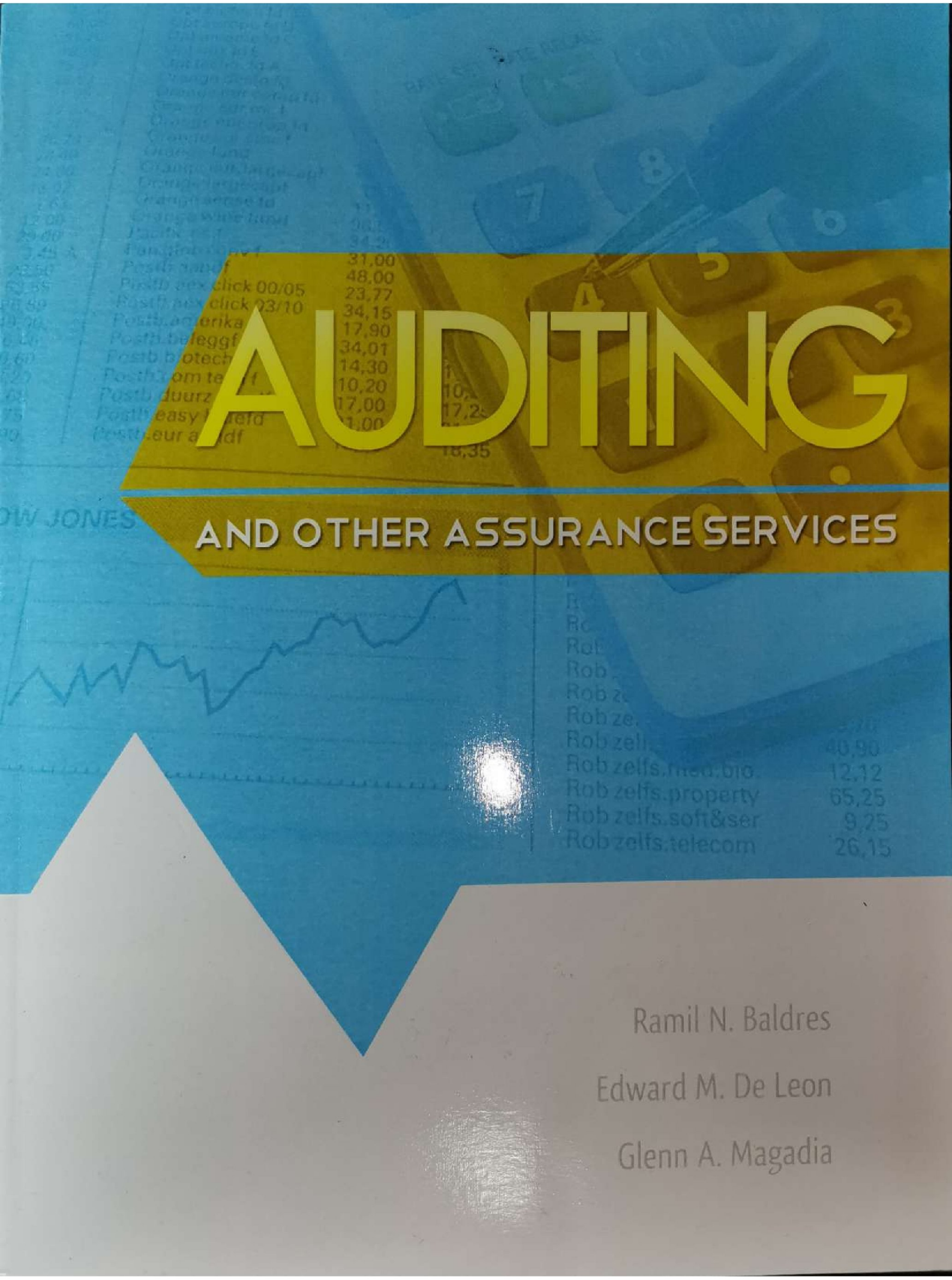


AUDITING

AND OTHER ASSURANCE SERVICES

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Chapter 1
INTRODUCTION TO ASSURANCE SERVICES AND ENGAGEMENTS

LEARNING OBJECTIVES

Upon completion of this chapter you will

1. **Understand the definition of an assurance services.**
2. **Understand the nature and objective of an assurance engagement.**
3. **Understand the differences between reasonable assurance engagements and limited assurance engagements.**
4. **Understand the differences between assertion-based engagements and direct reporting engagements.**
5. **Understand the five elements of assurance engagements.**
6. **Understand the circumstances where a practitioner should accept an assurance engagement.**
7. **Understand the types of other assurance and non-assurance engagements.**

DEFINITION OF ASSURANCE SERVICES

Assurance services may be defined with broad scope. The influential American Institute of Certified Public Accountants (AICPA) Special Committee on Assurance Services, the 'Elliot Committee', has defined assurance services as follows:

> *Assurance services are independent professional services that improve the quality of the information, or its context, for decision makers.*

The said definition focuses on the decision making aspect where the actions of responsible officer will depend on the qualitative and quantitative information. Let us elaborate further the important concepts mentioned in the above definition.

The first important concept in the definition is independence which is the hallmark of the profession. The Code of Ethics for Professional Accountants in the Philippines requires that the practitioner should be independent in mind and in appearance. Independence in mind is the state of the mind that permits the expressions of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity, and exercise objectivity, and professional skepticism. Independence in appearance, on the other hand, refers to the avoidance of the facts and circumstances that are so significant that a reasonable and informed third party, would be likely to conclude that a firm's or an audit or assurance team's member's integrity, objectivity, or professional skepticism had been compromised.

The second concept is the professional services that encompassed the application of professional judgment based on education and experience. Third is the improvement in the quality of the information or its context. An assurance service engagement can improve quality by increasing confidence in the information's reliability and relevance. Context can be improve though the format in which information is presented. The last concept is the decision makers. They are the

"consumers" of assurance services, and they personify the consumer focus of new and different professional work. They may or may not be the "client" that pays the fee, and they may or may not be one of the parties to an assertion or other information. The decision makers are the beneficiaries of the assurance services.

DEFINITION AND OBJECTIVE OF AN ASSURANCE ENGAGEMENTS

The Philippine Framework for Assurance Engagements, with more narrow scope than the previously discussed definition by the Elliot Committee, defined an assurance engagement as follows:

> *Assurance engagement means an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users, other than the responsible party, about the outcome of the evaluation or measurement of a subject matter against criteria.*

A number of terms used in this definition are defined below:

- **Practitioners** – those parties who are providing the assurance service.
- **Intended users** – those parties for whom the assurance report is prepared. This can include the responsible party although the responsible party cannot be the sole user of the report.
- **Responsible party** – the party that is responsible for preparing and providing the information or the assertion, for example, the management of a company.
- **Subject matter** (and subject matter information) – what practitioners are reporting on. Subject matter refers to underlying matter of interest to intended users and subject matter information is information that results from evaluating or measuring the subject matter.
- **Criteria** – the benchmarks against which to measure the subject matter.

REASONABLE AND LIMITED ASSURANCE ENGAGEMENTS

The Philippine Framework for Assurance Engagements directs that a practitioner can enter into two types of assurance engagements or, effectively, provide two levels of assurance on any particular type of an assurance engagement. These two types of assurance engagements are **reasonable assurance engagement** and **limited assurance engagement**. The difference between these types of assurance is reflected in the nature of the work performed, the level of engagement risk and the type of conclusion provided.

For a reasonable assurance engagement, the practitioner needs to reduce the assurance engagement risk (i.e., the risk that an inappropriate conclusion is expressed when the information on the subject matter is materially misstated) to an acceptably low level in the circumstances of the engagement as the basis for a positive form of expression of the practitioner's conclusion. Such risk is never reduced to nil and therefore, there can never be absolute assurance. Practitioners aiming to obtain reasonable assurance must obtain sufficient evidence in order that they may give a positive conclusion. The audit opinion as currently expressed in audit report reflects a reasonable assurance conclusion.

On the other hand, for a limited assurance engagement the practitioner needs to reduce the assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion. An interim review of the financial statements of listed companies is an example of a limited assurance engagement.

EXHIBIT 1.1 Why Absolute Assurance Engagements is Not Possible

Reducing assurance engagement risk to nil is rarely attainable or cost beneficial as a result of factors such as:

- Use of selecting testing
- Inherent limitations of internal controls
- The fact that much of the evidence available to the auditor is persuasive rather than conclusive
- The use of judgement in gathering and evaluating evidence and forming conclusions based on that evidence
- The characteristics of the subject matter.

The practitioner uses the same risk basis for planning their work and the same levels of materiality in evaluating the outcome of tests for reasonable and limited assurance engagements. Since the extent of evidence collected for a limited assurance engagement may be limited due to the reduced sample sizes and test coverage adopted, the level of risk of material misstatement remaining is potentially higher than in a reasonable assurance engagement. Hence, the practitioner is not in a position to express the same degree of confidence as in a reasonable assurance engagement. The conclusion in a limited assurance engagement is accordingly framed in a negative sense, "based on the procedures performed, nothing came to our attention that the management assertion on XYZ is materially misstated…" in contrast with a reasonable assurance conclusion which would be formed in a positive sense, i.e., "based on the procedures performed, the management assertion on XYZ is reasonably stated…"

TABLE 1.1 Expression of Conclusion in Reasonable Assurance Engagements and Limited Assurance Engagements

Reasonable Assurance Engagements	Limited Assurance Engagements
"In our opinion internal control is effective, in all material respects, based on XYZ criteria." POSITIVE	"Based on our work described in this report, nothing has come to our attention that causes us to believe that internal control is not effective, in all material respects, based on XYZ criteria." NEGATIVE

Table 1.2 summarizes the differences between reasonable assurance engagements and limited assurance engagements.

TABLE 1.2 Differences Between Reasonable Assurance Engagements and Limited Assurance Engagements

Type of Engagements	Objective	Evidence-gathering procedures	The assurance report
Reasonable assurance engagement	A reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement, as the basis for a positive form of expression of the member's conclusion.	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes: ▪ Obtaining an understanding of the engagement circumstances; ▪ Assessing risks; ▪ Responding to assessed risks; ▪ Performing further procedures using a combination of inspection, observation, confirmation, recalculation, reperformance,	Description of the engagement circumstances and a positive form of expression of the conclusion

		analytical procedures and inquiry. Such further procedures involve substantive procedures, including , where applicable, obtaining corroborating information, and depending on the nature of the subject matter, tests of the operating effectiveness of controls; and ▪ Evaluating the evidence obtained	
Limited assurance engagement	A reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the member's conclusion	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes obtaining an understanding of the subject matter and other engagement circumstances, but in which procedures are deliberately limited relative to a reasonable assurance engagement	Description of the engagement circumstances and a negative form of expression of the conclusion

ASSERTION-BASED AND DIRECT REPORTING ENGAGEMENTS

The Philippine Framework for Assurance Engagements further differentiates assurance engagements into two types. The differentiation is based on who initially measures or evaluates the subject of interest (subject matter) and provides information about it.

In an **assertion-based engagement** (also known as attestation engagement), the responsible party, (the preparer of the information; usually management), carries out the measurement or evaluation of the subject matter and reports the information (the subject matter information) which contains the responsible party's assertion (e.g., "the subject matter information is fairly stated as of date/month/year…"). The work the practitioner performs is to give an assurance conclusion on this assertion.

Both the subject matter information including the responsible party's assertion and the practitioner's assurance report are made available together to the intended users. Attestation engagements are a familiar form of assurance engagement, as audits and reviews of financial statements have been structured as attestation engagements: management reports the financial performance and position in the annual accounts, asserts the information as being true and fair, and the practitioner gives a conclusion on the assertion.

The second type of engagement is a **direct reporting engagement**. The responsible party does not present the subject matter information in a report in a direct engagement. Instead, the practitioner performs the evaluation or measurement of the subject matter information without any assertion by the responsible party, or obtains representation from the responsible party that it has performed the valuation or measurement but the information is not available to the intended users. The practitioners reports directly on the subject matter and provides the intended users with an assurance report containing the subject matter information.

An example of a direct engagement would be a Sarbanes-Oxley engagement to report on the effective control over the financial reporting process. A direct assurance conclusion would be

constructed as "... In our opinion the company maintained, in all material respects, effective internal control over financial reporting as of date/month/year, based on the criteria established in Internal Control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)..."

It is necessary to distinguish between an assertion-based assurance engagement and a direct reporting assurance engagement. An assertion-based assurance engagement requires the auditor to issue an opinion on written assertions made by others. On the other hand, direct-reporting assurance engagement requires the auditor to provide assurance on an accountability matter on which the responsible party has not made a written assertion.

For example, an audit report could be issue on the adequacy of internal control. Where management does not issue a report on the adequacy of internal control, and therefore the auditor is required to report directly on its adequacy, the engagement is classed as a direct reporting assurance engagement. If, however, management has stated an opinion on the adequacy of internal control and the auditor is required to attest to this statement, it is an assertion-based assurance engagement.

Practitioners more commonly perform assertion-based engagements. This is because, ultimately, management (as the responsible party) is responsible for their business and, therefore, should be in a position to present relevant assertions in the subject matter information. They are also in a better position to understand who would use the information, what users want to see, in what format, and for what purpose.

ASSURANCE ENGAGEMENT ACCEPTANCE

Acceptance decisions are crucially important, because new clients and/or engagements can pose threats to objectivity, or create risk exposure to the firm, which must be carefully evaluated. The practitioner (auditor or assurance provider) accepts an assurance engagement only where the practitioner's preliminary knowledge of the engagement circumstances indicates that:

- investigate the owners and business activities.
- can the firm identify the beneficiary?

1. The relevant ethical requirements, such as independence and professional competence will be satisfied. The Code of Ethics for Professional Accountants requires firm to investigate potential client, its owners and business activities in order to evaluate whether there are any questions over the integrity of the potential client which may create unacceptable risk. Also, the firm's competence to perform the potential work should be evaluated, especially if the potential client operates in a specialized industry, or if the client has a complex structure. Practical matters such as the resources needed to perform the work, the deadline for completion, and logistics like locations and geographical spread will have to be looked into as well.

2. Once a client has been accepted, the firm should consider the suitability of the specific engagement it has been asked to perform. The engagement exhibits all of the following characteristics:

    - The subject matter is appropriate;
    - The criteria to be used are suitable and are available to the intended users;
    - The practitioner has access to sufficient appropriate evidence to support his or her conclusion;
    - The practitioner's conclusion, in the form appropriate to either a reasonable or limited assurance engagement, is to be contained in a written report; and

- The practitioner is satisfied that there is a rational purpose for the engagement.

ELEMENTS OF AN ASSURANCE ENGAGEMENT

All assurance engagements possess certain basis elements that must be present for the engagement to meet professional standards. The five elements of an assurance engagement are the following: (1) a three party relationship involving a practitioner, a responsible party, and intended users; (2) an appropriate subject matter; (3) suitable criteria, (4) sufficient appropriate evidence; and (5) a written assurance report in the form appropriate to a reasonable assurance engagement or a limited assurance engagement.

