E. AUDIT EVIDENCE

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The Use of Assertions by Auditor

What are substantive procedures?

Substantive procedures are tests to obtain audit evidence to detect material misstatements in the financial statements. Substantive procedures generally include analytical procedures and test of detail of transactions, account balances and disclosures.

What are the assertions used by auditors?

Hint: PROVE

- Presentation and disclosures (or Classification and understandability)
- Records completeness, accuracy, cut-off (correct accounting period)
- Obligation (or rights and obligation)
- Valuation and allocation
- Existence

Audit Procedures

What are some of the typical audit tests?

- Confirming compliance with law and accounting standards
- Reviewing notes for understandability
- Reviewing of post year-end items
- Cut-off testing
- Analytical review
- Confirmations
- Reconciliations to control accounts
- Recalculation of correct amounts
- Third party confirmation
- Reviewing invoices for proof that item belongs to the company
- Matching amounts to invoices
- Confirming accounting policy consistent and reasonable
- Reviewing post year-end payments and invoices
What model can be used for designing an audit plan?

- Agree opening balances with previous year’s working papers
- Review general ledger for unusual records
- Agree client schedule to/from accounting records to ensure completeness
- Carry out analytical review
- Test transactions in detail
- Test balances in detail
- Review presentation and disclosure in accounts

What are tests designed to discover errors?

Tests design to discover errors start in the accounting records and such tests should detect any overstatements or understatements (not caused by omission).

What are tests designed to discover omissions?

Test design to discover omissions must start outside the accounting records and then matched back to accounting records. Understatements through omission can never be revealed by starting with the account itself as there is logically no chance of selecting items that have been omitted from the account.

What do analytical procedures provide comparisons with?

- Comparable information from prior periods
- Anticipated results of the entity, from budgets or forecasts
- Expectations prepared by the auditors
- Industry information

What are some important accounting ratios for use in analytical procedures?

- Gross profit margin
- Receivables ratio
- Inventory revenue ratio
- Current ratio
- Acid test ratio
- Gearing ratio
- Return on capital employed

What are some other areas for consideration of the audit evidence?
• Examine changes in products, customers and level of return
• Assess the effect of price and mix changes on the cost of sales
• Consider the effect of inflation, industrial disputes, changes in production methods and changes in activity on the charge for wages
• Obtain explanations for all major variances
• Compare trends in production and sales and assess the effect on any provisions for obsolete inventory
• Ensure that changes in the percentage labour or overhead content of production costs are also reflected in the inventory valuation
• Review rent with annual rent per rental agreement
• Review rates with previous year and know rates increases
• Review interest payable on loans with outstanding balance and interest rate per loan agreement
• Review hire or leasing charges with annual rate per agreement
• Review vehicle running expenses to vehicle
• Review other items related to activity level with general price increase and change in relevant level of activity
• Review other items not related to activity level with general price increases
• Ensure expected variations arising from industry, local trends or known disturbances of the trading pattern have occurred

**What is an accounting estimate?**

An accounting estimate is an approximation of a monetary amount in the absence of a precise means of measurement.

**What are examples of accounting estimates?**

• Allowance for doubtful accounts
• Inventory obsolescence
• Warranty obligations
• Depreciation method
• Asset useful life
• Outcome of long term contracts
• Costs arising from litigation settlements and judgements
• Provisions against carrying amount of an investment where there is uncertainty regarding its recoverability

**What must auditors understand in order to provide a basis for the identification and assessment of risks of material misstatement for accounting estimates?**

• What the required applicable reporting framework says
• How management identifies those transactions, events and conditions that give rise to a need for accounting estimates
• How management makes the accounting estimates
• Understanding of the data on which management based their estimates

The Audit of Specific Items

Tangible Non-Current Assets:

What are the audit objectives for tangible non-current assets?

Hint: PROVE

• Presentation and disclosure:
  Disclosures relating to cost, additions and disposals, depreciation policies, useful life, assets held under finance lease are in accordance with accounting standards
• Records (completeness)
  All additions and disposals that occurred in the year have been recorded and that balances represent assets in use at year-end
• Obligation and rights:
  That the entity has rights to the assets purchased and those recorded at the year-end
• Valuation, accuracy, and classification:
  Non-current assets are correctly stated at cost less accumulated depreciation and additions and that disposals are correctly recorded
• Existence and Occurrence
  Additions represent physical assets acquired in the year and disposals represent physical assets sold or scrapped in the year, and that recorded assets represent assets in use at year-end

What is the non-current asset register?

