Key Topics in Audit and Assurance

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- ***Corporate governance***
- ***Test of control & Substantive tests***

Corporate governance

Key Topics in Audit and Assurance- *Corporate governance*

- ***Learning objectives from syllabus***

✓ Discuss the objectives, relevance and importance of corporate governance

✓ Discuss the provisions of international codes of corporate governance (such as OECD) that are most relevant to auditors

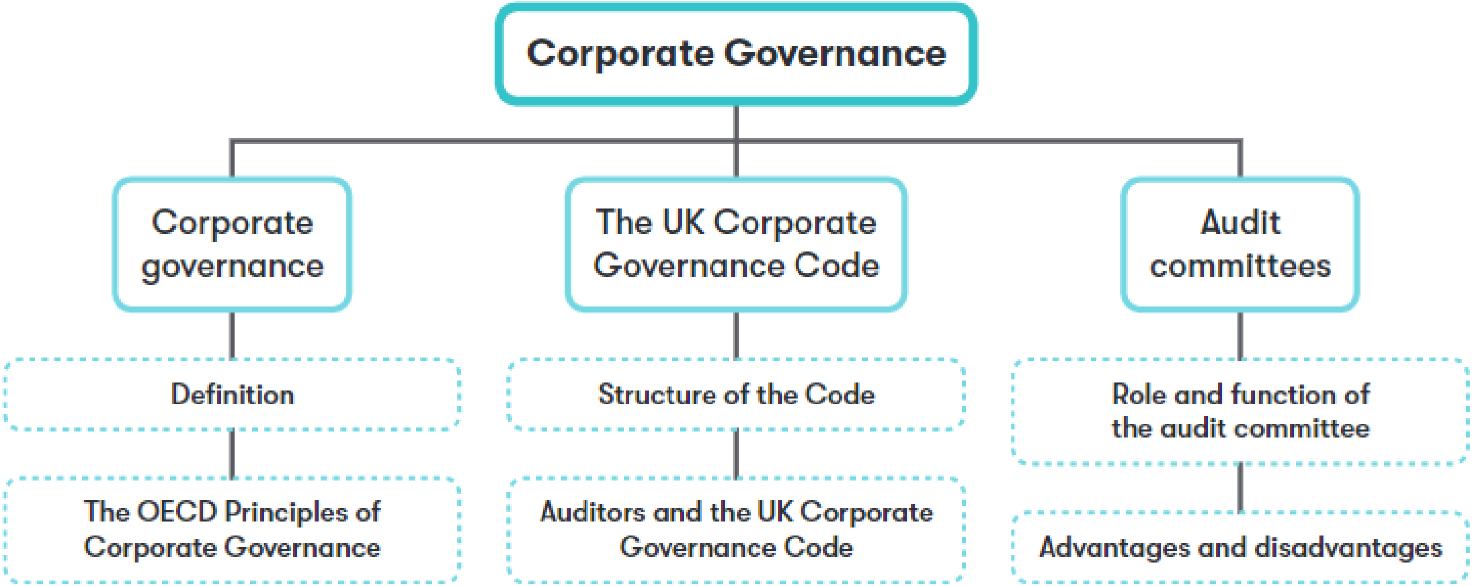
✓ Describe good corporate governance requirements relating to directors' responsibilities (e.g. for risk management and internal control) and the reporting responsibilities of auditors

✓ Evaluate corporate governance deficiencies and provide recommendations to allow compliance with international codes of corporate governance

✓ Analyse the structure and roles of audit committees and discuss their benefits and limitations

✓ Explain the importance of internal control and risk management

Key Topics in Audit and Assurance- *Corporate governance*



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Key Topics in Audit and Assurance- *Corporate governance*

Corporate governance is the internal system or means by which companies are directed and controlled.

Why do companies need corporate governance?
Corporate governance is important because it ensures that all stakeholders with a relevant interest in a company's business are fully taken into account.