The aforementioned elements are discussed in the following section:

Three-Party Relationships

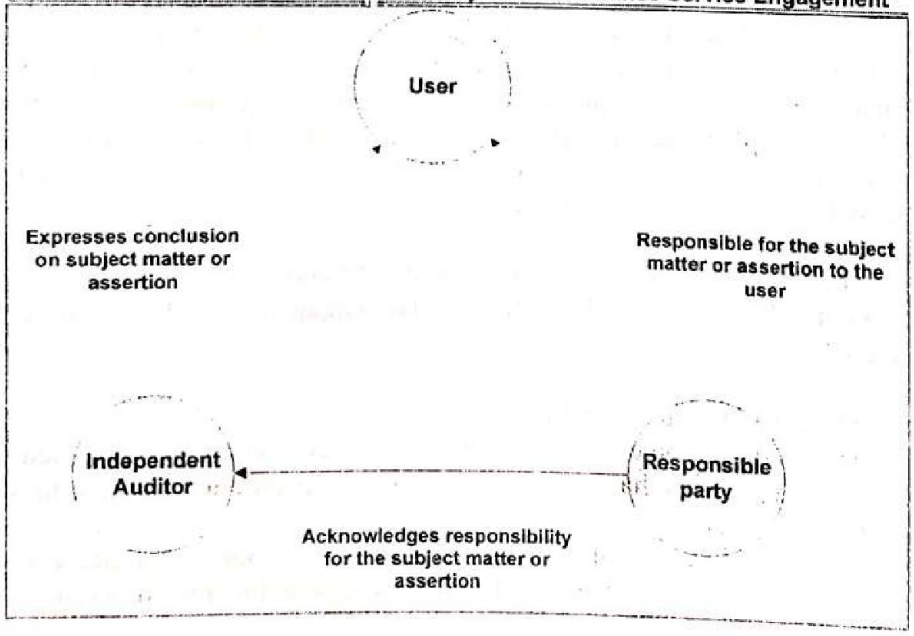
An assurance engagement involves three separate parties: an intended user or users; a party who is responsible for the subject matter or subject matter information, such as management; and the practitioner.

The **responsible party** is the person (or persons) responsible for the subject matter or subject matter information (the assertion) to the **user** and acknowledges the responsibility to the **practitioner**.

In a direct-reporting engagement the responsible party is responsible to the subject matter. In an assertion-based engagement, the responsible party is responsible for the subject matter information (the assertion), and maybe responsible for the subject matter. The responsible party may or may not be the engaging party (the party who engages the practitioner). The intended users are the person, persons or class of persons for whom the practitioner prepares the assurance report. The responsible party can be one of the intended users, but not the only one.

Exhibit 1.2 depicts the relationship among the three parties to an assurance engagement.

EXHIBIT 1.2 Diagrammatic Summary of an Assurance Service Engagement



Subject Matter and Subject Matter Information

Subject matter, and subject matter information, is the financial and non-financial information for which the practitioner gathers sufficient appropriate evidence to be evaluated or measured against suitable criteria as a reasonable basis for expressing a conclusion or reporting findings in the assurance engagement report.

The subject matter, and subject matter information, of an assurance engagement may take many forms such as:

- Financial performance or conditions (for example, historical or prospective financial position, financial performance and cash flows) for which the subject matter information may be the recognition, measurement, presentation and disclosure represented in financial statements.
- Non-financial performance or conditions (for example, performance of an entity) for which the subject matter information may be key indicators of efficiency and effectiveness.
- Physical characteristics (for example, capacity of a facility) for which the subject matter information may be a specifications document.
- Systems and processes (for example, an entity's internal control or IT system) for which the subject matter information may be an assertion about effectiveness.
- Behavior (for example, corporate governance, compliance with regulation, human resource practices) for which the subject matter information maybe a statement of compliance or a statement of effectiveness.

To be capable of evaluation or measurement in an assurance engagement, subject matter, and subject matter information, should be both:

- Identifiable and capable of consistent evaluation or measurement against the identified criteria.
- Be reasonably subjected to procedures for gathering sufficient appropriate evidence to support the desired level of assurance i.e., reasonable assurance or limited assurance conclusion.

Suitable Criteria

Assurance engagements require the practitioner to express an overall conclusion on the subject matter assessed in reference to specified criteria. Criteria are the benchmarks used to evaluate or measure the subject matter including, where relevant, benchmarks for presentation and disclosure. Criteria also assist the parties to the engagement and agreed recipients of the assurance report to understand how the practitioner has evaluated the subject matter to reach a conclusion. Criteria are dependent on the subject matter and may be already established or developed for a specific engagement.

Suitable criteria must be:

- Relevant to the purpose of the assurance engagement (relevant criteria contribute to conclusion that assist decision-making by the intended users of the assurance report).
- Complete including, where relevant, benchmarks for presentation and disclosure. Criteria are sufficiently complete when relevant factors that could affect the conclusions in the context of the engagement circumstances are not omitted.
- Reliable to allow a reasonably consistent evaluation or measurement of the subject matter including, where relevant, presentation and disclosure, when used in similar circumstances by similarly qualified practitioners.
- Neutral (i.e., neutral criteria contribute to conclusions that are free from bias).
- Understandable to contribute to conclusions that are clear, comprehensive and not subject to significantly different interpretations.

In addition, suitable criteria should be "available" to the intended users of the assurance engagement report in an effort to allow the users to understand how the subject matter information has been evaluated or measured. Criteria can be made available through public assess (such as PFRS Codifications and the COSO framework), inclusion in a clear manner in the presentation of the subject matter information (benchmark measurements included in the body of a performance report), inclusion in a clear manner in the assurance engagement report (repeating a statutory reference and wording in the body of the practitioner's report on compliance assurance), or by general understanding (measurement of weight or time).

Established criteria tend to be formal in nature, but the degree of formality depends on the subject matter. For example in the preparation of financial statements, the criteria may be Philippine Financial Reporting Standards; when reporting on internal control, the criteria may be an established internal control framework or individual control objectives specifically designed for the engagement; and when reporting on compliance, the criteria may be the applicable law, regulation or contract. Examples of less formal criteria are an internally developed code of conduct or an agreed level of performance (such as the number of times a particular committee is expected to meet in a year).

Suitable criteria are required and must be available for there to be a sufficient and generally accepted frame of reference for the reasonably consistent evaluation or measurement of the subject matter information within the context of professional judgment. Without an acceptable frame of reference provided by suitable criteria, the practitioner's conclusion could be more open to individual interpretation and misunderstanding among interest parties to the engagement.

Sufficient Appropriate Evidence

In an assurance engagement, the practitioner plans and performs an assurance engagement with an attitude of professional skepticism to obtain sufficient appropriate evidence about whether the subject matter information satisfies the criteria or is free of material misstatement. In doing so, the practitioner should consider issues of materiality, assurance engagement risk, and the sufficiency and appropriateness of evidence when planning and performing the engagement, in particular when determining the nature, timing and extent of evidence-gathering procedures. Sufficiency

involves considerations of the quantity of evidence, while appropriateness considers the quality of the evidence in terms of relevance and reliability.

The quantity and quality of evidence is dependent upon the level of assurance required and the risk of the subject matter information being materially misstated or misrepresented. For example, the higher the level of assurance required and the higher the risk of misstatement or misrepresentation, the higher the quantity and/or quality of evidence is required.

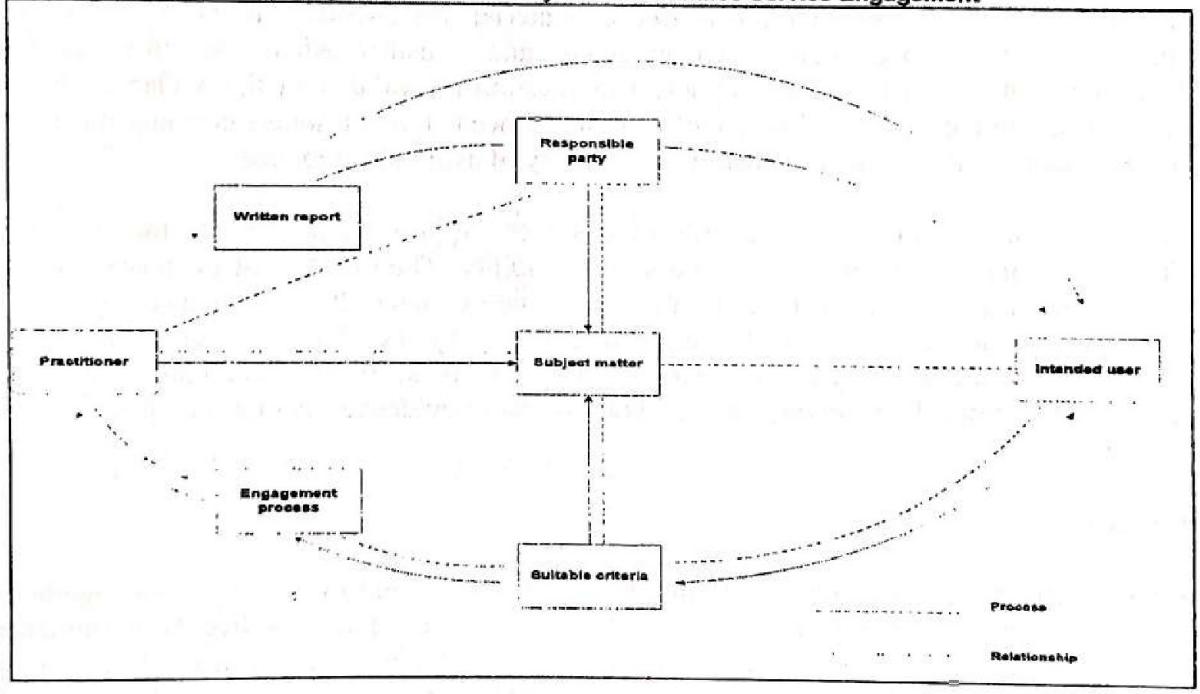
Written Assurance Report

In an assurance engagement, the practitioner provides a written report containing a conclusion that conveys the assurance obtained about the subject matter information or related assertion to the suitable criteria. Philippine Standards on Auditing, Philippine Standards on Review Engagements and Philippine Standards on Assurance Engagements establish basic elements for assurance reports. In addition, the practitioner considers other reporting responsibilities, including communicating with those charged with governance when it is appropriate to do so.

Reporting on assurance engagement varies depending on whether the engagement is an assertion-based or direct-reporting engagement and on the level of assurance provided as defined above.

Exhibit 1.3 is a diagrammatic summary of the interrelationship of the five components.

EXHIBIT 1.3 Diagrammatic Summary of an Assurance Service Engagement



FACTORS AFFECTING THE PRACTITIONER'S PERFORMANCE OF AN ASSURANCE ENGAGEMENT

The factors affecting the practitioner's performance of an assurance engagement are the following: (1) extent of work performed, (2) professional skepticism, (3) sufficiency and appropriateness of audit evidence, (4) materiality, and (5) assurance engagement risk.

Extent of Work Performed

The two types of assurance engagements are separated by the extent of worked performed. In reasonable assurance engagements, practitioners would do all that they need to do to support a positive opinion. However, this does not mean that absolutely all evidence is gathered or examined because there are time and cost factors to consider relative to the specific engagement. The gathering of evidence in limited assurance engagements is deliberately limited in comparison to a reasonable assurance engagement. Practitioners need to use their professional judgment in determining how much evidence is needed for limited assurance engagements. The sufficiency of evidence is affected by the risk of the specific engagement and the quality of evidence.

Professional Skepticism

The practitioner plans and performs an assurance engagement with an attitude of professional skepticism recognizing that circumstances may exist that cause the subject matter information to be materially misstated. An attitude of professional skepticism means the practitioner makes a critical assessment, with a questioning mind, of the validity of evidence obtained and is alert to evidence that contradicts or brings into question the reliability of documents or representations by the responsible party.

Sufficiency and Appropriateness of Audit Evidence

To express a conclusion on subject matter, practitioners need sufficient appropriate evidence to obtain assurance that the information is free of material misstatement. In planning the work, practitioners will exercise professional judgment and consider what constitutes sufficient evidence and will use professional skepticism to question the validity of the evidence obtained. When determining the extent and nature of procedures needed, practitioners consider materiality, assurance engagement risk and the quantity and quality of available evidence.

Sufficiency is the measure of the quantity of evidence. Appropriateness is the measure of the quality of evidence; that is, its relevance and its reliability. The quantity of evidence needed is affected by the risk of the subject matter information being materially misstated (the greater the risk, the more evidence is likely to be required) and also by the quality of such evidence (the higher the quality, the less may be required). Accordingly, the sufficiency and appropriateness of evidence are interrelated. However, merely obtaining more evidence may not compensate for its poor quality.

Materiality

Materiality helps the practitioners determine the nature, timing and extent of evidence-gathering procedures, and when assessing whether the subject matter information is free of misstatement. When considering materiality, the practitioner understands and assesses what factors might influence the decisions of the intended users. For example, when the identified criteria allow for variations in the presentation of the subject matter information, the practitioner considers how the adopted presentation might influence the decisions of the intended users. Materiality is considered in the context of quantitative and qualitative factors, such as relative magnitude, the nature and extent of the effect of these factors on the evaluation or measurement of the subject matter, and the interests of the intended users. The assessment of materiality and the relative importance of quantitative and qualitative factors in a particular engagement are matters for the practitioner's judgment.

Assurance Engagement Risk

Assurance engagement risk represents the risk that practitioners provide an inappropriate conclusion when the subject matter information is materially misstated. There are ordinarily three components of assurance engagement risk for practitioners to think about when planning and performing an assurance engagement:

- **Inherent risk** – the susceptibility of the information to a material misstatement (e.g., where there have been complex transactions).
- **Control risk** – the risk a material misstatement will not be prevented or detected on a timely basis by internal controls.
- **Detection risk** – the risk that the practitioners will not detect a material misstatement that exists.

When assessing these risks, practitioners will need to understand the type of engagement and nature of information being reported on. In a reasonable assurance engagement, the practitioner reduces assurance engagement risk to an acceptably low level in the circumstances of the engagement to obtain reasonable assurance as the basis for a positive form of expression of the practitioner's conclusion. The level of assurance engagement risk is higher in a limited assurance engagement than in a reasonable assurance engagement because of the different nature, timing or extent of evidence gathering procedures. However in a limited assurance engagement, the combination of the nature, timing and extent of evidence gathering procedures is at least sufficient for the practitioner to obtain a meaningful level of assurance as the basis for a negative form of expression.

Conclusion Provided

The types of assurance are distinctly expressed in the report wording. Practitioners provide a positive form of conclusion for a reasonable assurance engagement, for example, 'In our opinion, the internal controls are effective, in all material respects, based on XYZ criteria'. In a limited assurance engagement, practitioners express a conclusion in a negative form, such as, 'Based on our work described in this report, nothing has come to our attention that causes us to believe that the internal control are not effective, in all material respects, based on XYZ criteria'.

TYPES OF ASSURANCE ENGAGEMENTS

The following are the typical types of assurance engagements:

1. **Audit of Historical Financial Information.** An audit of historical information i.e., such as financial statements or some component of financial statements, is a form of assurance engagements in which the auditor issues a written report expressing an opinion about whether the financial statements are fairly stated in accordance with the Philippine Financial Reporting Standards. Audits represent the predominant form of assurance performed by CPA firms.
2. **Review of Historical Financial Information.** A review of historical financial information i.e., such as financial statements or some component of financial statements, provides a moderate amount of assurance on the financial statements, and less evidence necessary to support this level of assurance. A review is often adequate to meet financial

statement users' needs, and it can be provided by the CPA firm at a much lower fee than an audit.