The non-current asset register enables assets to be identified. It is an aspect of the internal control system. Comparison between the general ledger, the non-current asset register and the asset of itself provides evidence that the assets are completely recorded.

What aspects of non-current assets should be considered?

• That all acquisitions are authorised
• That all disposals are authorised
• That all proceeds from disposals are accounted for
• Security arrangements over non-current assets are sufficient
• Non-current assets are maintained properly
• Depreciation is reviewed every year
• All income is collected from income-yielding assets

What are the audit procedures for tangible non-current assets?
• Obtain and prepare a summary of tangible non-current assets showing how gross book value, accumulated depreciation and net book value reconcile with the opening position
• Compare non-current assets in the general ledger with the non-current assets register and obtain explanations for differences
• Agree a sample of the assets that physically exist are recorded in the non-current assets register
• In the event that the non-current asset register does not exist, obtain a schedule showing the original costs and present depreciated value of major non-current assets
  o Reconcile the schedule of non-current assets with the general ledger
• Confirm that the company physically inspects all items in the non-current asset register each year
• Inspect high value items and additions confirming that items inspected exist, are in use, are in good condition, and have correct serial numbers
• Review records of income-yielding assets
• Reconcile opening and closing vehicles by numbers as well as amounts
• Verify valuation to valuation certificate
• Consider the reasonableness of valuation, considering the experience of valuer, scope of work, methods, assumptions used, and whether the valuation bases are in line with accounting standards
• Re-perform calculation of revaluation surplus
• Confirm whether valuations of all assets have been updated regularly
• Inspect that the client has recognised revaluation losses and that revaluation gains are credited to equity
• Review depreciation rates
• Ensure depreciation has been charged on all assets with a limited useful life
• Ensure that the depreciation charges on re-valued items are based on the re-valued amount
• Ensure that depreciation policies and rates are disclosed in the accounts
• Review insurance policies and consider the adequacy of non-current assets insured values and check expiry dates
• Verify title to land and buildings by inspection of title deeds, land registry certificate, leases
• If deeds are being held inquire the purpose for which they are held
• If deeds are not being held obtain a certificate from solicitors or bankers stating that they are free from lien or mortgage
• Inspect registration documents for vehicles held confirming that they are in the client’s name
• Confirm all vehicles are used for the client’s business
• Examine documents of title for other assets
• Review evidence of charges in statutory books and by company search
• Review leases that the company has kept covenants
• Examine invoices received after year-end, orders and minutes for capital commitments
• Inspect a sample of non-current asset accounts for a sample of purchases to ensure they have been properly allocated
• For self-constructed assets verify material, labour and overhead costs to invoices, wage records etc...
• Ensure that expenses capitalised are those that
  o Enhance the economic benefits in excess of its previous standard
  o Replaces or restores a component
  o Relates to major inspection or overhaul that restores the economic benefit
  o Finance costs have been capitalised
• Verify disposals
• Recalculate profit or loss on disposal
• Check that disposals have been authorised by reviewing boards minutes
• Consider whether proceeds are reasonable
• If asset was used as security ensure release from security has been correctly made
• For assets that are fully depreciated inspect the register to ensure no further depreciation is charged

Intangible non-current assets:

What are the key assertions for intangible non-current assets?
The key assertions for intangible non-current assets are valuation and existence (are they genuine assets?).

What are the other non-current assets?

• Goodwill
• Research and development costs
• Other intangibles

What are the audit procedures for other non-current assets?

• Goodwill
  o Agree the consideration to sales agreement by inspection
  o Consider whether asset valuation is reasonable
  o Agree goodwill calculation by recalculation
  o Review the impairment review and discuss with management
• Research and development
  o Confirm that development cost meet IAS criteria by inspecting details of projects and discussion with technical managers
  o Confirm feasibility and viability by inspection of budgets
  o Recalculate amortisation calculation
  o Inspect invoices to verify expenditure incurred on R&D projects
• Other intangibles
  o Agree purchases to purchase documentation by inspection
  o Inspect specialist valuation of intangibles and ensure it is reasonable
Recalculate amortisation calculation

**Inventory:**

**What are the audit objectives for inventory?**

- Recorded purchases and sales represent inventories bought and sold
- Inventory on the statement of financial position represent physically exist
- All purchases and sales are recorded
- All inventory at year-end is included in the statement of financial position
- The entity has rights to inventory recorded in the period and at the year-end
- Costs are accurately determined in accordance with accounting standards
- Inventory is recorded at year-end at the lower of cost and net realisable value
- All purchases and sales of inventories are recorded in the correct period
- Inventory is properly classified in the accounts
- Disclosures relating to classification and valuation are adequate and in accordance with accounting standards

**What is cost?**

IAS2 defines cost as comprising all cost of purchase and other cost incurred in bringing inventory to its present condition and location.