Key Topics in Audit and Assurance- *Corporate governance*

The ***OECD Principles of Corporate Governance*** serve as a reference point for countries and companies to develop their own codes of corporate governance

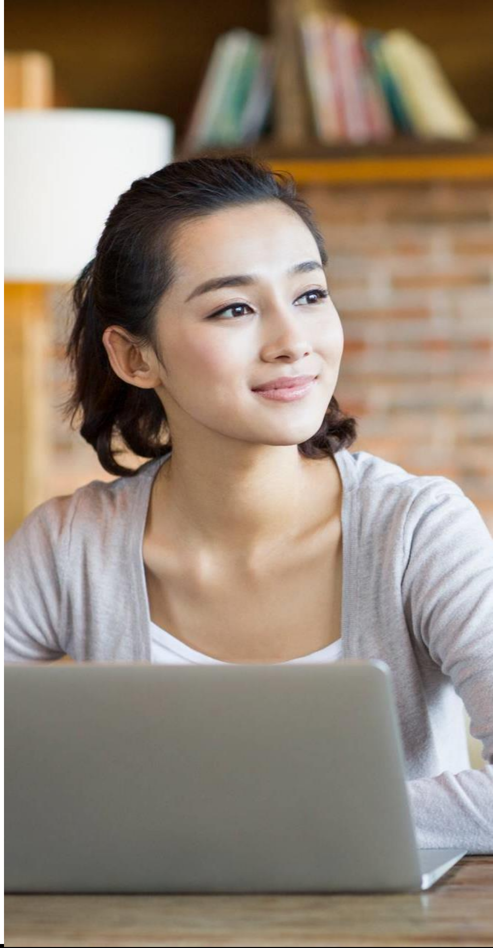
(a) Ensuring the basis of an effective corporate governance framework.
(b) The rights of shareholders and key ownership functions.
(c) The equitable treatment of shareholders.
(d) The role of stakeholders in corporate governance.
(e) Disclosure and transparency.
(f) The responsibility of the board.

Key Topics in Audit and Assurance- *Corporate governance*

- We will use ***UK Corporate Governance Code*** as an example. It sets out standards of good practice in the following five areas:

  - **Board leadership and company purpose**
  - **Division of responsibilities**
  - **Composition ,succession and eval**
  - **Audit, risk and internal control**
  - **Remuneration**

Detail information is supplemented in the essential readings



Key Topics in Audit and Assurance- *Corporate governance*

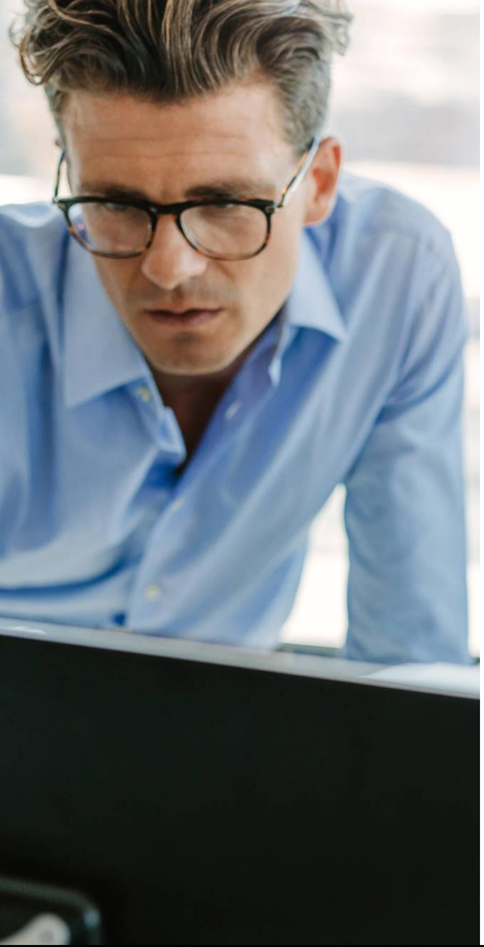
In the UK, auditors are required to **review** whether listed companies have complied with specific provisions in the Code and **report** this to shareholders in the auditor's report.

	Provision	Yes ✔	No ✔
(a)	Is the directors' responsibility for preparing the annual report and accounts explained in the report?		
(b)	Have the directors reviewed and reported on the effectiveness of the risk management and internal control systems		
(c)	Has the board established an audit committee of at least three non-executive directors (or at least two non-executive directors for smaller companies)?		
(d)	Does the audit committee have written terms of reference?		
(e)	Are the terms of reference for the audit committee available/ described in the annual report?		
(f)	Does the audit committee arrange methods for staff to report impropriety in financial reporting?		
(g)	Does the audit committee monitor and review the effectiveness of the internal audit activities?		
(h)	Does the audit committee have primary responsibility for the appointment of the external auditors?		
(i)	Are there procedures in place to ensure that auditor independence is maintained where the external auditor provides non-audit services?		