3. **Other Assurance Engagements.** The demand for new types of assurance services was developed as a natural extension of the audit function. Management realized that contracting costs could be reduced in many situations by providing investors, creditors, customers, and others transacting with the company access to information that is certified as to its reliability. As with an audit, these new assurance services reduce information risk for the outside parties and thus enable the company to contract at more favorable terms. These emerging assurance engagements are in the following areas:

   a. **Corporate Sustainability Reporting.** Corporate sustainability reporting (CSR), also known as triple-bottom-line reporting, involves reporting non-financial and financial information to a broader set of stakeholders than just shareholders. The reports inform stakeholder groups of the reporting organization's ability to manage key risks. Because these interests vary, the type of information various; however, much of it has to do with the company's economic, operational, social, philanthropic and environmental objectives.

      Corporate sustainability reporting is still at a relatively early stage of development. Currently, there are no authoritative generally accepted criteria for reporting on sustainability or standards for performing assurance. A number of initiatives have, however, been taken.

   b. **Trust Services. Trust Services** – jointly developed by the American Institute of Certified Public Accountants (AICPA) and Canadian Institute of Chartered Accountants (CICA) – are set of services designed to provide information system business assurance and advisory services that instill confidence in an organization, system, or other entity by improving the quality or context of information for decision makers. They were developed by the AICPA's Assurance Services Executive Committee.

      As seen in Table 1.3, Trust Services are built on five principles: security, availability, processing integrity, online privacy, and confidentiality.

      In a Trust Services engagement, management prepares and communicates a system description that can be included on the company's Web site, attached to the practitioners' report, or communicated to users in some other manner. It must clearly articulate the boundaries of the system so as to allow individuals to understand both the scope of management's assertions related to it and the practitioners' report. At present CPAs offers two types of trust services – WebTrust and SysTrust.

TABLE 1.3 Trust Services Principles

Security The system is protected against unauthorized access (both physical and logical)
Availability The system is available for operation and use as committed or agreed
Processing Integrity System processing is complete, accurate, timely and authorized

Online Privacy
Personal information obtained as a result of e-commerce is collected, used, disclosed, and retained as committed or agreed

Confidentiality
Information designated as confidential is protected as committed or agreed

i. WebTrust provides assurance on electronic commerce (including Web sites). The CPA is engaged to examine both that a client complied with the Trust Services criteria (e.g., the company uses procedures in accordance with its defined policies) and that it maintained effective controls over the system based on Trust Services criteria (e.g., the company's procedures are effective).

ii. SysTrust provides assurance on any defined electronic system. The system components include its infrastructure, software, personnel, procedures and data. In a SysTrust engagement the CPA is engaged to examine only that a client maintained effective controls over the system based on the Trust Services Principles and Criteria. The practitioner then performs tests to determine whether those controls were operating as effectively during the specified period.

Both WebTrust and SysTrust are designed to incorporate a seal management process by which a seal (logo) may be included on a client's Web site as an electronic representation of the practitioner's unqualified WebTrust report. If the client wishes to use the seal (logo), the engagement must be updated at least annually. Also, the initial reporting period must include at least two months.

c. **CPA Performance View.** This service is intended to demonstrate that the public accountants can aide client firms in developing an integrated set of financial and non-financial performance and measures to employ in managing the client's business.

CPA Performance View identifies and measures key activities that are critical to the entity. Rather than relying strictly on historical financial information, CPA Performance View uses non-financial information such as customer satisfaction, employee training and satisfaction, and product quality to identify critical success factors that can lead to organizational change, better performance, and increased revenue for an organization.

d. **CPA Risk Advisory Services.** This service is intended to help organizations manage risk. The overall approach may be viewed as one of (1) identifying and analyzing risks, (2) designing and implementing strategies related to risks, and (3) measuring, monitoring, and reporting on solutions.

e. **CPA ElderCare/Prime Plus.** CPA ElderCare/Prime Plus services is designed to provide assurance to individuals that their elderly family members' needs are being met by various institutions and professionals by comparing its specific objectives in providing care with actual services rendered. These services may include financial services such as goal setting, funding analysis, cost management, and needs assessment or non-financial services such as interpersonal and relationship management. Exhibit 1.4 provides more detailed examples of these services.

EXHIBIT 1.4 Examples of Eldercare/Prime Plus Services

Financial Services	Non-financial Services
▪ Evaluating financing options ▪ Receiving, depositing, and accounting for clients receipts ▪ Ensuring that expected revenues are received ▪ Submitting claims to insurance companies ▪ Tax planning and return preparation ▪ Evaluating investments and trust activity ▪ Portfolio management ▪ Risk management and insurance planning	▪ Lifestyle planning ▪ Lifestyle management services ▪ Coordinating support and health care services ▪ Helping family members monitor the elder's care ▪ Communicating family expectations to care providers ▪ Establishing, in concert with the family, appropriate standards of care ▪ Establishing performance monitoring systems

f. **Health Care Performance Measurement.** Health care recipients and their employers are increasingly concerned about the quality and availability of health care services. This service provides assurance about the effectiveness of health services provides by health maintenance organizations, hospitals, doctors and other health care providers.

NON-ASSURANCE ENGAGEMENTS

Not all engagements performed by practitioner are assurance engagements. Other frequently performed engagements that are not assurance engagements (and therefore expressly excluded from the Philippine Framework on Assurance Engagements) include:

- Non-assurance engagements such as agreed-upon procedures engagements and compilations of financial or other information.
- The preparation of tax returns where no conclusion conveying assurance is expressed.
- Consulting (or advisory) engagements such as management and tax consulting, where no opinion on the subject matter is expressed.

REPORTS ON NON-ASSURANCE ENGAGEMENTS

A practitioner reporting on a non-assurance engagement within the scope of the Framework clearly distinguishes that report from an assurance report. So as not to confuse users, a report that is not an assurance report avoids, for example:

- Implying compliance with this Framework, PSAs, PSREs or PSAEs;
- Inappropriately using the words "assurance," "audit" or "review"; and
- Including a statement that could reasonably be mistaken for a conclusion designed to enhance the degree of confidence of intended users about the outcome of the evaluation or measurement of a subject matter against criteria.

REVIEW QUESTIONS

1. What is an assurance services? What are the important concepts of an assurance services? What is the difference between independence in mind and independence in appearance?

2. What is an assurance engagement? Define the following important concepts of an assurance engagement: (a) practitioners, (b) intended users, (c) responsible party, (d) subject matter and subject matter information, and (e) criteria.

3. What are the two types of assurance engagement a practitioner is permitted to perform? Differentiate one from the other.

4. What is the difference between assertion-based engagement and direct reporting engagement? Differentiate the objective of an assertion-based engagement and direct reporting engagement.

5. What are the factors that auditors should consider before an accepting assurance engagement? What is the objective of considering these factors in an auditor's engagement acceptance procedures?

6. What are the five elements of assurance engagements?

7. What are the five factors affecting the practitioner's performance of an assurance engagement? Explain how these factors affect the performance of an engagement.

8. What the other assurance engagements that an auditor usually performs?

9. What are the examples of non-assurance engagements? What should an auditor avoid in preparing non-assurance engagement reports?

MULTIPLE CHOICE QUESTIONS

1. A practitioner's assurance report contains the following conclusion:

   "Based on our work described in this report, nothing has come to our attention that causes us to believe that internal control is not effective, in all material respects, based on ABC criteria."

   What type of assurance engagement was performed?
   a. Reasonable assurance engagement.
   b. Positive assurance engagement.
   c. Negative assurance engagement.
   d. Limited assurance engagement. → THE QUESTION IS WHAT TYPE OF ASSURANCE ENGAGEMENT WAS PERFORMED.

2. The following are characteristics of "direct reporting" assurance engagements, except
   a. The practitioner either directly performs the evaluation or measurement of the subject matter or obtains a representation from the responsible party that has performed the evaluation or measurement.

   → EVEN IF THE RESPONSIBLE PARTY MEASURES THE SM, THERE IS STILL AN ASSERTION ASSERTING APPROPRIATE CRITERIA.
   - THE ASSURANCE REPORT PROVIDES DESCRIBES THIS ENOUGH FOR THE USERS TO UNDERSTAND

b. The representation of the responsible party that has performed the evaluation or measurement of the subject matter is not available to the intended users.
c. The subject matter information is in the form of an assertion by the responsible party that is made available to the intended users.
d. The subject matter information is provided to the intended users in the assurance report.

3. An assurance engagement should exhibit the following elements except
a. A conclusion.
b. A subject matter.
c. A three party relationship.
d. Appropriate professional fee.

4. Assurance engagements involve
a. Three separate parties: a professional accountant, intended users, and responsible party.
b. Two separate parties: a professional accountant and a responsible party.
c. Two separate parties: a professional accountant and intended users.
d. Two separate parties: a responsible party and intended users.

5. Which of the following is incorrect regarding the "three-party relationship" element of assurance engagements?
a. The responsible party is the person or persons, either as individuals or representatives of an entity, responsible for the subject matter.
b. The responsible party and the intended user will often be from separate organizations but need not be.
c. The intended user is the person or class of persons for whom the professional accountant prepares the report for a specific use or purpose.
d. Professional accountants as those persons who are members of an IFAC member body, which should be in public practice.

6. Which of the following statements is incorrect regarding the three-party relationship element of an assurance engagement?
a. The responsible party and the intended user will often be from separate organizations.
b. The responsible party is generally the addressee of the professional accountant's report.
c. The responsible party may also be one of the intended users.
d. The responsible party may not be the party who engages the professional accountant.

7. In an assurance engagement, the person or persons, either as individuals or representatives of a entity, responsible for the subject matter is the
a. Client.
b. Intended user.
c. Practitioner.
d. Responsible party.

8. In an assurance engagement, the person or class of persons for whom the professional accountant prepares the report for a specific use or purpose is the
a. Client.
b. Intended user.
c. Practitioner.

d. Responsible party.

9. The subject matter of an assurance engagement may include
   a. An entity's internal control or IT system.
   b. Compliance with regulations.
   c. Historical or prospective financial information.
   d. All of the above.

10. The subject matter of an assurance engagement may take many forms, including
   a. Behavior.
   b. Data.
   c. Systems and processes.
   d. All of these.

11. These are the benchmark used to evaluate or measure the subject matter of an assurance engagement.
   a. Assertions.
   b. Conclusions.
   c. Criteria
   d. Principles

12. The decision as to whether the criteria are suitable involves considering whether the subject matter is capable of reasonably consistent evaluation against or measurement using such criteria. The characteristics for determining whether criteria are suitable include the following, except:
   a. Relevance.
   b. Reliability.
   c. Sufficiency
   d. Understandability

13. Assurance engagement risk is the risk
   a. Of expressing an inappropriate conclusion when the subject matter information is not materially misstated.
   b. Of expressing an inappropriate conclusion when the subject matter information is either materially misstated or not materially misstated.
   c. That the practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated.
   d. Through loss from litigation, adverse publicity, or other events arising in connection with a subject matter reported on.

14. Attestation services on information technology include WebTrust services and SysTrust services. Which of the following statements most accurately describes SysTrust services?
   a. SysTrust services provide assurance as to whether accounting personnel are following procedures prescribed by the company controller.
   b. SysTrust services provide assurance on business processes, transaction integrity and information processes.
   c. SysTrust services provide assurance on internal control over financial reporting.
   d. SysTrust services provide assurance on system reliability in critical areas such as security and data integrity.

15. Which of the following professional services would be considered an assurance engagement?
   a. A compilation of financial statements from a client's accounting records.
   b. A management consulting engagement to provide IT advice to a client.
   c. An engagement to report on compliance with statutory requirements.
   d. An income tax engagement to prepare tax returns.

16. Engagements frequently performed by professional accountants that are not assurance engagements include the following except
    a. Agreed-upon procedures.
    b. Compilation.
    c. Compliance audit.
    d. Management consulting.

17. Which of the following statements best describes assurance services?
    a. The preparation of financial statements or the collection, classification, and summarization of other financial information.
    b. Services designed to express an opinion on the fairness of historical financial statements based on the results of an audit. → only audit engagement not assurance
    c. Services designed for the improvement of operations, resulting in better outcomes. → internal audit / consulting
    d. Independent professional services that are intended to enhance the credibility of information to meet the needs of an intended user.

18. Unlike consulting services, assurance services
    a. Report on the quality of information.
    b. Report on how to use information.
    c. Make recommendations to management.
    d. Are two-party contracts.

19. Assurance engagement
    a. Is an engagement intended to enhance the credibility of information about a subject matter by evaluating whether the subject matter conforms in all material respects with suitable criteria, thereby improving the likelihood that the information will meet the needs of an intended user. → more conceptual and purpose oriented
    b. Is an engagement in which the auditor provides a moderate level of assurance that the information subject to the engagement is free of material misstatement.
    c. Is an engagement in which a practitioner is engaged to issue, or does issue, a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party. → assertion-based not general assurance
    d. Is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users. → ISAE 3000

20. Which statement is correct regarding assurance engagements?
    a. All engagements performed by professional accountants are assurance engagements.
    b. All engagements undertaken by an auditor that is similar to an agreed-upon procedures engagement does not result in the expression of a conclusion that provides a level of assurance.
    c. The objective of an assurance engagement is for a professional accountant to evaluate or measure a subject matter that is the responsibility of another party against identified suitable criteria, and to express a conclusion that provides the intended user with a level of assurance about that subject matter.
    d. Whether a particular engagement is an assurance engagement will depend upon whether it exhibits all the following elements - a three party relationship, a subject matter, suitable criteria and a conclusion. [need S/A evidence]

21. Which of the following best describes the objective of an assurance engagement?

a. To compare the company's information and policies to those of other entities.
b. To enhance the credibility of information in order to improve the likelihood that the information will meet the needs of an intended user.
c. To improve the company's outcomes.
d. None of the above.

22. A practitioner who is engaged to perform an assurance engagement other than an audit or a review of historical financial information should comply with which of the following standards?
a. PSAEs and PSAs.
b. PSAEs, PSREs, and PSAs.
c. PSAEs.
d. PSAs and PSREs.

23. Which of the following is incorrect regarding the Philippine Standards on Assurance Engagements (PSAE)?
a. If no specific standards exist for an assurance engagement, PSAE apply.
b. It provides an overall framework for assurance engagements intended to provide either a high or moderate level of assurance.
c. It provides basic principles and essential procedures for engagements intended to provide a moderate level of assurance.
d. When a professional accountant is engaged to perform an assurance engagement for which specific standards exist, those standards apply.

24. Assurance engagements encompasses the following types of services, except:
a. Review engagements.
b. Management consulting.
c. Audit of historical financial statements.
d. Attestation services.

25. What type of assurance engagement is involved when the practitioner expresses a negative form of conclusion?
a. Reasonable assurance engagement.
b. Negative assurance engagement.
c. Limited assurance engagement.
d. Assertion-based assurance engagement.