**What is net realisable value?**

Net realisable value is the estimated selling price in the ordinary course of business, less the estimated costs of completion and the estimated cost necessary to make the sale.

**What are the audit procedures for inventory?**

- Complete the disclosure checklist to ensure that all the disclosures relevant to inventory have been made
- Physically inspect inventory held at third party locations or review confirmations received from third party and match to general ledger
- Observe the physical inventory count
- Verify that inventory held for third parties are not included in the year-end inventory figure
- Ensure build-and-hold inventory is not included in the year-end inventory
- Confirm that any inventory held at third party locations are included in the year-end inventory listing
- Obtain and agree inventory listing to general ledger
- Review the inventory listing to ensure it is mathematically correct
- Vouch a sample of inventory items to suppliers’ invoices to ensure it is correctly valued
- Ensure standard costing is correctly valued
- Agree the valuation of raw materials to invoices and price list
• Confirm that an appropriate basis of valuation is being used by discussing with management
• Agree labour cost to wage records
• Compare standard labour cost with actual labour cost
• Inquire of management any slow-moving or obsolete inventory that should be written down
• After year-end examine finished goods that have been sold to ascertain whether any finished goods need to be written down
• If significant levels of finished goods remain unsold for an unusually long period of time, discuss with management and consider the need to make allowances
• Compare the gross profit % to the previous year or industry data
• Compare raw material, finished goods and total inventory turnover to the previous year after considering current conditions
• Compare inventory days to the previous year or industry average
• Compare the current year standard costs to the previous year after considering current conditions
• Compare actual manufacturing overheads costs with budgeted or standard manufacturing overhead costs
• Note the numbers of the last GDNs and GRNs before the year-end and the first GDNs and GRNs after the year-end and check that these have been included in the correct financial year
• Cast the inventory listing and test the mathematical extensions of quantity multiplied by price
• Inquire of management and review any loan agreements and board minutes for evidence that inventory has been pledged or assigned
• Inquire of management about warranty obligations issues
• Review the inventory listing to ensure that inventory has been properly classified between raw materials, work-in-progress and finished goods
• Read the notes to the accounts relating to inventory to ensure they are understandable
• Review the financial statements to confirm whether the cost method used to value inventory is accurately disclosed
• Read the notes to the accounts to ensure that the information is accurate and properly presented at the appropriate amounts

**What factors should auditors consider when planning the attendance of an inventory count?**

• The risk of material misstatement of inventory
• Internal controls related to inventory
• Whether adequate procedures are expected to be established for counting
• Whether proper instructions have been issued for counting
• The timing of the count
• Whether or not the entity maintains a perpetual inventory system
• Locations of which inventory is held
• Whether the assistance of an auditor’s expert is required

**What is involved in planning attendance at inventory counts?**
• Review previous years arrangements
• Discuss with management inventory count arrangements and significant changes
• The nature and volume of inventory
• The risk relating to inventory
• Identification high value items
• The method of accounting for inventory
• Location of inventory and how it affects inventory control and recording
• Internal control and accounting systems to identify potential areas of difficulty
• Third party confirmation of inventory held
• Consider the need for expert help
• Review of inventory count instructions
  o Supervision by senior staff including senior staff not normally involved with inventory
  o Tidying and marking inventory to help counting
  o Restriction of inventory movement during count
  o Identification of damaged, obsolete, slow-moving third-party and returnable inventory
  o Systematic counting to ensure all inventory is counted
  o Teams of two counters
  o Serial numbering, control and return of all inventory sheets
  o Inventory sheets being completed in ink and signed
  o Recording of quantity, conditions and stage of production of work-in-progress

**When will net realisable value be less than cost?**

• An increase in cost
• A fall in selling price
• Physical deterioration
• Obsolescence of products
• A marketing decision to manufacture and sell products at a loss
• Errors in production or purchasing