Key Topics in Audit and Assurance- *Corporate governance*

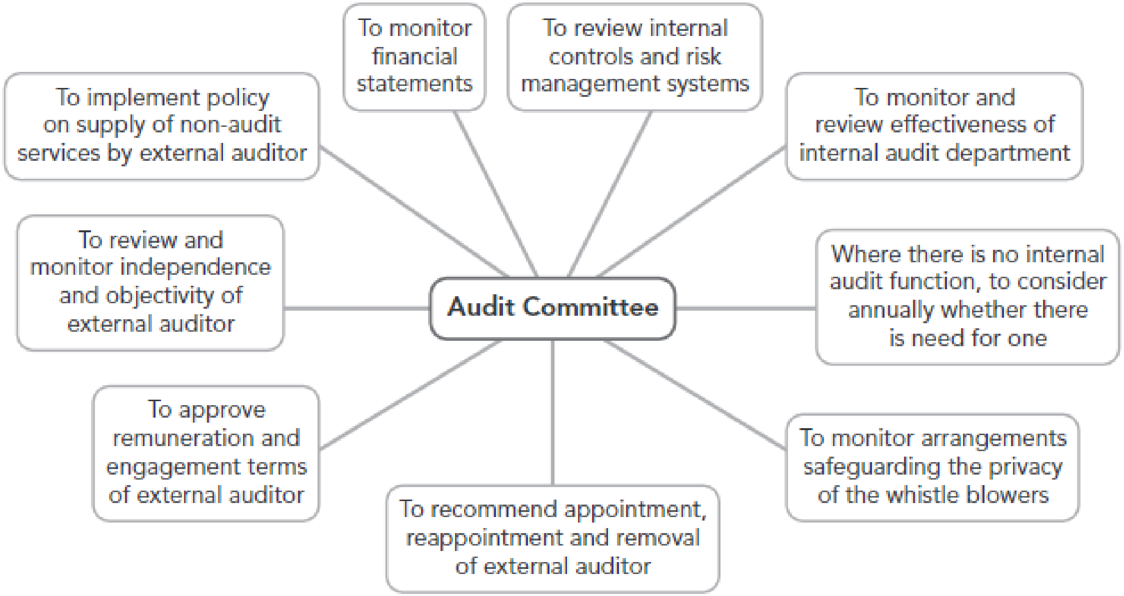
An audit committee is a sub-committee of the board of directors, usually containing a number of non-executive directors.

For example, the UK Corporate Governance Code states that an audit committee should consist of **at least three independent non-executive** directors.



Key Topics in Audit and Assurance- *Corporate governance*

Role and function of the audit committee



Test of control & Substantive tests

Key Topics in Audit and Assurance- *TOC & ST*

There are two types of audit procedure:

Tests of controls: audit procedures designed to **evaluate the operating effectiveness of controls** in preventing, or detecting and correcting, material misstatements at the assertion level *(ISA 330: para. 4(b))*.

Substantive procedures: audit procedures designed to detect material misstatements at the assertion level. Substantive procedures comprise:

(a) Tests of details (of classes of transactions, account balances, and disclosures); and

(b) Substantive analytical procedures

(ISA 330: para. 4(a))

Key Topics in Audit and Assurance- *TOC & ST*

Evidence must be relevant to the particular financial statement assertion the auditor is trying to test

Assertions about classes of transactions and events and related disclosures	Occurrence: Transactions and events that have been recorded or disclosed have occurred and pertain to the entity.
	Completeness: All transactions and events that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
	Cut-off: Transactions and events have been recorded in the correct accounting period.
	Classification: Transactions and events have been recorded in the proper accounts.

Key Topics in Audit and Assurance- *TOC & ST*

Evidence must be relevant to the particular financial statement assertion the auditor is trying to test

Assertions about classes of transactions and events and related disclosures (continued)	**Accuracy:** **Amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.**
	Presentation: **Transactions and events are appropriately aggregated or disaggregated and are clearly described, an related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.**

Key Topics in Audit and Assurance- *TOC & ST*

Evidence must be relevant to the particular financial statement assertion the auditor is trying to test

Assertions about account balances and related disclosures at the period end	Existence: Assets, liabilities, and equity interests exist.
	Completeness: All assets, liabilities and equity interests that should have been recorded have been recorded and all related disclosures that should have been included in the financial statements have been included.
	Rights and obligations: The entity holds or controls the rights to assets, and liabilities are the obligations of the entity
	Classification: Assets, liabilities, and equity interests have been recorded in the proper account.