26. In some assurance engagements, the evaluation or measurement of the subject matter is performed by the responsible party, and the subject matter information is in the form of an assertion by the responsible party that is made available to intended users. These engagements are called
a. Recurring engagements.
b. Non-assurance engagements.
c. Direct reporting engagements.
d. Assertion-based engagements.

27. Suitable criteria are required for reasonably consistent evaluation or measurement of the subject matter of an assurance engagement. Which of the following statements concerning the characteristics of suitable criteria is correct?
a. Criteria are sufficiently complete when they contribute to conclusions that are clear, comprehensive, and not subject to different interpretations.

① RELEVANT = HELPS USERS MAKE DECISIONS
② COMPLETE = COVERS ALL MATERIAL ASPECTS
③ RELIABLE = CONSISTENT, ACCURATE, VERIFIABLE
④ NEUTRAL = FREE FROM BIAS

b. Neutral criteria contribute to conclusions that are free from bias.
c. Relevant criteria allow reasonably consistent evaluation or measurement of the subject matter including, where relevant, presentation and disclosure, when used in similar circumstances by similarly qualified practitioners. → THIS IS RELIABLE CRITERIA
d. Reliable criteria contribute to conclusions that are clear, comprehensive, and not subject to significantly different interpretations.
↳ NOT PART OF RELIABLE DEFINITION

28. Criteria that are embodied in laws or regulations, or issued by authorized or recognized bodies of experts that follow a transparent due process are called
a. Established criteria. → WIDELY ACCEPTED BENCHMARKS [IFRS / GAAP]
b. General criteria. → BROAD STANDARDS [KEY GUIDING PRINCIPLES / IT GOVERNANCE]
c. Specifically developed criteria. → PARTICULAR ENGAGEMENT [PERFORMANCE BENCHMARK]
d. Suitable criteria. → APPROPRIATE AND FIT FOR THE ENGAGEMENT

29. In an assurance engagement, the outcome of the evaluation or measurement of a subject matter against criteria is called
a. Assurance.
b. Conclusion.
c. Subject matter information.
d. Subject matter.

30. Which statement is incorrect regarding assurance engagement risk?
a. All components of the engagement risk model will be significant for all assurance engagements.
b. Business risk is not part of engagement risk and does not affect the application of Philippine Standard on Assurance Engagements. ✓
c. Engagement risk is the risk that the practitioner will express an inappropriate conclusion that the subject matter conforms in all material respects with suitable criteria. ✓
d. The extent to which the practitioner considers the relevant components of engagement risk will be affected by the engagement circumstances. ✓

31. Auditing is a systematic process that includes all of the following except
a. Degree of correspondence between these assertions and established criteria
b. Assertions about economic actions and events
c. Systematic process
d. Objectively obtaining and evaluating assurance evidence

32. If information accompanying the basic financial statements in an auditor-submitted document has been subjected to auditing procedures, the auditor may express an opinion which states that the accompanying information is fairly states in
a. Terms of positive assurance only.
b. Conformity with the principles for presenting accompanying information.
c. Conformity with Auditing Standards.
d. All material respects in relation to the basic financial statements taken as a whole.

33. An accountant who is not independent may issue all of the following except
a. Review report
b. Non-assurance report. ✓
c. Compilation report ✓
d. Agreed upon procedures ✓

34. The independent auditor's plan for an audit in accordance with generally accepted auditing standards is influenced by the possibility of material errors. The auditor will therefore conduct the examination with the attitude of
    a. Subjectivity.
    b. Professionalism.
    c. Professional skepticism.
    d. Objectivity.

35. Components of audit risk may be assessed both in quantitative and non-quantitative (qualitative) terms. Which of the following is an example of quantitative terms?
    a. Percentages
    b. High or Low.
    c. Favorable or Unfavorable
    d. Positive or Negative

36. The WebTrust engagement relates most directly to
    a. Financial statements maintained on the internet.
    b. Health care facilities.
    c. Risk assurance procedures.
    d. Electronic commerce systems.

37. It means an attitude of impartiality. → FREEDOM FROM BIAS, FAVORITISM, AND UNDUE INFLUENCE.
    a. Independence in fact
    b. Independence in tact
    c. Independence in appearance
    d. State of mind

38. Materiality
    a. gauge through the use of the quantitative characteristics only of the business as going concern entity. X → IT INCLUDES QUALITATIVE FACTORS
    b. measured using the standards in auditing. ✓
    c. rest with the practitioner's skepticism.
    d. stated in peso or certain amount.

39. Which of the following criteria is unique to the auditor's attest function?
    a. Due professional care
    b. General competence
    c. Higher level knowledge for a particular industry
    d. Independence

40. In determining whether transactions were really exist, the direction of the audit testing should be from the
    a. Original Source Documents
    b. General Ledger Balances
    c. General Journal Entries
    d. Financial Statements FS → GD = VOUCHING

41. It is an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.
    a. Attestation engagement
    b. Assurance engagement
    c. Financial audit engagement
    d. Other engagement

COMPREHENSIVE CASES

CASE 1 – Evaluating and Planning an Assurance Engagement

Princess Mae Asuncion of Two Brothers Grocery, Inc. has asked you and your team to meet with her concerning a possible assurance engagement relating to the assertion that Two Brothers has the lowest overall prices of all grocery items in the Vigan City area. Two Brothers has just recently moved into the Vigan City area and is trying to establish a high volume, profitable position. Asuncion has suggested to you that she believes that while Two Brothers certainly doesn't have the lowest prices on all of the 12,500 types of items it sells, on most any rational basis she believes that its prices are "on the whole" lower than competition – JTC, Ergo, and Super 8. In thinking about this, you realize that to perform such an assurance engagement, suitable criteria must be used to evaluate the subject matter.

Required:

1. For this engagement, what would you consider to be the subject matter?

2. Provide an approach on how one might derive suitable criteria for such an engagement, given that costs are considered lowest on an overall basis, but not necessarily for every item.

3. Discuss the nature of the required assertion from management for an engagement such as this.

CASE 2 – Proposing an Assurance Engagement

To compete with manufacturers like Burrows Company Ltd., Snowfield Corporation, a manufacturer of mainframe servers, makes oral claims of product superiority to engineers and scientists, their targeted end users. Some of the claims amount to little more than puffery, "the best..., the most...," but others relate to performance and to market share. Two that are particularly important to Michael Snowfield, the corporation's chief executive officer, are:

- Average end-user support time is 150 hours per end-user.
- Four-hundred satisfied customers.

During the financial statement audit, Belinda Tolentino, engagement partner, discovers that the performance and market share claims will be made in an upcoming advertising campaign and included in sales contracts. Tolentino decides to propose an assurance service to Michael Snowfield.

Required:

1. What argument could Tolentino make to justify that the proposed assurance service will add value to Snowfield Corporation's product-performance and market-share claims?

2. Use your imagination to explain what evidence Tolentino would gather to test Snowfield's claims.

Chapter 2
INTRODUCTION TO AUDITING AND FINANCIAL STATEMENT AUDIT

LEARNING OBJECTIVES

Upon completion of this chapter you will

1. **Understand the basic concept and objective of auditing.**
2. **Understand why there is a demand for auditing.**
3. **Understand the meaning of information risk and how it will be reduced.**
4. **Understand the philosophy of an audit.**
5. **Understand the economic benefits of a financial statement audit.**
6. **Understand the limitations of a financial statement audit.**
7. **Know the different types of auditors.**
8. **Know the different types of audits.**
9. **Be familiar with the history of auditing.**
10. **Recognize the relationship and differences of accounting and auditing.**

DEFINITION OF AUDITING

In today's environment, the type of assurance engagement that is most common is an audit of historical financial information. Part of the reason for this is that the requirement for an audit is contained in many pieces of legislation, including the Corporation Code of the Philippines, which governs the audit of annual financial reports for reporting entities.

Interestingly, auditing, or the audit of financial reports, is no longer defined in the Auditing and Assurance Standards Council (AASC) Glossary. In Philippine Standards on Auditing (PSA) 200.11, the objectives of the auditor in undertaking an audit of a financial report are stated as follows:

a. *To obtain reasonable assurance about whether the financial report as a whole is free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial report is prepared, in all material respects, in accordance with an applicable financial reporting framework; and*

b. *To report on the financial report, and communicate as required by the Philippine Auditing Standards, in accordance with the auditor's findings.*

While these objectives describe the expected outcomes, they do not describe the process. A useful definition is that developed by the American Accounting Association (AAA) in *A Statement of Basic Auditing Concepts* (ASOBAC). It defines auditing as:

> *A systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between these assertions and established criteria and communicating the results to interested users.*

This definition contains several ideas important in a wide variety of audit practices. The attributes of auditing contained in this definition that merit special comment are as follows:

1. A systematic process – connotes a purposeful and logical steps and is based on the discipline of a structured and organized series of procedures to decision making. It is not haphazard, unplanned, or unstructured.

2. Objectively obtaining and evaluating evidence – means examining the underlying support for assertions or representations and judiciously evaluating the results without bias or prejudice either for or against the individual or entity making the assertions.

3. Assertions about economic actions and events – are the information or representations made by the individual or entity. They comprise the subject matter of auditing. Assertions include information contained in the financial statements, management internal operating reports, and tax returns.

4. Degree of correspondence – refers to the closeness with which the assertions can be identified with the established criteria. The expression of correspondence may be quantified, such as the amount of a shortage in a petty cash fund, or it may be qualitative, such as the fairness of financial statements.

5. Established criteria – are the standards against which the assertions or representations are judged. Established criteria may be specific rules prescribed by a legislative or regulatory body, budgets and other measures of performance set by management, or the Philippine Financial Reporting Standards (PFRS).

6. Communicating the results – is the communication of the auditor's findings to users and is achieved through a written report, called audit report, that inform readers of the degree of correspondence between the assertions and established criteria. The communication of results either enhances or weakens the credibility of the representations made by another party. The goal of the audit process is to add credibility to management's representations so that interested users can use the information with reasonable assurance that it is free of material misstatement.

7. Interested users – are individuals or entities who rely on the auditor's findings. In a business environment, they include stockholders, management, employees, creditors, governmental agencies and the general public.

Exhibit 2.1 depicts an overview of financial statement auditing.

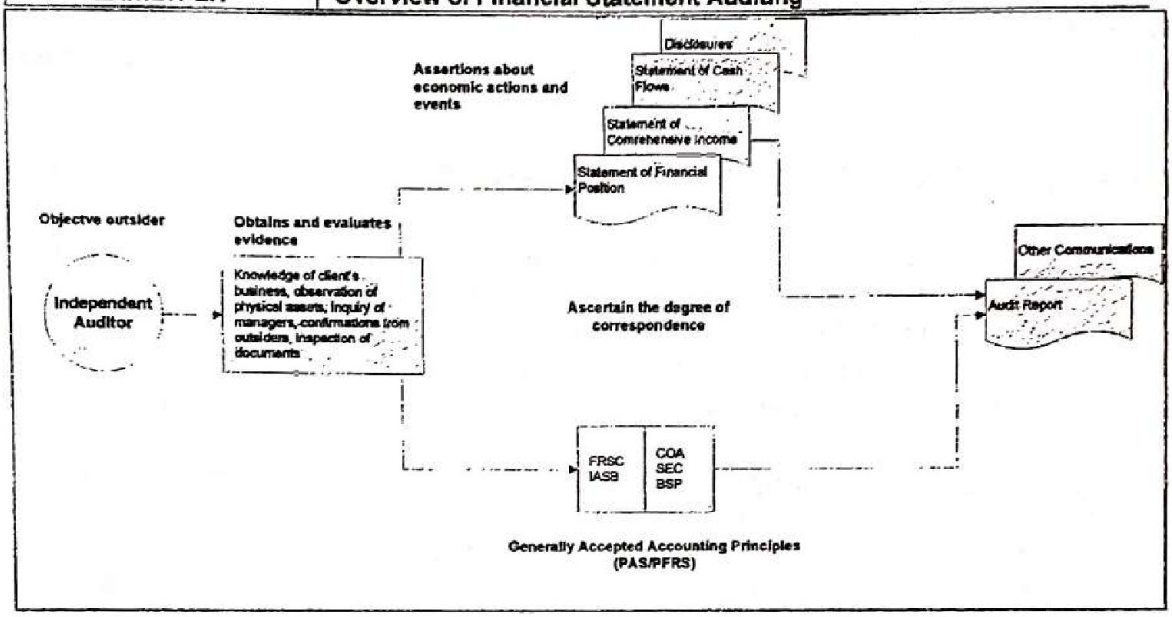
This broad definition reflects the essential nature of all assurance engagements as investigative processes sufficient to encompass the many different purposes for which an assurance service might be conducted.

OBJECTIVE OF A FINANCIAL STATEMENT AUDIT

The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework. The phrase used to express the auditor's opinion is "present fairly, in all material respects".

Although the auditor's opinion enhances the credibility of the financial statements, the user cannot assume that the opinion is an assurance as to the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity.

EXHIBIT 2.1 **Overview of Financial Statement Auditing**



GENERAL PRINCIPLES OF A FINANCIAL STATEMENT AUDIT

The auditor should comply with the "Code of Professional Ethics for Certified Public Accountants" promulgated by the Board of Accountancy and approved by the Philippine Professional Regulation Commission. Ethical principles governing the auditor's professional responsibilities are:

- Independence.
- Integrity.
- Objectivity.
- Professional competence and due care.
- Confidentiality.
- Professional behavior.
- Technical standards.

The auditor should conduct an audit in accordance with Philippine Standards on Auditing (PSA). These contain basic principles and essential procedures together with related guidance in the form of explanatory and other material.

The auditor should plan and perform the audit with an attitude of professional skepticism recognizing that circumstances may exist which cause the financial statements to be materially misstated. For example, the auditor would ordinarily expect to find evidence to support management representations and not assume they are necessarily correct.

SCOPE OF A FINANCIAL STATEMENT AUDIT

The term "scope of an audit" refers to the audit procedures deemed necessary in the circumstances to achieve the objective of the audit. The procedures required to conduct an audit in accordance with Philippine Standards on Auditing should be determined by the auditor having regard to the requirements of Philippine Standards on Auditing, relevant professional bodies, legislation, regulations and, where appropriate, the terms of the audit engagement and reporting requirements.

DEMAND FOR FINANCIAL STATEMENT AUDIT

Users of financial statements look to the independent auditor's report for assurance about reliability of information and its conformance to the applicable financial reporting framework (e.g., Philippine Financial Reporting Standards). The need for independent audits of financial statements can further be attributed to four conditions as follows: (1) complexity of transactions, (2) remoteness of information, (3) biases and motives of the provider, and (4) consequence.

1. Complexity of Transactions – Both the transactions between organizations and the process of preparing financial statements have become numerous and increasingly complex and therefore more difficult to record properly. As the level of complexity increases, the risk of misinterpretations and of intentional or unintentional misstatements also increases. Finding it impossible to evaluate the quality of the financial statements themselves, users rely on the independent auditors to assess the reliability of the information contained in the statements.

   The volume and complexity of economic activities in business and related authoritative pronouncements often require the assistance and objective evaluation of professional accountants to properly record the transactions related to those economic activities.

