items or unusual patterns.

- ▶ For example:
  - ▶ Negative balances in Trade Receivables sub-ledger
  - ▶ Positive balances in Trade Payables sub-ledger
  - ▶ Reversing entries in expenses/revenues

# Substantive analytical procedures: predictive

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Predictive: calculation of expected amounts based on identified variables for comparison

- ▶ For example:
  - ▶ Overall depreciation test
  - ▶ Reasonableness test of interest expense/investment income
  - ▶ Expenses on contracted services
  - ▶ Predicting commission expense
  - ▶ Predicting payroll expense

# Substantive analytical procedures: ratio/trend analysis

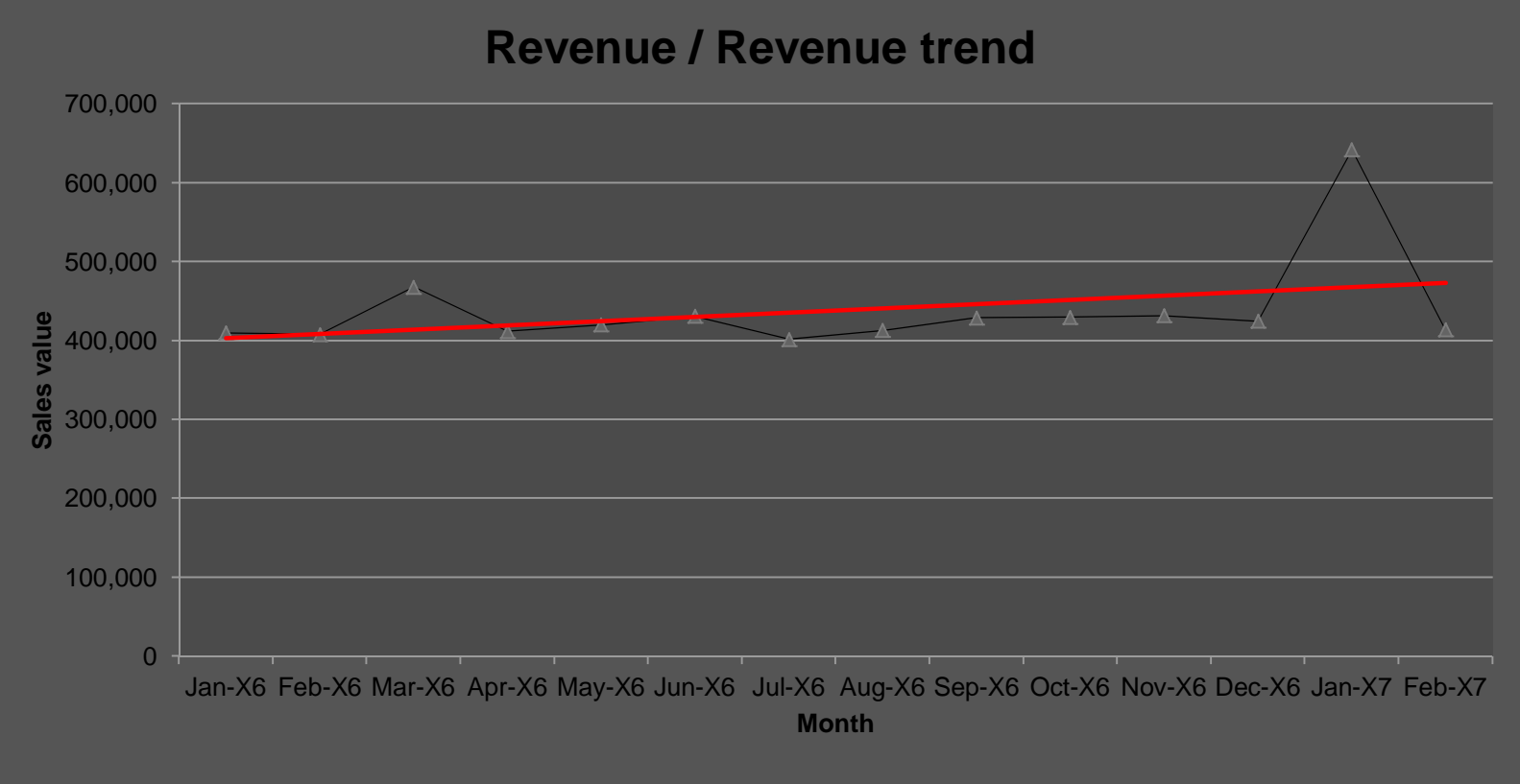
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Ratio/trend analysis: Analysis of financial or non-financial amounts over a period, or at a point in time, to identify significant variations from our expectations.

- ▶ For example:
  - ▶ Year-over-year comparison of Balance Sheet and Income Statement line items, and investigation of related line items within the period
  - ▶ Seasonality trend analysis
  - ▶ Comparisons to budget
  - ▶ Margin/trend analysis
  - ▶ Movements in key ratios



# Example of trend analysis



# Benefits of performing analytical procedures

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- ▶ Enhances our understanding of the business and the risks
- ▶ Provides an effective and efficient audit strategy
- ▶ Increases flexibility in the timing of our work
- ▶ Helps us consider the reasonableness of large amounts of data

# Basic documentation requirements

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- ▶ For all analytical procedures performed, we need to document:
  - ▶ Our comparison of our expectations with the results
  - ▶ Our evaluation of any differences in excess of our desired precision
  - ▶ Our follow-up on any significant differences
- ▶ Documentation increases, the more complex, risky or significant the account.
- ▶ **If it is not documented, it is not done.**

# Summary

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Now you should be able to:

- ▶ Describe the relationship between substantive procedures and risk for the revenue account
- ▶ Describe substantive procedures performed on revenue account
- ▶ Recall the importance of substantive analytical procedures
- ▶ Identify analytical techniques and tools

# Audit conclusion

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- ▶ General audit procedures
  - ▶ Legal letter
  - ▶ Consideration of legal and regulatory matters, going concern, related parties
  - ▶ Final overall analytical review
  - ▶ Audit differences – unadjusted differences, adjusted differences
  - ▶ Representation letter
  
- ▶ Audit summary document which includes our conclusions including any consultations with others

# Audit conclusion

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- ▶ Impact of audit procedures on audit report –
    - ▶ ISA 700 – Forming an opinion and reporting on financial statements
    - ▶ ISA 705 – Modifications to the Opinion in the Independent Auditors' Report
    - ▶ ISA 706 – Emphasis of Matter Paragraph and Other Matter Paragraphs in Independent Auditors' Report
  - ▶ Other deliverables
    - ▶ Communicating Deficiencies in Internal Control with those charged with governance (ISA 265)
    - ▶ Communication to those charged with governance (ISA 260)
  - ▶ Cold review of file for quality and subsequent archival not more than 60 days after audit report
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# Questions?



# Thank you!