Key Topics in Audit and Assurance- *TOC & ST*

Evidence must be relevant to the particular financial statement assertion the auditor is trying to test

Assertions about account balance and related disclosures at the period end (continued)	Valuation, accuracy 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, and related disclosures have been appropriately measured and described.
	Presentation: Assets, liabilities and equity interests are appropriately aggregated or disaggregated and are clearly described, an related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

Key Topics in Audit and Assurance- *TOC & ST*

There are **six** systems detailed in the syllabus:

- **Sales system**

- **Purchases system**

- **Payroll system**

- **Inventory system**

- **Cash system**

- **Non-current assets**

Key Topics in Audit and Assurance- *TOC & ST*

Audit procedures can be used as TOC and ST

Procedures	
Inspection of tangible assets	Inspection of tangible assets that are recorded in the accounting records confirms existence, but does not necessarily confirm rights and obligations or valuation. Confirmation that assets seen are recorded in accounting records gives evidence of completeness.
Inspection of documentation or records	This is the examination of documents and records, both internal and external, in paper, or other forms. This procedure provides evidence of varying reliability, depending on the nature, source and effectiveness of controls over production. Inspection can provide evidence of existence, but not necessarily about ownership or value.

Key Topics in Audit and Assurance- *TOC & ST*

Audit procedures can be used as TOC and ST (continue)

Procedures	
Observation	This involves watching a procedure or process being performed. It is of limited use, as it only confirms the procedure took place when the auditor was watching, and because the act of being observed could affect how the procedure or process was performed.
Enquiry	This involves seeking information from client staff or external sources. Strength of evidence depends on the knowledge and integrity of source of information. Enquiry alone does not provide sufficient audit evidence to detect a material misstatement at assertion level, nor is it sufficient to test the operating effectiveness of controls.
Confirmation	This is the process of obtaining a representation of information or of an existing condition directly from a third party, eg confirmation bank balances from the bank.

Key Topics in Audit and Assurance- *TOC & ST*

Audit procedures can be used as TOC and ST (continue)

Procedures	
Recalculation	This consists of checking the mathematical accuracy of documents or records and can be performed through the use of IT
Reperformance	This is the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.
Analytical procedures	Evaluating and comparing financial and/or non-financial data for plausible relationships; also include the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts.

Key Topics in Audit and Assurance- *TOC & ST*

- **TOC**

Main control activities designed to prevent or to detect and correct errors. Examples include:

- ***Authorisation***
- ***Performance reviews***
- ***Information processing***
- ***Physical controls***
- ***Segregation of duties***

Key Topics in Audit and Assurance- *TOC & ST*

Example	Explanation	Category
Approval and control of documents	Transactions should be approved by an appropriate person. For example, overtime should be approved by departmental managers.	Authorisation
Checking the arithmetical accuracy of records	For example, checking to see if individual invoices have been added up correctly	Information processing
Maintaining and reviewing control accounts and trial balances	Control accounts bring together transactions in individual ledgers. Trial balances bring together transactions for the organization as a whole. Preparing these can highlight unusual transactions or accounts.	Performance review
Reconciliations	Reconciliations involve comparison of a specific balance in the accounting records with what another source says the balance should be; for example, a bank reconciliation. Differences between the two figures should only be reconciling items (eg resulting from timing differences).	Information processing

Key Topics in Audit and Assurance- *TOC & ST*

Example	Explanation	Category
Comparing the results of cash, security and inventory counts with accounting records	For example, in a physical count of petty cash, the balance shown in the cash book should be the same as the amount held.	Performance review
Comparing internal data with external sources of information	For example, comparing records of goods dispatched to customers with customers' acknowledgement of goods that have been received.	Performance review
Limiting physical access to assets and records	Only authorized personnel should have access to certain assets, eg ensuring that the inventory stores are locked unless store personnel are there.	Physical control
Segregation of duties	Assigning different people the responsibility of authorizing transactions, recording transactions and maintaining custody of assets	Segregation of duties

Key Topics in Audit and Assurance- *TOC & ST*

TOC

Test of controls include ***enquiry*** in combination with other audit procedures, for example:

- ***Inspection of documents supporting controls or events to gain audit evidence that controls have operated effectively, for example verifying that a transaction has been authorised***
- ***Observation of the entity's control procedures, for example observing an inventory count to ensure it is being conducted in accordance with the inventory count instructions***
- ***Re-performance of the application of a control to ensure it was performed correctly, for example reperforming a bank reconciliation to verify that it has been done properly.***
- ***Examination of evidence of management review, for example minutes of board meetings.***

Key Topics in Audit and Assurance- *TOC & ST*

Substantive Tests- Transaction

Transaction Assertions	Relevant test
Occurrence	Select a sample of entries from the sales account in the general ledger and trace to the appropriate sales invoice and supporting goods dispatched notes and customer orders.
Completeness	Select a sample of customer orders and check to dispatch notes and sales invoices and the posting to the sales account in the general ledger.
Accuracy	Reperformance of calculations on invoices, payroll, etc, and the review of control account reconciliations are designed to provide assurance about accuracy.

Key Topics in Audit and Assurance- *TOC & ST*

■ Substantive Tests- Transaction

Transaction Assertions	Relevant test
Cut–off	Recording last goods received notes and dispatch notes at the inventory count and tracing to purchase and sales invoices to ensure that goods received before the year end are recorded in purchases at the year end and that goods dispatched are recorded in sales.
Classification	Check purchase invoices postings to general ledger accounts.
Presentation	Confirm that the total employee benefits expense is analysed in the notes to the financial statements under separate headings– ie wages and salaries, pension costs, social security contributions and taxes, etc.

Key Topics in Audit and Assurance- *TOC & ST*

Substantive Tests- Account Balance

Account Balance Assertions	Relevant test
Existence	Physical verification of non–current assets, circularisation of receivables, payables and the bank letter.
Rights and obligations	In the case of property, deeds of title can be reviewed. Current assets are often agreed to purchase invoices although these are primarily used to confirm cost. Long term liabilities such as loans can be agreed to the relevant loan agreement.
Completeness	A review of the repairs and expenditure account can sometimes identify items that should have been capitalised and have been omitted from non–current assets. Reconciliation of payables ledger balances to suppliers' statements is primarily designed to confirm completeness although it also gives assurance about existence.

Key Topics in Audit and Assurance- *TOC & ST*

Substantive Tests- Account Balance

Account Balance Assertions	Relevant test
Accuracy, valuation and allocation	Vouching the cost of assets to purchase invoices and checking depreciation rates and calculations.
Classification	The test for transactions of checking purchase invoice postings to the appropriate accounts in the general ledger will be relevant again. Also that research expenditure is only classified as development expenditure if it meets the criteria specified in IAS® 38 Intangible Assets.
Presentation	auditors often use disclosure checklists to ensure that financial statement presentation complies with accounting standards and relevant legislation. These cover all items (transactions, assets, liabilities and equity interests) and would include for example confirming that disclosures relating to non–current assets include cost, additions, disposals, depreciation, etc.

Key Topics in Audit and Assurance- *TOC & ST*

Gaining audit evidence through tests of controls is very different from gaining audit evidence through substantive procedures.

Tests of controls	Substantive procedures
These focus on the auditor confirming their understanding of the control being in place and testing that it has operated effectively throughout the period	These focus on the auditor performing detailed procedures on the numbers in the financial statements. Source documentation → financial statements
This includes: • Observing the control taking place • Reperforming the control • Inspecting evidence that the control has taken place	This includes: • AEIOU
Enquire from management the process used to reconcile supplier statements. For a sample of supplier statement reconciliations, **inspect** the reconciliation to see evidence that the reconciliation has been performed and any differences investigated and resolved. Verify that any necessary changes to the accounting system have been authorised and processed. **Reperform** the reconciliation to ensure it has been completed accurately. **Inspect** the reconciliation to verify it has been reviewed by an appropriate level of management. **Observe** a supplier statement reconciliation being performed.	Perform **analytical procedures** on the amounts owed to major suppliers at the year end compared to the prior period. **Enquire** from management the reasons for any significant differences. Circularise a sample of year-end payables and request them to **confirm** the balance owed at the year end. **Inspect** the cash book payments in the post year end period for any significant payments to suppliers to ensure the year-end liability is accurately recorded. **Calculate** the payables payment ratio and compare to the prior period. Discuss any significant differences with management.
Does the control operate efficiently? This will depend on the level of errors in the sample, ie the **number of times** the control did not operate.	Is the balance complete? This will depend on the level of errors in the sample, ie the **monetary value** of any errors.


Thank you