2. Remoteness of Information – In today's global economy, it is virtually impossible users of financial information to have much firsthand knowledge about the organization with which they do business. Distance, time, cost, as well as lack of expertise, make it impractical for decision makers to seek direct access to the underlying accounting records to perform their own verifications of the financial statement. Rather than accept the quality of the financial data provided by others, users rely on the independent auditor's report to meet their needs.

   The separation between the transactions details (e.g., supporting documents of the journal entries) that produce financial statements and the users who need to make decisions based on those financial statements creates a demand for an independent party to examine the information for multiple users.

3. Biases and Motives of the Provider – If the information is provided by someone whose goals are inconsistent with those of the user of the financial statements, the information may be biased in favor of the provider. Many users of financial statements are concerned about conflict of interest between themselves and the management of the reporting entity. The apprehension extends to a fear that the financial statements prepared by management may be significantly biased in favor of the management and do not represent the actual results of operations of the reporting entity. Users seek assurance from independent auditors that financial statements are free of management biases.

Biases and potential conflicts of interests of persons who provide information about the economic activities create a demand for an independent party to lend credibility to the provider's information.

4. Consequences – Financial statements represent an important and, in some cases, the only source of information used in making significant business decisions. Thus, users want the financial statement to contain as much relevant and reliable information as possible. This need is recognized by the extensive disclosure requirements imposed by the Securities and Exchange Commission and other regulatory agencies such as Insurance Commission and Bangko Sentral ng Pilipinas. It is also recognized by the relevance of the financial statements disclosures to many lenders. Financial statement users look to the independent auditor for assurance that the financial statements have been prepared in conformity with the applicable financial reporting framework, including all the appropriate disclosures.

   Economic activities involve many different types of users who create a demand for an independent party to increase the relevance and reliability of the information they use to make a wide variety of decisions which significantly affect many people.

These four conditions collectively contribute to **information risk**, which is the risk that the information used to assess business risk is not accurate or misleading. Information risk includes the possibility that the financial statements may be incorrect, incomplete, or biased. Thus, it can be said that financial statement audits enhance the credibility of financial statement by reducing information risk. ~ RISK THAT THE INFORMATION PROVIDED BY MANAGEMENT IS INCORRECT, MISLEADING, OR BIASED. [RISK THAT THE FS IS WRONG]

REDUCING INFORMATION RISK

After comparing costs and benefits, managers and financial statement users may conclude that the best way to deal with information risk is simply to have it remain reasonably high. A small company may find it less expensive to pay higher interest costs than to increase costs of reducing information risk. For larger businesses, it is usually practical to incur costs to reduce information risk. Three main ways to do so are as follows: (1) user verifies information, (2) user shares information risk with management, and (3) user are provided with audited financial statements.

1. User Verifies Information – The user may go to business premises to examine books of accounts and other accounting records in order to obtain information about the reliability of the financial statements. Normally, this is impractical because of costs of doing so. In addition, it would be economically inefficient for all users to verify the information individually.

2. User Shares Information Risk with Management – Management is responsible for providing reliable information to users. If users rely on inaccurate financial statements and as a result incur financial loss, they may have a basis for a lawsuit against management. A difficulty with sharing information risk with management is that users may not be able to collect on losses. If a company is unable to repay a loan because of bankruptcy, it is unlikely that management will have sufficient funds to repay users.

3. User Are Provided With Audited Financial Statements – The most reasonable and common way for users to obtain reliable information is to have it audited. Decision makers can then use the audited information on the assumption that it is reasonably complete, accurate, and unbiased.

Typically, the management or audit committee of the board of directors of a company engages an independent auditor to provide assurance to users that the financial statements are free from material misstatements. If the financial statements are ultimately determined to be misleading, the auditor can be sued by both the management and users.

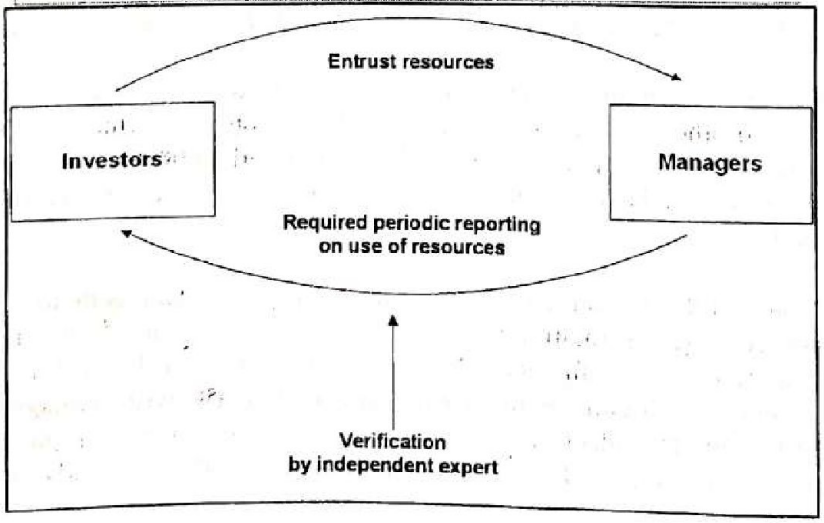
THE PHILOSOPHY OF AN AUDIT AND NOTION OF ACCOUNTABILITY, STEWARDSHIP AND AGENCY

Principals (i.e., business owners) appoint agents (i.e., managers) and delegate some decision making authority to them. In doing so, principals place trust in their agents to act in the principals' best interest. However, as a result of information asymmetries between principals and agents and differing motives, principals may lack trust in their agents and may therefore need to put in place mechanism, such as the audit, to reinforce this trust. The philosophical theories that explain the demand for auditing and support the performance of an independent audit are as follows: (a) stewardship or agency theory, (2) motivational theory, (3) information theory, and (4) insurance theory.

1. Stewardship or Agency Theory – Stewardship or agency theory implies that the manager (as well as the owners or investors) wants the credibility an audit adds to the financial statement assertions. The manager is the agent or steward of the owners or investors, but each party acts in his or her own self-interest and the goals or objectives of each party are different. This situation inevitably creates conflict between the owner and manager. The owner perceives that the manager's goals or objectives may be detrimental to the owner's own goals. Thus, the manager wants financial statement representations audited by an independent party to enhance his or her stewardship of these financial statements and to lessen the owner's mistrust of the manager.

   Exhibit 2.2 is simple diagram on agency relationship between managers and its investors.

EXHIBIT 2.2 Agency Relationship



2. Motivational Theory – Preparers of financial statements know that their assertions will be subjected to an audit; thus, financial statements will be brought more in line with accounting standards. The motivational benefits of an audit are difficult to prove

conclusively, but some believe that management's knowledge that an audit will be performed mitigates against improper financial statement preparation.

3. Information Theory – An assurance service is a means of improving the quality of information. For example, investors require information to make an assessment of expected returns and risks associated with their investment. An assurance service is also valued as a means of improving financial and non-financial data for internal decision making, detecting errors and motivating employees to exercise more care in preparing records.

   The information theory also states that investors benefit through the increased confidence of external users of the information. For example, for private companies seeking funds from lending institutions, the costs incurred in audit fees were more than recompensed by the increased savings associated with lower interest rates when compared with the interest rates charged to similar companies that weren't audited.

4. Insurance Theory – The insurance theory states that demand for assurance occurs from those who may suffer loss when things go wrong. For example, if an organization goes into liquidation and has no resources to pay its debts, it may be possible to recover some of the losses from the auditor. As auditors are required to have insurance against such potential losses, this has given rise to a 'deep-pockets' effect in that the auditor is seen to have a greater ability to pay. As audit firms will be very concerned with maintaining their reputation, any legal action undertaken against them may damage this reputation will be treated very seriously.

ECONOMIC BENEFITS OF A FINANCIAL STATEMENT AUDIT

Among the economic benefits of financial statement audits are the following: (1) access to capital markets, (2) lower cost of capital, (3) deterrent to inefficiency and fraud, and (4) control and operational improvements.

1. Access to Capital Markets – public companies must satisfy statutory audit requirements under the securities acts in order to register securities and have them traded on securities markets. In addition, stock markets may impose their own requirements for listing securities. Without audits, companies would be denied access to these capital markets and many private companies would be denied access to loans.

2. Lower Cost of Capital – companies often engages auditor to have their financial statement audited in order to obtain bank loans with more favorable terms. Because of the reduced information risk associated with audited financial statements, creditors may offer loans with lower interest rates.

3. Deterrent to Inefficiency and Fraud – research has demonstrated that when employees know that an independent audit is to be made, they take care to make fewer errors in performing accounting functions and are less likely to misappropriate company assets. Thus, the data in company records will be more reliable, and losses from embezzlements and the like will be reduced. In addition, the fact that financial statement assertions are to be verified reduces the likelihood that management will engage in fraudulent financial reporting.

4. Control and Operational Improvements – the independent auditor often makes suggestions to improve internal control, to evaluate management's assessments of business risks, to recommend improved performance measures and to make recommendations to achieve greater operational efficiencies within the client's organization.

LIMITATIONS OF A FINANCIAL STATEMENT AUDIT

A financial statement audit is subject to a number of inherent limitations. One constraint is that the auditor works within fairly restrictive economic limits. Following are two important economic limitations.

1. Reasonable Cost – A limitation on the cost of an audit results in selective testing, or sampling, of the accounting records and supporting data. In addition, the auditor may choose to test internal controls and may obtain assurance from a well-functioning system of internal controls.

2. Reasonable Length of Time – time constraint may affect the amount of evidence that can be obtained concerning events and transactions after the balance sheet date that may have an effect on the financial statements. Moreover, there is a relatively short time period available for resolving uncertainties existing at the statement date.

Another significant limitation is the established accounting framework for preparing financial statements. Following are two important limitations associated with the established accounting framework.

3. Alternative Accounting Principles – Alternative accounting principles are permitted under GAAP. Financial statement users must be knowledgeable about a company's accounting choices and their effect on financial statements.

4. Accounting Estimates – Estimates are an inherent part of the accounting process, and no one, including auditors, can foresee the outcome of uncertainties. Estimates range from the allowance for doubtful accounts and an inventory obsolescence reserve to impairment tests for fixed assets and goodwill. An audit cannot add exactness and certainty to financial statements even if these factors do not exist.

Despite these limitations, a financial statement audit adds credibility to the financial statements.

RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

While the auditor is responsible for forming and expressing an opinion on the financial statements, the responsibility for preparing and presenting the financial statements (i.e., assertions embodied within the financial statements) is that of the management of the entity. For example, management, not the auditor, is responsible that all recorded assets and liabilities exist, that all recorded transactions occurred, that no transactions are omitted, that assets are the rights and liabilities are the obligations of the entity, that all disclosed amounts are appropriate, and that the financial statements are properly classified and disclosed. Moreover, the audit of the financial statements does not relieve management of its responsibilities.

TYPES OF AUDITORS

Individuals who are engaged to audit economic actions and events can be classified into three groups as follows: (1) external or independent auditors, (2) internal auditors, and (3) government auditors.

1. External or independent auditors – are certified public accountants (CPA) who have their own independent accounting practices that provide independent auditing services of client financial statements. Independent auditors mostly perform financial statement audits, but they may also perform compliance and operational audits. They are also referred to as external auditors.

2. Internal auditors – are employees of the entities they audit and are primarily concerned in determining whether organizational policies and procedures have been followed in safeguarding the entity's assets. They are involved in an independent appraisal activity called internal auditing, which is designed to assist the management of the organization in the effective discharge of its responsibilities. Internal auditors generally perform compliance and operational audits.

   The internal auditing staff often reports to the president and also to the audit committee of the board of directors. This is to ensure that the internal auditors will have ready access to all units of the organization, and their recommendations will be given prompt attention by department heads. It is also necessary that the internal auditors be independent of the department heads and other line executives whose work they review.

3. Government auditors – are engaged to provide assurance that all local and national governmental agencies, including government owned and controlled corporations, have complied with laws, rules, regulations, policies, and procedures. Government auditors generally conduct comprehensive audits which combine elements of financial, compliance and operational auditing.

   Government auditors perform audits to determine that spending programs follow the intent of Congress and operational audits to evaluate the effectiveness and efficiency of selected government programs Government auditors also conduct examinations of government owned and controlled corporations' financial statements.

TYPES OF AUDITS

Audits are generally classified into different types of activities as follows: (1) financial or independent audits, (2) compliance audits, and (3) operational audits.

1. Financial or independent audits – is an audit of the financial statements of an entity. It involves obtaining and evaluating evidence about an entity's presentation of its financial position, results of operations, and cash flows for the purpose of expressing an opinion as to whether they are presented fairly in accordance with a specified financial reporting framework or criteria most often the Philippine Financial Reporting Standards (PFRS).

2. Compliance audits – involves obtaining and evaluating evidence to determine whether certain financial or operating activities of an entity conform to established policies and

procedures, conditions, laws, rules, or regulations set by some higher authority that may have a material effect on the financial statements.

For example, auditors may perform an audit to provide assurance that the client is in compliance with loan covenants established by the client's lender (e.g., banks and other financial institutions) in financing agreements such as whether the client maintained or exceeded the specified minimum debt to equity ratio level.

3. Operational audits – is a study of a specific unit of an organization for the purpose of measuring its performance. It involves obtaining and evaluating evidence about the efficiency, economy and effectiveness of an entity's operating activities, policies and procedures in relation to specified objectives. At the completion of an operational audit, management normally expects recommendations for improving operations. This type of audit is sometimes referred to as a performance audit or a management audit.

   For example, auditors may perform an audit of a client's employee cash advance liquidation policy to determine that approved business expenses are liquidated by the employees (effectiveness), the expenses incurred are ordinary and reasonable, and the process of liquidating the expenses is fair and timely (efficient).

Table 2.1 summarizes the basic differences between the financial statement audit, compliance audit and operational audit as to purpose, users of report, report and criteria.

TABLE 2.1 Differences Between Financial Statement Audit, Compliance Audit and Operational Audit

	Financial Statement Audit	Compliance Audit	Operational Audit
Purpose	Express an opinion on the fairness of financial information (i.e., presentation of financial statements)	To determine whether client is following specified procedures set by higher authority (i.e., policies, laws, regulations, etc.)	To determine the efficiency, economy and effectiveness of an entity's operating activities
Users of Report	Shareholders, creditors, regulatory agencies and general public	Board of directors, management of the entity or third parties setting down procedures	Board of directors, management of the entity or third parties
Report	Opinion of independent CPA	Summary of findings or assurance degree of compliance	Summary of findings regarding efficiency and effectiveness observed
Criteria	Identified financial reporting framework (e.g., PFRS)	Management policies, rules or regulations	Performance measures, indicators or objectives as determined by the management

ORIGIN AND HISTORY OF AUDITING

The *Concise Oxford Dictionary* defines 'account' variously, including 'to answer for', and the 'reckoning of money held in trust'. In these senses of the word, traces of accounting can be found

in the histories of the earliest civilization, even those in which the art of the recorded word was little known.

The following discussion relates to the history of auditing from the primitive until the emergence of auditing firms and popularization of auditing in the United States of America.