**receivables:**

**What are the assertions that apply to receivables?**

• All sales transactions recorded have occurred and relate to the entity
• All sales transactions that should have been recorded have been recorded
• Amounts relating to transactions have been recorded accurately
• Amounts relating to transactions have been recorded in the correct period
• All transaction are have been classified correctly
• Recorded receivables exist
• The entity controls the rights to receivables and related accounts
• All receivables that should have been recorded have been recorded
• All disclosed events and transactions relating to receivables have occurred and pertain to the entity
• All disclosures required have been included
• Financial information is appropriately presented and described and disclosures clearly expressed

What are the audit procedures for receivables?

• Agree the balance from the individual sales ledger account to the aged receivables’ listing and vice versa
• Match the total of the aged receivables’ listing to the sales ledger control account
• Cast and cross-cast the aged trial balance
• Trace a sample of shipping documentation to sales invoices and into the sales and receivables ledger
• Complete the disclosure checklist to ensure that all the disclosures relevant to receivables have been made
• Review detailed statement of financial position to ensure all likely prepayments have been included
• Prepare a receivables circularisation on a sample of year-end receivables
• Follow up all balance disagreements and non-replies to the receivables’ confirmation
• Examine the customer’s account and customer correspondence to assess whether the balance outstanding represents specific invoices and confirm their validity
• Examine underlying documentation
• Inquire from management explanations for invoices remaining unpaid after subsequent ones have been paid
• Observe whether the balance on the account is growing and if so, find out why by discussing with management
• Review bank confirmation for any liens on receivables
• Inquire of management, review loan agreements and review board minutes for any evidence of receivables being sold or factored
• Compare receivables’ turnover and receivables’ days to the previous year
• Compare receivables’ turnover and receivables’ days to the industry data
• Compare the aged analysis of receivables from the aged trial balance to the previous year
• Review the reasonableness of the allowance for the allowance of bad debts through discussion with management
• Compare bad debt expense as a % of sales to the previous year
• Compare bad debt expense as a % of sales to the industry data
• Confirm adequacy of allowance by reviewing correspondence with customers and solicitors
• Examine large customer accounts individually and compare to the previous year’s balance
• Obtain further information regarding the recoverability of old debts by discussions with management and review of customer correspondence
• Recalculate prepayments from the prepayments’ listing to ensure it has been accurately calculated
• Sample sales invoices around year-end, inspect the dates and compare with the dates of dispatch and the dates recorded in the ledger for application of correct cut-off
• Sample sales returns around year-end and trace to the related credit entries
• Perform analytical procedures on sales returns comparing the ratio of sales returns to sales
• Take a sample of sales invoices and examine for proper classification into revenue accounts
• Take a sample of sales invoices and compare prices and terms to the authorised price list and terms
• Sample invoices and recalculate discounts to ensure they have been properly calculated and applied
• Sample invoices and recalculate tax to ensure they have not been included in sales
• Sample sales transactions recorded in the ledger, vouch the sales invoices back to customer orders and dispatch documentation
• Discuss with management whether any receivable have been pledge assigned or discounted and whether such items require disclosure in the financial statement
• Review for understandability notes relevant to receivables in the draft financial statement
• Read the disclosure notes to ensure the information is accurate

What are the two forms of confirmation of receivables?

• Positive
• Negative

What is positive confirmation?

Positive confirmation is one where the confirming party responds directly to the auditor indicating whether they agree or disagree with the information in the request or provides the requested information.

What is negative confirmation?

Negative confirmation is one in which the confirming party responds directly to the auditor only if they disagree with the information in the request.

What classes of accounts receivables should receive special attention?

• Old unpaid accounts
• Accounts written-off during the period
• Accounts with credit balances
• Accounts with nil balances
• Accounts which have been paid by the date of the examination

Cash and Bank:
**What is cash represented on the Financial Statements?**

Cash in the financial statements represent cash in-hand and cash on deposit in bank accounts.

**What are the audit objectives as regards to Banked cash?**

- Recorded cash balances include the effects of all transactions that occurred
- Year-end transfers are recorded in the correct period
- The entity has legal title to all cash balances shown at the year-end
- Recorded balances are realisable at the amounts stated
- Recorded cash balances exist at the year-end

Bank balances are usually confirmed directly by the bank in question. Obtaining third party confirmation from the client’s bank and reconciling these with the accounting records will cover the assertions such as, completeness, existence, rights and obligation, and valuation.

**What responsibilities do auditors have over confirmation requests?**

- Control over the content
- Control over the dispatch of confirmation requests
- Replies should be returned directly to the auditors

**What content would be included in the confirmation requests?**

- Balances due to the client entity’s current, deposit, loan and other accounts
- Balances due from the client entity’s current, deposit, loan and other accounts
- Request for nil balances on accounts
- Request information on accounts which were closed in the 12 months prior to the chosen confirmation date
- Confirmation of contingent liabilities
- Securities held on behalf of the client in safe custody
- Request for other information, such as:
  - Maturity on loans
  - Interest terms on loans
  - Interest on overdrafts
  - Unused facilities
  - Lines of credit/standby facilities
  - Offsets, rights or encumbrances
  - Details of any collateral given or received

**Before confirmation request is granted what will the banks request from their customer?**

The banks will require:

- Explicit written authority from their customer to disclose the information requested
The auditor’s request must refer to the client’s letter of authority and the date thereof
Letters of authority signed by all parties in the case of joint accounts
Whether permission is for an indeterminate length of time or a specific request
Given at least one month in advance of the client’s year-end and state both the year-end date and the previous year-end date

The auditors should themselves check that the bank response covers all the information in the standard and other responses.

**The audit plan for Bank would include:**

- Obtaining standard bank confirmations
- Re-performing arithmetic of bank reconciliation
- Tracing cheques shown as outstanding from the bank reconciliation to the cash book prior to the year-end and to the after-date bank statements and obtaining explanations for any large or unusual items not cleared at the time of the audit
- Review bank reconciliation previous to the year-end bank reconciliation and test whether all items are cleared in the last period or taken forward to the year-end bank reconciliation
- Obtain satisfactory explanations for all items in the cash book for which there are no corresponding entries in the bank statement by discussion with finance staff
- Obtain satisfactory explanation for all items in the bank statement for which there are no corresponding entries in the cash book by discussion with finance staff
- Verify contra items appearing in the cash books and bank statements with original entry
- Verify that un-cleared deposits are paid in prior to the year-end by inspecting pay-in slips
- Examine all deposited checks of which payment has been refused by the bank
- Verify the bank balances with reply to standard bank letter and with the bank statements
- Inspect the cash book and bank statement for exceptional entries or transfers
- Identify whether any accounts are secured on the assets of the company by discussion with management
- Consider whether there is a legal right of set-off of overdrafts against positive bank balances
- Determine whether the bank accounts are subject to any restrictions by inquiries with management
- Review disclosures for bank to ensure completeness and accuracy in accordance with accounting standards

**Cash:**

Cash balances or floats are often individually immaterial but they may require some audit emphasis because of the opportunities for fraud that could exist where internal control is weak and because they may be material in total.

Where the auditors determine that cash balances are potentially material they may conduct a cash count.
Cash may include notes, coins, unbanked cheques received, IOUs and credit card slips.

**Cash count:**

- All cash and petty cash books should be written up to date in ink at the time of the count
- All balance must be counted at the same time
- All negotiable securities must be available and counted at the same time the cash balances are counted
- At no time should auditors be left alone with the cash and negotiable securities
- All cash and securities counted must be recorded on working papers and subsequently filed on the current audit file
- Reconciliation should be prepared

**Audit plan of cash:**

- Agree counted cash balances held to petty cash book or other records
- Count all balances simultaneously
- All counting should be done in the presence of the individuals responsible
- Enquiries should be made into any IOUs or cashed cheques outstanding for a long period of time
- Obtain a certificate of cash-in-hand from responsible officials
- Confirm that bank and cash balances as reconciled are correctly stated in the financial statements
- Follow up that un-banked cheques or cash receipts have been paid in and agree to the bank reconciliation by inspection of relevant documents

**Liabilities and Capital**

**What are the assertions for Liabilities?**

- All purchase transactions recorded have occurred and relate to the entity
- All purchase transactions that should have been recorded have been recorded
- Amounts relating to transactions have been recorded appropriately
- Purchase transactions have been recorded in the correct period
- Purchase transactions are recorded properly in the accounts
- Trade payables and accrued expenses are valid liabilities
- Trade payables and accrued expenses are the obligations of the entity
- All liabilities have been recorded
- All liabilities are included in the accounts at appropriate amounts
- All disclosed events and transactions relating to liabilities have occurred and relate to the entity
- All disclosures required have been included
- Financial information is appropriately presented and described
- Financial information is disclosed fairly and at appropriate amounts
Audit Plan: accounts payable and accruals