Primitive Auditing

Accounting in those far-off days could only have taken place orally. The steward in charge of the cattle, goods and other forms of wealth would, from time to time, produce to his master the wealth with which he was entrusted and give an account of his stewardship, reciting from memory the goods and chattels acquired, those disposed of and those still in his possession. The master would listen to this recital of the steward's transaction and question him thereon. The master was the listener, the auditor. So the word "auditor" (derived from the Latin word *audire*, which means to hear) acquired a secondary meaning: "one who satisfies himself as to the truth of the accounting of another".

Auditing in Ancient Egypt and Babylonia

With the advent of writing and the acquisition of the art by the most literate of the population, some form of written record was kept by the steward and the master (or his delegate) examined the record. So there evolved, side by side, the art of bookkeeping and the practice of auditing, the latter no longer being confined to a mere listening to an account of stewardship.

A method of auditing that seemed to be prevalent in ancient Egypt and Babylonia consisted of, in part, two or more officials keeping separate records and checking the accuracy of these records by comparing them with each other. This concept of checks and balances is an acceptable business practice even today. Auditor's look it in evaluating their client's control.

Auditing in Ancient Greece and Rome

Many social and political traditions in Western society have their origins in ancient Greece. One of these traditions was the audit of public accounts. All public officials apparently had to submit their accounts to designated auditors. This requirement probably extended to the highest ranking members of the Greek society.

To many, Roman civilization was the epitome of structure and organization. We should not b surprised to learn, then, that audits of some type were performed in that era. Roman officials, like their Greeks counterparts, were required to submit their accounts to a designated person or body when they left office.

Auditing in Medieval Period

Audits became more sophisticated during the medieval period of British history. High officials accountable to heads of state compared independent tallies of monies collected by sheriffs for the crown. Today, we refer to independent tallies as controls and the verification of these tallies by a high official as auditing.

Auditing During the Industrial Revolution

The Industrial Revolution produced early examples of English corporations registered with the state. This practice led to laws mandating the preparation of statements by boards of directors and provisions for "shareholder audits" of these statements by shareholders of the company. These auditors possessed little or no independence, at least, by our modern definition. The only vestige of independence was the requirement that auditors not hold office in the audited company. Auditors were not only allowed to own stock in the audited company, but were required to do so. In later years, this requirement was lifted, and external professionals were hired to perform the audits.

Early Auditing in the United States of America

The American audits in the late nineteenth and early twentieth centuries were patterned after the British model, that is, examinations were made to report on the stewardship of management and to detect fraud. In many cases, all transactions of an entity were audited. Later, cost consideration forced auditors to shift their techniques from detailed examinations to sampling and testing. In addition, early American audits emphasized the balance sheet because the purpose of many of these audits was to secure financing from a bank.

The fair presentation of financial statements became the dominant standard when companies were subjected to more government regulation. In the United States, income taxes were established in the early 1900s. The passage of federal securities act in 1933 and 1934 mandated audits for companies with publicly traded securities, and the creation of the Securities and Exchange Commission in 1934 provided for a federal government oversight of the audits of most large corporations in the country.

1960s to 1990s

The world economy continued to grow in the 1960s to 1990s. This period marked an important development in the technological advancement and the operating size and complexity of the companies. In the 1970s, auditors performed an important role in enhancing the credibility of the financial information and advancing the operations of an effective capital market. Thus, the role of auditors among others, were to affirm the truthfulness and ensure the fair presentation of the financial statements.

In the earlier part of this period, auditors changed its audit approach from "verifying transaction in the books" to "relying on system". Such a change resulted due to the increase in the number of transactions from the continued growth in the size of companies, where it is unlikely for auditors to verify all the transactions. Thus, the auditors had placed higher reliance on companies' internal control system in their audit procedures. Furthermore, auditors were required to ascertain and document the accounting system with particular consideration to the flow information and identification of internal controls in place. When internal control of the company was effective, auditors reduced the level of detailed substance testing.

In the early 1980s, there was a readjustment in auditors' approaches where the assessment of internal control systems was found to be an expensive process and so auditors began to cut back their systems work and make greater use of analytical procedures. An extension of readjustment was the development of risk-based auditing. Risk-based auditing is an audit approach where an auditor will focus on those areas which are more likely to contain errors. To adopt its use, the

auditors are required to gain a thorough understanding of clients' organization, its key personnel, policies and procedures, and the market that they operate.

Moreover, most of the companies in this period had introduced the used computer systems to process their financial and other data, and to perform, monitor and control many of their operational and administrative processes. Similarly, auditors placed heavy reliance on the advanced computer assisted auditing tools to facilitate their audit procedures. In addition to the auditing of the financial statements, the auditors at the same time were providing advisory services to the audit clients.

Moreover, accounting and auditing during this period has become an industry with strong competition among auditing firms. Thus, the role of auditors in the provision of advisory services emerged as a secondary audit objective. Since then, the role of the auditor has always been highly associated with such advisory services instead of audit of financial statements.

1990s to present

The auditing profession witnessed substantial and rapid change since 1990s as a result of the accelerating growth at the world economies. Auditing in the present day has expanded beyond the basic financial statement attest function and has developed into new processes that build on a business risk perspective of their clients. The business risk approach rests on the notion that a broad range of the client's business risks are relevant to the audit. Advocates of the business risk approach opined that many business risks, if not controlled, will eventually affect the financial statements. Moreover, by understanding the full range of risks in businesses, the auditor will be in a better position to identify matters of significance and relevance to the audit profession on a timely basis.

Since the early 1990s, the audit profession began to take increased responsibility to detect and report fraud and to assess, and report more explicitly, doubts about an auditee's ability to continue in conformance with society's and regulators' increasing concern about corporate governance matters. Adoption of the business risk approach in turn enhances auditor's ability to fulfill these responsibilities.

Presently, the objective of auditing is to lend credibility to financial and non-financial information provided by management in its financial statements. By 2000, consulting revenues exceeded auditing revenues at all the major audit firms in the United States. Regulators of the auditing profession and the investing public began to doubt whether audit firms could remain independent on audit issues when the firms were so dependent on consulting revenues. The quality of audits is being placed under scrutiny after a series of financial scandals of public companies such as Sunbeam, Waste Management, Xerox, Adelphia, Enron and WorldCom. The collapses of these giant corporations had brought about a crisis of confidence in the work of auditors.

As a consequence of the high level of litigation and criticism against the auditors, nearly all large accounting firms split their consulting practice into separate companies and made announcements on their more stringent rules and measures to ensure better independence and audit quality. In addition, a spate of radical reforms was undertaken in various countries, by the accounting bodies, governments and stock exchange commissions to strengthen the audit practice.

DISTINCTION BETWEEN ACCOUNTING AND AUDITING

Many financial statement users and members of the general public confuse auditing with accounting. The confusion results because most auditing is usually concerned with accounting information, and may auditors have considerable expertise in accounting matters.

Accounting is the process of recording, classifying, and summarizing of economics events for the purpose of providing financial information used in decision making. To provide relevant information, accountants must have a thorough understanding of the principles and rules that provide the basis for preparing the accounting information. In addition, accountants must develop a system to make sure that the entity's economic events are properly recorded on a timely basis and at a reasonable cost.

On the other hand, **auditing** is determining whether recorded information properly reflects the economic events that occurred during the accounting period. When auditing accounting data, the auditor must possess expertise in the accumulation and interpretation of audit evidence. It is this expertise that distinguishes auditors from accountants. Determining the proper audit procedures, deciding the number and types of items to test, and evaluating the results are problems unique to the auditor.

Accounting and auditing are separate disciplines within dissimilar bodies of knowledge. However, a familiarity with the audit process is not wholly sufficient to render an auditor competent. Because an auditor audits financial statements, he or she must also be familiar with the Philippine Financial Reporting Standards.

REVIEW QUESTIONS

1. What is the definition of auditing? Enumerate and discuss its key attributes?
2. What are the types of auditors and the audits they performed? Differentiate one from another.
3. What is the objective and scope of a financial statement audit?
4. What are the general principles of a financial statement audit?
5. What are the four conditions attributable in the need for independent audits of financial statements? Discuss each.
6. Enumerate and discuss the ways of reducing information risk.
7. What are the two theories that support the performance of an audit? Differentiate one from the other.
8. What are the economic benefits and limitations of a financial statement audit? Explain each.
9. Differentiate accounting from auditing.

MULTIPLE CHOICE QUESTIONS

1. Which of the following statements does not properly describe an element of the theoretical framework of auditing?
   a. An audit benefits the public.
   b. Auditors act on behalf of management.
   c. Short-term conflicts may exist between managers who prepare data and auditors who examine the data.
   d. The data to be audited can be verified.

2. Which of the following is an incorrect phrase?
   a. Auditing subjectively obtains and evaluates evidence.
   b. Auditing is a systematic process.
   c. Auditing evaluates evidence regarding assertions.
   d. Auditing communicates results to interested users.

3. The auditor gathers evidential matter in order to
   a. Form an opinion with respect to financial assertions.
   b. Evaluate management's stewardship.
   c. Eliminate detection risk.
   d. Detect fraud and irregularity.

4. Evidence is defined as any information used by the auditor to determine whether the quantifiable information being audited is stated in accordance with the established criteria. Evidence takes many different forms, including

a. Written communication (confirmation) with outsiders.
b. Oral representation (testimony) of the client management.
c. Observation made by the auditor.
d. All of these.

5. Which of the following least likely limits the auditor's ability to detect material misstatement?
a. The inherent limitations of any accounting and internal control system.
b. Most audit evidences are conclusive rather than being persuasive.
c. Audit procedures that are effective in detecting ordinary misstatements are ineffective in detecting intentional misstatements.
d. Audit is based on testing.

6. As used in auditing, which of the following statements best describes "assertions"?
a. Assertions are the representations of management as to the reliability of the information system.
b. Assertions are the representations of management as to the fairness of the financial statements.
c. Assertions are the auditor's findings to be communicated in the audit report.
d. Assertions are found only in the footnotes to the financial statements.

7. Which of the following is an example of an assertion made by management in an entity's financial statements?
a. The scope of the auditor's investigations is not limited in any way by management.
b. The financial statements are prepared in an unbiased manner.
c. Reported inventory balances reflect all related transactions for the period.
d. Reported accounts receivables do not include any uncollectible accounts.

8. It refers to the level of auditor's satisfaction as to the reliability of an assertion being made by one party for use by another party.
a. Tolerable level.
b. Reasonableness level.
c. Confidence level.
d. Assurance level.

9. A financial statement audit aids in the communication of economic data because the audit
a. Lends credibility to the financial statements.
b. Guarantees that financial data are fairly presented.
c. Confirms the accuracy of management's financial representations.
d. Assures the readers of financial statements that any fraudulent activity has been corrected.

10. In all cases, audit reports must
a. Inform readers of the degree of correspondence between the quantifiable information and the established criteria.
b. Communicate the auditor's finding to the general public.
c. Certify the accuracy of the quantitative information which was audited.
d. Be signed by the individual who performed the audit procedures.

11. Which of the following statements best describes operational audits?
    a. This type of audit is performed to determine whether an entity's financial statements are fairly stated in conformity with generally accepted accounting principles. → FS AUDIT
    b. This type of audit is performed in order to determine the degree of adherence to specific procedures and rules set down by some higher authority. → COMPLIANCE AUDIT
    c. This type of audit involves a review of an organization's procedures and methods for the purpose of evaluating efficiency and effectiveness of operations, and identifying areas for improvement.
    d. All of these statements describe operational audits.

12. Which of the following best describes the operational audit?
    a. It requires the constant review by internal auditors of the administrative controls as they relate to operations of the company. → INTERNAL CONTROL REVIEW
    b. It concentrates on seeking out aspects of operations in which waste would be reduced by the introduction of controls.
    c. It concentrates on implementing financial and accounting control in a newly organized company. → IMPLEMENTATION OF CONTROLS
    d. It attempts and is designed to verify the fair presentation of a company's results of operations. → FS AUDIT ?

13. An audit of financial statements is conducted to determine if the
    a. Overall financial statements are stated in accordance with specified criteria.
    b. Organization is operating efficiently and effectively. → OPS AUD
    c. None of these.
    d. Auditee is following specific procedures or rules set down by some higher authority.

14. An audit is an assurance engagement. One of the elements of an assurance is suitable criteria. The criteria for evaluating quantitative information vary. For example, in the audit of historical financial statements by CPA firms, the criteria are usually
    a. Regulations of the Securities and Exchange Commission. ✗
    b. Regulations of the Bureau of Internal Revenue. ✗
    c. Generally accepted auditing standards.
    d. Generally accepted accounting principles.

15. An audit involves ascertaining the degree of correspondence between assertions and established criteria. In the case of financial statement audit, which of the following is not a valid criterion?
    a. Philippine Standards on Auditing.
    b. International Accounting Standards.
    c. Authoritative financial reporting framework.
    d. Accounting standards generally accepted in the Philippines.

16. The auditor communicates the results of his or her work through the medium of the
    a. Audit report.
    b. Engagement letter. → AGREEMENT BETWEEN THE AUDITOR AND THE CLIENT THAT DEFINES THE TERMS AND SCOPE OF THE AUDIT ENGAGEMENT.
    c. Financial statements.
    d. Management letter. → PREPARED BY THE AUDITOR AFTER THE AUDIT THAT COMMUNICATES OBSERVATIONS, WEAKNESSES, OR RECOMMENDATIONS FOR IMPROVING OPERATIONS OR CONTROLS.

17. The auditor's opinion:
    a. Certifies the correctness of the financial statements.

b. Enhances the credibility of the financial statements.
c. Is an assurance as to the efficiency with which management has conducted the affairs of the entity, but not effectiveness.
d. Is an assurance as to the future viability of the entity.

18. An audit which is undertaken in order to determine whether the auditee is following specific procedures or rules laid down by some higher authority is classified as a(n)
a. Production audit.
b. Operational audit.
c. Compliance audit.
d. Audit of financial statements.

19. Which of the following types of audit uses as its criteria laws and regulations?
a. Operational audit.
b. Financial statement audit.
c. Financial audit.
d. Compliance audit.

20. Which of the following is **more** difficult to evaluate objectively?
a. Presentation of financial statements in accordance with GAAP.
b. Efficiency and effectiveness of operations.
c. Compliance with government regulations.
d. All the three above are equally difficult.

21. Which of the following statements is true concerning a compliance audit?
a. Risks such as inherent risk, control risk, and detection risk are not appropriate in the planning and performance of a compliance audit.
b. Materiality is difficult to measure in a compliance audit.
c. Compliance audits are only performed by government auditors.
d. A report on compliance can only include negative assurance.

22. A review of any part of an organization's procedures and methods for the purpose of evaluating efficiency and effectiveness is classified as a(n)
a. Production audit.
b. Operational audit.
c. Compliance audit.
d. Audit of financial statements.

23. An operational audit is designed to
a. Determine whether the audit committee of the board of directors is effectively discharging its responsibility to oversee management's operations.
b. Determine whether management has complied with applicable laws and regulations.
c. Assess the presentation of management's financial statements in accordance with generally accepted accounting principles.
d. Assess the efficiency and effectiveness of management's operating procedures.

24. A typical objective of an operational audit is for auditor to
a. Report on the entity's relative success in maximizing its profits.
b. Make recommendations to client for improving its performance.
c. Evaluate the feasibility of attaining the client entity's operational objectives.

d. Determine whether the financial statements fairly present the client entity's operations.

25. Governmental effectiveness (program) auditing seeks to determine whether the desired results are being achieved and objectives are being met. The first step in the performance of such an audit would be to
    a. Collect and analyze quantifiable data.
    b. Determine the sampling frame to use in studying the system.
    c. Evaluate the system used to measure results.
    d. Identify the legislative intent of the program being audited.

26. Which of the following best describes the objective of an audit of financial statements?
    a. To express an opinion whether the financial statements are prepared in accordance with prescribed criteria.
    b. To express an opinion whether the financial statements are prepared, in all material respect, in accordance with an identified financial reporting framework.
    c. To express an assurance as to the future viability of the entity whose financial statements are being audited.
    d. To express an assurance about the management's efficiency or effectiveness in conducting the operations of entity. OA

27. The primary purpose of an independent audit of financial statements is to
    a. Provide users with an unbiased opinion about the fairness of information presented in the financial statements.
    b. Provide a basis for assessing management's performance.
    c. Comply with laws and regulations. CA
    d. Assure management that the financial statements are unbiased and free from material misstatements.

28. The primary reason for a financial statement audit by an independent CPA is to
    a. Guarantee that there are no misstatements in the financial statements and ensure that any fraud will be discovered.
    b. Provide increased assurance to users as to the fairness of the financial statements.
    c. Relieve management of responsibility for the financial statements.
    d. Satisfy government regulatory responsibility.

29. The purpose of an audit of financial statements is to
    a. Assure the future viability of the entity by expressing an opinion on the entity's financial statements.
    b. Enhance the degree of confidence of intended users in the financial statements.
    c. Obtain an absolute level of assurance that the financial statements as a whole are free from material misstatement.
    d. Relieve management or those charged with governance of the responsibility for the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework.

30. Services provided by CPAs may be classified into those services which are covered by PSAs and those services which are not covered by PSAs. Which PSA covers the objective and general principles governing an audit of financial statements?
    a. PSA 210. → AGREEING THE TERMS OF AUDIT ENGAGEMENT
    b. PSA 200. → OVERALL OBJECTIVE OF THE INDEPENDENT AUDITOR

c. PSA 120. → PROFESSIONAL SKEPTICISM
d. PSA 100. → QUALITY CONTROL FOR FIRMS

31. The following statements pertain to the general principles governing an audit of financial statements. Which one is incorrect?
    a. The auditor would ordinarily expect to find evidence to support management representations and assume they are necessarily correct.
    b. The auditor should plan and perform an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.
    c. The auditor should conduct an audit in accordance with PSAs.
    d. The auditor should comply with the "Code of Ethics for Professional Ethics for Certified Public Accountants" promulgated by the Philippine Professional Regulation Commission.

32. Because an external auditor is paid a fee by a client company, he or she
    a. Must receive approval of the Securities and Exchange Commission before conducting an audit. ✗
    b. May be sufficiently independent to conduct an audit.
    c. Is never considered to be independent. ✗
    d. Is absolutely independent and may conduct an audit. ✗ → MAY BE THREATENED

33. Because an examination in accordance with Philippine Standards on Auditing is influenced by the possibility of material errors, the auditor should conduct the examination with an attitude of
    a. Professional skepticism.
    b. Professional responsiveness.
    c. Objective judgment.
    d. Conservative advocacy.

34. Professional skepticism dictates that when management makes a statement to the auditors, the auditors should
    a. Require that the statement be put in writing. ✗
    b. Disregard the statement because it ranks low of the evidence quality scale. ✗
    c. Corroborate the evidence with other supporting documentation whenever possible.
    d. Believe the statement in order to maintain the professional client-auditor relationship. ✗

35. Which of the following criteria is unique to the independent auditor's attest function?
    a. Independence.
    b. General competence. → ALL PROFESSION
    c. Familiarity with the particular industry of each client. → ALL PROFESSION?
    d. Due professional care. → ALL PROFESSION

36. In order to conduct an audit in accordance with PSAs, the auditor considers which procedures must be performed in order to achieve the objective an audit. Which of the following terms refers to "the audit procedures deemed necessary in the circumstances to achieve the objective of the audit"?
    a. Audit program.
    b. Reasonable assurance.
    c. Scope of an audit.
    d. Sufficiency of procedures.

37. Which of the following are sources of procedures to be considered by the auditor to conduct an audit in accordance with PSAs?

	a.	b.	c.	d.
Legislation and regulation	No	No	Yes	Yes
Philippine Standards on Auditing	Yes	No	No	Yes
Terms of audit engagements (as agreed with the client)	No	Yes	Yes	Yes
Type of opinion	No	Yes	No	No

38. Which of the following matters would an auditor most likely consider when establishing the scope of the audit?
    a. Audit areas where there is a higher risk of material misstatement.
    b. The discussion with the entity's management concerning the expected communications on the status of audit work throughout the engagement and the expected deliverables resulting from the audit procedures.
    c. The entity's timetable for reporting, such as interim and final stages.
    d. The expected audit coverage, including the number and locations of the entity's components to be included.

39. The assumption underlying an audit of financial statements is that they will be used by
    a. Different groups for different purposes.
    b. The board of directors as basis of declaring cash dividends.
    c. The general public in making investment decisions.
    d. The regulatory agencies to verify information that is relevant to their supervisory functions.

40. An independent audit is important to readers of financial statements because it
    a. Measures and communicates the financial data included in the financial statements.
    b. Objectively examines and reports on management's financial statements.
    c. Provides a measure of management's stewardship function.
    d. Reports on the accuracy of information in the financial statements.

41. Why does a company choose to have an independent auditor report on its financial statements?
    a. An independent audit is designed to search for deficiencies in the company's internal controls.
    b. Independent auditors guarantee the accuracy of the financial statements.
    c. Independent auditors will always detect management fraud.
    d. The company's management preparing the statements may have a vested interest in reporting certain results.

42. Users of financial statements demand independent audit because
    a. Management may not be objective in reporting.
    b. Management relies on the auditor to improve internal control.
    c. Users demand assurance that fraud does not exist.
    d. Users expect auditors to correct management errors.

43. Which of the following best describes why an independent auditor reports on financial statements?
    a. Competing interests may exist between management and the users of the statements.
    b. Independent auditors are likely to detect fraud.
    c. Ineffective internal controls may exist.

c. Ineffective internal controls may exist.
d. Misstated account balances are generally corrected by an independent audit.

44. Which of the following is a cause of information risk?
a. Biases and motives of the provider of information.
b. Each of these is a cause of information risk.
c. Remoteness of the provider of the information.
d. Voluminous data.

45. The main way(s) to reduce information risk is to have
a. Audited financial statements provided.
b. The users share the information risk with management.
c. The users verify the information.
d. All of the above.

46. Financial statements audit
a. Assess management's efficiency. OA
b. Overlook information risk. FS AUDIT REDUCE IR
c. Reduce cost of capital. FS AUDIT INCREASES THE CREDIBILITY OF FS
d. Report on compliance with laws and regulations. CA

47. Which of the following is responsible for an entity's financial statements?
a. The entity's audit committee.
b. The entity's board of directors.
c. The entity's internal auditors.
d. The entity's management.

48. The best statement of the responsibility of the auditor with respect to audited financial statement is:
a. The audit of the financial statements relieves management of its responsibilities
b. The auditor is responsible only to his unqualified opinion but not for any other type of opinion.
c. The auditor's responsibility is confined to his expression of opinion about the audited financial statements.
d. The responsibility over the financial statements rests with the management and the auditor assumes responsibility with respect to the notes of financial statements.

49. In determining the primary responsibility of the external auditor for an audit of a company's financial statements, the auditor owes primary allegiance to: EX REGULAR MEETINGS EXIST TO PROTECT PUBLIC INTEREST [PSA 260]
a. Stockholders, creditors, and the investing public.
b. The audit committee of the audit client because that committee is responsible for coordinating and reviewing all audit activities within the company.
c. The Auditing and Assurance Standards Council, because it determines auditing standards and auditor's responsibility.
d. The management of the audit client because the auditor is hired and paid by management.

50. When compared to an audit performed prior to 1900, an audit today
a. Has bank loan officers as the primary financial statement user group.
b. Includes a more detailed examination of all individual transactions.
c. Is less likely to include consideration of the effectiveness of internal control.

d. Is more likely to include tests of compliance with laws and regulations.

51. The expertise that distinguishes auditors from accountants is in the
    a. Requirement to possess education beyond the Bachelor's degree.
    b. Accumulation and interpretation of evidence.
    c. Ability to interpret generally accepted accounting principles.
    d. Ability to interpret AASC Statements.

52. Because an external auditor is paid a fee by a client company, he or she
    a. Is absolutely independent and may conduct an audit.
    b. Is never considered to independent.
    c. May be sufficiently independent to conduct an audit.
    d. Must receive approval of the Securities and Exchange Commission before conducting an audit.

53. The word auditing comes from the Latin audire, which means:
    a. To see b. To believe c. To hear d. To test

54. Independent auditing can best be described as a
    a. Regulatory function that prevents the issuance of improper financial information.
    b. Professional activity that measures and communicates financial and business data.
    c. Discipline that attests to the results of accounting and other operations and data.
    d. Branch of accounting.

55. A financial statement audit
    a. Assures that fraud had been detected.
    b. Confirms that financial statement assertions are accurate.
    c. Guarantees that financial statements are presented fairly.
    d. Lends credibility to the financial statements.

56. In "auditing" accounting data, the concern is with
    a. Analyzing the financial information to be sure that it complies with government requirements.
    b. Determining if fraud has occurred.
    c. Determining if taxable income has been calculated correctly.
    d. Determining whether recorded information properly reflects the economic events that occurred during the accounting period.

57. Certain fundamental beliefs called "postulates" underlie auditing theory. Which of the following is not a postulate of auditing?
    a. An audit has a benefit only to the owners.
    b. Economic assertions can be verified.
    c. No long-term conflict exists between the auditor and the management of the enterprise under audit.
    d. The auditor acts exclusively as an auditor.

58. Which of the following is a correct statement relating to the theoretical framework of auditing?
    a. An audit has a benefit only to the owners.
    b. Auditors do not necessarily need independence.

c. Short-term conflicts do not exist between managers who prepare data and auditors who examine data.
d. The financial data to be audited can be verified.

59. Internal auditors cannot be independent
a. As long as an employer-employee relationship exists.
b. Because they don't audit financial statements.
c. Since they do not possess the CPA license.
d. Unless their immediate supervisor is a CPA.

60. In comparison to the independent auditor, an internal auditor is more likely to be concerned with
a. Operational auditing.
b. Legal and regulatory compliance.
c. Internal control.
d. Cost accounting procedures.

61. A government auditor evaluates a disbursement to determine if it is necessary, excessive or extravagant and if it is in accordance with existing rules and regulations. What kind of audit is he conducting?

	a	b	c	d
Economy audit	No	Yes	Yes	No
Compliance audit	Yes	Yes	No	No

62. Which of the following types of audit is performed to determine whether an entity's financial statements are fairly stated in conformity with the Philippine Financial Reporting Standards?
a. Performance audit.
b. Operational audit.
c. Financial statement audit.
d. Compliance audit.

63. Which of the following types of auditing is performed most commonly by CPAs on a contractual basis?
a. Internal auditing.
b. Government auditing.
c. External auditing.
d. BSP bank auditing.

64. The underlying conditions that create a demand by users for reliable information include the following except:
a. Decisions are not time sensitive.
b. Financial decisions that are important to investors and users.
c. Transactions that are numerous and complex.
d. Users separated from the providers of the information by distance and time.

65. Which of the following types of audits is performed most frequently by CPAs on a fee basis and for more than one client?
a. Government audits.
b. Internal audits.
c. Financial statement audits.
d. Compliance audits.

66. Which of the following statements does not describe a condition that creates a demand for auditing?
    a. Users can directly assess the quality of information.
    b. Information can have substantial economic consequences for a decision maker.
    c. Expertise is often required for information preparation and verification.
    d. Conflict between an information provider and a user can result in biased information.

67. Which of the following problems would not represent one of the primary problems that would lead to the demand for independent audits of a company's financial statements?
    a. Management bias in preparing financial statements.
    b. The complexity of transactions affecting financial statements.
    c. The downsizing of business and financial markets.
    d. The remoteness of the user from the organization and thus the inability of the user to directly obtain financial information from the company.

68. An audit can have a significant effect on
    a. Business risk.
    b. Information risk.
    c. The risk-free interest rate.
    d. All of these.

69. Information risk refers to the risk that
    a. Errors and frauds would not be detected by the auditor's procedures.
    b. The auditor may express an unqualified opinion on financial statements that are materially misstated.
    c. The client entity may not be able to remain in business.
    d. The client's financial statements may be materially false and misleading.

70. Which of the following is NOT an element of an assurance engagement?
    a. Appropriate professional fees
    b. Sufficient appropriate evidence
    c. A subject matter
    d. A written assurance report

COMPREHENSIVE CASES

CASE 1 – Elements of the Definition of Auditing

Fred Perry is the loan officer of the Standard Chartered Bank. Standard has a loan of ₱ 5,000,000 outstanding to National Delivery Service, a company specializing in delivering products of all types on behalf of smaller companies. Standard's collateral on the loan consists of 11 delivery trucks with an average original cost of ₱ 550,000.

Perry is concerned about the collectability of the outstanding loan and whether the trucks still exist. He therefore engages Aimee Asuncion, CPA, to count the trucks, using registration information held by Perry. She was engaged because she spends most of her time auditing used automobiles and truck dealerships and has extensive knowledge about used trucks. Perry requests that Asuncion issue a report stating the following:

1. Which of the 11 trucks is parked in National's parking lot on the night of June 30, 2011?
2. Whether all of the trucks are owned by National Delivery Service.
3. The condition of each truck, using the guidelines of poor, good, and excellent.
4. The fair market value of each truck, using a reasonable basis of determining such amount.

Required:

1. For each of the following parts of the definition of auditing, state which part of the preceding narrative fits the definition: (a) objectively obtaining and evaluating evidence, (b) assertions about economic actions and events, (c) established criteria, and (e) communicating the results.

2. Identify the greatest difficulties Asuncion is likely to have doing this audit.

CASE 2 – Differentiating the Types of Auditor

Katherine Fernandez, a college senior, has begun the interviewing process. She has discovered a great variety of organizations in search of "accounting majors". She finds that various public accounting firms, corporations, the Commission on Audit (COA), and the Bureau of Internal Revenue (BIR) are all interviewing candidates at her school.

Katherine has come to you for advice. She has suggested that although she has had only one class session of auditing, she already realizes that it is going to be a great course; however, she also especially enjoyed her tax and accounting systems courses.

Required:

1. Compare and contrast her possibilities with public accounting firms, corporations, the COA, and the BIR if she wishes to emphasize the following areas of expertise: (a) taxation, (b) auditing, and (c) systems design.