- Obtain a listing of trade accounts payables and agree the total to the general ledger by casting and cross casting
- Test for unrecorded liabilities by inquiries of management on how unrecorded liabilities and accruals are identified
- Obtain selected suppliers’ statements and reconcile these to the relevant suppliers’ accounts
- Perform a confirmation on accounts payables for a sample
- Complete the disclosure checklist to ensure that all the disclosures relevant to liabilities have been made
- Compare the current year balances for trade accounts payables and accruals to the previous year
- Compare the amounts owed to a sample of individual suppliers in the trade accounts payables listing to amounts owed to these suppliers in the previous year
- Compare the payables’ turnover and payables’ day to the previous year and industry data
- Re-perform casts of payroll records to confirm completeness and accuracy
- Confirm payment of net pay per payroll records to cheque or bank transfer summary
- Agree net pay per cashbook to payroll
- Inspect payroll for unusual items and investigate them further by discussion with management
- Vouch selected amounts from the trade accounts payables listing and accruals listing to supporting documentation
- Obtain selected suppliers’ statements and reconcile these to the relevant suppliers amount
- For a sample of vouchers, compare the dates with the dates they were recorded in the ledger for application of correct cut-off
- Test transactions around the year-end to determine whether amounts have been recognised in the correct financial period
- Perform analytical procedures on purchase returns, comparing the purchase returns as a % of sales or cost of sales to the previous year
- Recalculate the mathematical accuracy of a sample of suppliers’ invoices to confirm the amounts are correct
- Recast calculation of remuneration
- Re-perform calculation of statutory deductions and other deductions to confirm whether correct
- For a sample of vouchers, inspect supporting documentation such as authorised purchase orders
- Agree individual remuneration per payroll to personnel records, records of hours worked, salary agreement
- Confirm existence of employees on payroll by meeting them, attending wages pay-out, inspecting personnel and tax records, and confirmation from managers
- Review the trade payables listing to identify any large debits or long-term liabilities which should be disclosed separately
• Read the disclosure notes relevant to liabilities in the draft financial statements and review for understandability
• Read the disclosure notes to ensure the information is accurate and properly presented at the appropriate amounts

**Confirmation of trade payables:**

Confirmation of trade payables provides evidence primarily for the completeness assertion. Where the auditor is concerned about the presence of unrecorded liabilities, regular suppliers with small or zero balances on their accounts and a sample of other accounts will be confirmed as well as large balances.

**Audit plan for Non-current liabilities:**

• Obtain or prepare schedule of loans outstanding at the year-end date
• Compare opening balances to previous year’s papers
• Test the clerical accuracy of the analysis
• Compare balances to the general ledger
• Agree name of lender to register of debenture holders
• Trace additions and repayments to entries in the cash book
• Confirm repayments are in accordance with loan agreement
• Verify that borrowing limits imposed by agreements are not exceeded
• Examine signed Board minutes relating to new borrowings or repayments
• Obtain direct confirmation from lenders of the amounts outstanding, accrued interest and what security they hold
• Verify interest charged for the period
• Confirm assets charged have been entered in the register of charges and notified to the registrar
• Review restrictive covenant and provisions relating to default
• Review any correspondence relating to the loan
• Review confirmation replies for non-compliance
• Review minutes and cashbook to confirm all loans have been recorded
• Review draft accounts to ensure that:
  • Disclosures for non-current liabilities are correct and in accordance with accounting standards
  • Any elements repayable within one year should be classified under current liabilities

**Provisions and contingencies:**

**What is a provision?**

A provision is a liability of uncertain timing or amount.

**What is a liability?**
A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

**What is a contingent liability?**

A contingent liability is a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity or a present obligation that arises from past events but is not recognised because it is not possible that an outflow will be required to settle the obligation or the amount of the obligation cannot be measured with sufficient reliability.

**Audit plan for provisions – BPP page 277**

**Capital and other issues – BPP page 278**

### Audit Sampling and Other means of Testing

**What is audit sampling?**

Audit sampling involves seeking evidence from less than 100% of items of the balance or transaction being tested by using sampling techniques. All sampling units have a chance of selection. Audit sampling provides auditors with reasonable basis on which to draw conclusions about the entire population. Audit sampling can be applied using either statistical or non-statistical approaches.

**Why do auditors sample from a population?**

To examine all the information available would be impractical so auditors use audit sampling to produce valid conclusions.

**When do auditors test 100% of items?**

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

**What is statistical sampling?**

Statistical sampling involves random selection of the sample items, and the use of probability theory to evaluate sample results, including measurement of sampling risk.

**What is non-statistical sampling?**

Non-statistical sampling involves sampling items discriminately without the use of probabilities or measurement.

**What are some specific characteristics that may cause auditor to select certain items from a population?**
• High value items
• Items that are suspicious
• Items that are usually prone to error
• Items above a certain amount
• Items to obtain information
• Items to test procedures

**What is sampling risk?**

Sampling risk arises from the possibility that the auditor’s conclusion, based on a sample of a certain size, may be different from the conclusion that would have been reached if the entire population were subject to the same audit procedure.

**What is Non-sampling risk?**

Non-sampling risk arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the size of the sample.

**What is a sampling unit?**

A sampling unit is the individual items making up a population.

**What is stratification?**

Stratification is the process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics.

**Note:** ISA 530 requires auditors to select items from the sample in such a way that each sampling unit in the population has a chance of selection. When statistical sampling is used, each sampling unit has a known probability of being selected.

**What are the main methods of selecting samples?**

• Random selection
  where all items in the population have an equal chance of selection.

• Systematic selection
  involves selecting items using a constant interval between selections, the first interval having a random start

• Haphazard selection
  an alternative to random selection, care must be taken so as not to make a bias selection

• Block selection
  for example, sampling 50 consecutive checks for authorisation, block sampling can be misleading as errors may occur in the same time period
• Monetary Unit sampling
  value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amount

**Computer-Assisted Audit Techniques**

**What are the internal controls in a computer environment?**

• Application controls
• General controls

**What are application controls?**

Application controls involve procedures to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized and are completely and accurately recorded.

• **Give examples of application controls?**
  Existence check e.g. that a supplier exists
  • Character check e.g. that there are no alphabetical characters in a sales invoice number field
  • Range check e.g. no employee’s weekly wage is more than $2,000

**What are general controls?**

General controls include general IT controls that maintain the integrity of information and security of data.

**Give examples of general controls?**

• Administrative controls:
  Controls over data centre and network operations and access security; i.e. procedure manuals, job scheduling, training and supervision, prevention of unauthorized amendments to data files, backup and physical protection of files and access controls such as passwords
• System development controls
  System software acquisition, development and maintenance; controls over application development; use of test data to identify program code errors, good system over program writing, segregation of duties so that operators are not involved in program development, controls over program changes, controls over installation and maintenance of system software.

**What are Computer-Assisted Audit techniques?**

CAATs are the application of auditing procedures using the computer as a tool.

**What are the three categories of CAATs?**

• Audit software
• Test data
• Other techniques

**Audit software:**

Audit software is where the auditor uses computer programs to interrogate client’s computer files (substantive testing). Using audit software, the auditor can investigate large volumes of data and present results that can then be investigated further.

**Test data:**

Test data consists of data submitted by the auditor for processing by the client’s computer system. The objective is to test the operation of application controls – auditor will arrange for dummy data to be processed that include many error conditions, to ensure that the client’s application controls can identify particular problems. As well, auditor will also include correct transactions to ensure that correct transactions are processed properly.

**Other techniques:**

The main two are:

• Integrated test facility
• Embedded audit facilities

**Integrated test facility:**

This is where test data is run live and this involves dummy records being processed. Later these records can be reversed out.

**Embedded audit facilities (a.k.a embedded audit monitor):**

Embedded audit facilities involve the auditor's own program code to be embedded into the client’s application software. The embedded code is designed to perform audit functions and can be switched on at selected times or activated each time the application program is used.

**What are the advantages of using CAATs?**

• Auditors can test program controls as well as general internal controls associated with computers
• Auditors can test a greater number of items more quickly and accurately
• Auditors can test transactions rather than paper records of transactions that could be incorrect
• CAATs are cost-effective
• CAATs can be compared with results from traditional testing – if the results correlate then overall confidence is increased

**Not-for-Profit Organisations**
THE END.