Chapter 3
PROFESSIONAL REGULATIONS AND QUALITY CONTROL

LEARNING OBJECTIVES

Upon completion of this chapter you will

1. **Be familiar with Philippine Accountancy Act of 2004 including its objectives..**
2. **Know the qualifications, powers and functions of members of the professional regulatory board.**
3. **Understand the qualifications of applicants for CPA licensure examination including the scope of the examination.**
4. **Be familiar with the accounting and auditing standard setting council.**
5. **Be familiar with the Continuing Professional Education.**
6. **Be familiar with the accreditation of accounting teachers.**
7. **Be familiar with the Advertising for the Philippine Accountancy Profession.**
8. **Appreciate the need for quality controls.**
9. **Know the different elements of a system of quality control.**

This chapter discusses the various regulations affecting the practice of accountancy in the Philippines. This chapter includes an in-depth discussion of the Philippine Accountancy Act of 2004, the establishment and objectives of accounting and auditing standards setting councils, continuing professional education, accreditation of accounting teachers, advertising for the Philippine accountancy profession, and the quality standards governing the performance of audit engagements.

PHILIPPINE ACCOUNTANCY ACT OF 2004
(Republic Act No. 9298 and its Implementing Rules and Regulations)

Republic Act (RA) No. 9298, also known as the "Philippine Accountancy Act of 2004", regulates the practice of accountancy in the Philippines. RA No. 9298 repealed Presidential Decree No. 692, otherwise known as The Revised Accountancy Law, and was signed into law on March 13, 2004. Exhibit 3.1 provides the objectives of the Philippine Accountancy Act of 2004.

EXHIBIT 3.1 Objectives of Philippine Accountancy Act of 2004

The Philippine Accountancy Act of 2004 shall provide for and govern:

- The standardization and regulation of accounting education;
- The examination for registration of certified public accountants; and
- The supervision, control, and regulation of the practice of accountancy in the Philippines.

Scope of Practice of Accountancy

The practice of accountancy shall include, but not limited to practice of public accountancy, practice in commerce and industry, practice in education or academe and practice in the government. Table 3.1 provides the detailed descriptions of each of the said practice.

TABLE 3.1 Scope of Practice of Accountancy

The practice of accountancy shall include, but not limited to, the following:

Practice of Public Accountancy - shall constitute in a person, be it his/her individual capacity, or as a partner or as a staff member in an accounting or auditing firm, holding out himself/herself as one skilled in the knowledge, science and practice of accounting, and as a qualified person to render professional services as a certified public accountant; or offering or rendering, or both, to more than one client on a fee basis or otherwise, services such as the audit or verification of financial transaction and accounting records; or the preparation, signing, or certification for clients of reports of audit, balance sheet, and other financial, accounting and related schedules, exhibits, statements or reports which are to be used for publication or for credit purposes, or to be filed with a court or government agency, or to be used for any other purpose; or the design, installation, and revision of accounting system; or the preparation of income tax returns when related to accounting procedures; or when he/she represents clients before government agencies on tax and other matters related to accounting or renders professional assistance in matters relating to accounting procedures and the recording and presentation of financial facts or data.

Practice in Commerce and Industry - shall constitute in a person involved in decision making requiring professional knowledge in the science of accounting, as well as the accounting aspects of finance and taxation, or when he/she represents his/her employer before government agencies on tax and other matters related to accounting; or when such employment or position requires that the holder thereof must be a certified public accountant.

Practice in Education/Academe - shall constitute in a person in an educational institution which involve teaching of accounting, auditing, management advisory services, accounting aspect of finance, business law, taxation, and other technically related subjects. However, members of the Integrated Bar of the Philippines may be allowed to teach business law and taxation subjects.

Practice in the Government - shall constitute in a person who holds, or is appointed to, a position in an accounting professional group in government or in a government–owned and/or controlled corporation, including those performing proprietary functions, where decision making requires professional knowledge in the science of accounting, or where a civil service eligibility as a certified public accountant is a prerequisite.

Professional Regulatory Board of Accountancy

The Professional Regulatory Board of Accountancy, under the supervision and administrative control of the Professional Regulation Commission, shall be composed of a chairman and six (6) members to be appointed by the President of the Philippines from a list of three (3) recommendees for each position and ranked by the Professional Regulation Commission, from a list of five (5) nominees for each position submitted by the accredited national professional organization of certified public accountant. The Board of Accountancy shall elect a vice-chairman from among its members for a term of one (1) year. The chairman shall preside in all meetings of the Board of Accountancy and in the event of a vacancy in the office of the chairman, the vice-chairman shall assume such duties and responsibilities until such time as a chairman is appointed.

The four (4) sectors in the practice of accountancy shall as much as possible be equitably represented in the Board of Accountancy. The Professional Regulation Commission, in consultation with the Board of Accountancy shall select three (3) nominees from those recommended by the Accredited National Professional Organization of Certified Public Accountants (APO) and submit such list to the President of the Philippines for consideration.

The APO shall submit its nominations with complete documentation to the Professional Regulation Commission not later than (60) days prior to the expiry of the term of an incumbent chairman or member. There should be adequate documentation to show the qualification and

primary field of professional activity of the nominee to enable the Professional Regulation Commission to determine the competence of the nominee and the sector where he/she belongs. If the APO fails to submit its own nominee(s) to the Professional Regulation Commission with the required documentations within the period provided herein, the Professional Regulation Commission in consultation with the Board of Accountancy shall submit to the President of the Philippines a list of three (3) nominees for each vacant position.

Exhibit 3.2 provides the qualifications of members of the Professional Regulatory Board of Accountancy.

EXHIBIT 3.2 **Qualifications of a Members of the Professional Regulatory Board**

A member of the Board of Accountancy shall, at the time of his/her appointment, posses the following qualifications:

- Natural-born citizen and a resident of the Philippines;
- Duly registered CPA with at least ten (10) years of work experience in any scope of practice of accountancy. He/shall be nominated to represent a sector from which he/she has considerable and meaningful professional experience;
- A good moral character and not have been convicted of crimes involving moral turpitude;
- Not have any pecuniary interest, directly or indirectly, in any school, college, university or institution conferring an academic degree necessary for admission to the practice of accountancy or where review classes in preparation for the licensure examination are being offered or conducted, nor shall he/she be a member of the faculty or administration thereof; and
- Must not be a Director or Officer of the APO at the time of his appointment.

TERM 3 YEARS
↳ CAN BE REAPPOINTED ONCE
↳ 1 YEAR COOL OFF PERIOD BEFORE ANOTHER REAPPOINTMENT
↳ DO ONE SHOULD SERVE FOR MORE THAN 12 YEARS

The chairman and members of the Board of Accountancy shall hold office for a term of three (3) years. Any vacancy occurring within the term of a member shall be filled up for the unexpired portion of the term only. No person who has served two (2) successive complete terms shall be eligible for reappointment until the lapse of one (1) year. Appointment to fill up an unexpired term is not to be considered as a complete term. Moreover, no person shall serve in the Board of Accountancy for more than twelve (12) years.

Exhibit 3.3 provides the powers and functions of the Professional Regulatory Board of Accountancy.

EXHIBIT 3.3 **Powers and Functions of the Professional Regulatory Board**

The Board of Accountancy shall exercise the following specific powers, functions and responsibilities:

- To prescribed and adopt the rules and regulations necessary for carrying out the provisions of the Philippine Accountancy Act of 2004;
- To supervise the registration, licensure and practice of accountancy in the Philippines;
- To administer oaths in connection with the administration of the Philippine Accountancy Act of 2004;
- To issue, suspend, revoke, reinstate the Certificate of Registration for the practice of the accountancy profession;
- To adopt an official seal of the Board;
- To prescribe and/or adopt a Code of Ethics for the practice of accountancy;
- To monitor the conditions affecting the practice of accountancy and adopt such measures, including promulgation of accounting and auditing standards, rules and regulations and best practices as may be deemed proper for the enhancement and maintenance of high professional, ethical, accounting and auditing standards;
- To conduct an oversight into the quality of audits of financial statements though a review of the quality control measures instituted by auditors in order to ensure compliance with the accounting and auditing standards and practices;
- To investigate violations of the Philippine Accountancy Act of 2004 and the rules and regulations promulgated hereunder and for the purpose, to issue summons, subpoena

and *subpoena ad testificandum* and *subpoena duces tecum* to violator or witness thereof and compel their documents in connection therewith;
- The Board may, *muto propio* in its discretion, may such investigations as it deem necessary to determine whether any person has violated any provisions of the Philippine Accountancy Act of 2004, any accounting or auditing standard or rules duly promulgated by the Board of Accountancy as part of the rules governing the practice of accountancy;
- To issue a cease or desist order to any person, associations, partnership or corporation engaged in violation of any provision of the Philippine Accountancy Act of 2004, any accounting or auditing standards or rules of duly promulgated by the Board of Accountancy as part of the rules governing the practice of accountancy in the Philippines;
- To punish for contempt of the Board of Accountancy, both direct and indirect, in accordance with the pertinent provision of and penalties prescribed by the Rules of Court;
- To prepare, adopt, issue or amend the syllabi of the subjects for examinations in consultation with the academe, determine and prepare questions for the licensure examination which shall strictly be within the scope of the syllabi of the subjects for examinations as well as administer, correct and release the result of the licensure examinations;
- To ensure the coordination with the Commission of the Higher Education (CHED) or other authorized government offices that all higher educational instruction and offering of accountancy comply with the policies, standards and requirements of the course prescribed by the CHED or other authorized government offices in the areas of curriculum, faculty, library and facilities; and
- To exercise such other powers as may be provided by law as well as those which may be implied from, or which are necessary or incidental to the carrying out of, the express powers granted to the Board to achieve the objectives and purposes of the Philippine Accountancy Act of 2004.

The President of the Philippines, upon the recommendation of the Professional Regulation Commission, after giving the concerned member an opportunity to defend himself in a proper administrative investigation to be conducted by the Professional Regulation Commission, may suspend or remove any member of the Board of Accountancy. Table 3.2 provides for the grounds for suspension or removal of members of the Board of Accountancy.

TABLE 3.2 Grounds for Suspension or Removal of Members of the Board of Accountancy

The following are grounds for suspension or removal of members of the Board of Accountancy:

- Neglect of duty or incompetence;
- Violation or tolerance of any violation of this Act and its implementing rules and regulations or the Certified Public Accountant's Code of Ethics and the technical and professional standards of practice for certified public accountants;
- Final judgment of crimes involving moral turpitude; and
- Manipulation or rigging of the certified public accountants licensure examination results, disclosure of secret and confidential information in the examination questions prior to the conduct of the said examination or tampering of grades.

Examination, Registration and Licensure

All applicants for registration for the practice of accountancy shall be required to undergo a licensure examination to be given by the Board of Accountancy.

Exhibit 3.4 provides the qualifications of any persons applying for the licensure examinations.

EXHIBIT 3.4 Qualifications of Applicants for CPA Licensure Examination

Any person applying for examination shall establish the following requisites to the satisfaction of the Board of Accountancy that he/she:

- Is a Filipino citizen;

- Is of good moral character;
- Is a holder of the degree of Bachelor of Science in Accountancy conferred by a school, college, academy or institute duly recognized and/or accredited by the CHED or other authorized government offices; and
- Has not been convicted of any criminal offense involving moral turpitude.

Exhibit 3.5 provides the scope of the CPA licensure examination.

EXHIBIT 3.5 Scope of CPA Licensure Examination

The licensure examination for CPA shall cover, but not limited to, the following subjects:

- Financial Accounting and Reporting;
- Advanced Financial Accounting and Reporting;
- Management Advisory Services;
- Auditing;
- Taxation; and
- Regulatory Framework for Business Transaction.

The Board of Accountancy, subject to the approval of the Professional Regulation Commission, may revise or exclude any of the subjects and their syllabi, and add new ones as the need arises.

To be qualified as having passed the licensure examination for accountants, a candidate must obtain a general average of seventy-five percent (75%), with no grades lower than sixty-five percent (65%) in any given subject. In the event a candidate obtains the rating of seventy-five percent (75%) and above in at least a majority of subjects, he/she shall receive a conditional credit for the subjects passed. The candidate shall take an examination in the remaining subjects within two years from the preceding examination. However, if the candidate fails to obtain at least a general average of seventy-five percent (75%) and a rating of at least sixty-five percent (65%) in each of the subjects reexamined, he/she shall be considered as failed in the entire examination.

Any candidate who fails in two (2) complete Certified Public Accountant Board Examinations shall be disqualified from taking another set of examinations unless he/she submits evidence that he/she enrolled in and completed at least twenty-four (24) units of subject given in the licensure examination.

Suspension, Revocation, Reinstatement and Reissuance of Revoked Certificates of Registration and Cancellation of Special Permits

The Board of Accountancy shall have the power, upon the notice and hearing, to suspend or revoke the practitioner's Certificate of Registration and professional identification card or suspend his/her from the practice of his/her profession or cancel his/her special permit for any of the causes or ground mentioned or any of the provisions of the Philippine Accountancy Act of 2004, and its implementing rules and regulations, the Certified Public Accountants' Code of Ethics and the technical and professional standards of practice for certified public accountants.

However, the Board of Accountancy may also, after the expiration of two (2) years from the date of revocation of a Certificate of Registration and upon application and for reasons deemed proper and sufficient, reinstate the validity of a revoked Certificate of Registration and in so doing, may, in its discretion, exempt the applicant from taking another examination.

Foreign Reciprocity and Issuance of Temporary/Special Permits

Subject or citizen of foreign countries may be allowed to practice accountancy in the Philippines in accordance with the provisions of existing laws, international treaty obligations including mutual recognition agreement entered into by the Philippines government with other countries. A person who is not a citizen of the Philippines shall not be allowed to practice accountancy in the Philippines unless he/she can prove, in the manner provided by the Rules of Court that, specific provision of law country of which he/she is a citizen, subject or national admits citizens of the Philippines to the practice of the same profession without restriction.

Special/temporary permit may be issued by the Board of Accountancy subject to the approval of the Professional Regulation Commission and payment of the fees the latter has prescribed and charged thereof to the following persons:

1. A foreign certified public accountant called for consultation or for specific purpose which, in the judgment of the Board of Accountancy, is essential for the development of the country. However, his/her practice shall be limited only for the particular work that he/she is being engaged and there is no Filipino certified public accountant qualified for such consultation or specific purposes;

2. A foreign certified public accountant engaged as professor, lecturer or critic in fields essential to accountancy education in the Philippines and his/her engagement is confined to teaching only; and

3. A foreign certified public accountant who is an internationally recognized expert or with specialization in any branch of accountancy and his/her service is essential for the advancement of accountancy in the Philippines.

ACCOUNTING AND AUDITING STANDARD SETTING COUNCIL
(Republic Act No. 9298 and its Implementing Rules and Regulations)

The Professional Regulation Commission, upon the recommendation of the Board of Accountancy, created an accounting standard setting body known as the Financial Reporting Standards Council (FRSC) and an auditing standard setting body known as the Auditing and Assurance Standards Council (AASC) to assist the Board of Accountancy in carrying out its powers and functions.

The FSRC was established to assist the Board of Accountancy in carrying out its power and function to promulgate accounting standards in the Philippines. The FRSC's main function is to establish generally accepted accounting principles in the Philippines. The FSRC shall be composed of fifteen (15) members with a Chairman, who had been or presently a senior accounting practitioner in any of the scope of accounting practice and fourteen (14) representatives from the following:

Board of Accountancy	1
Securities and Exchange Commission	1
Bangko Sentral ng Pilipinas	1
Bureau of Internal Revenue	1
A major organization composed of preparers and users of financial statements	1
Commission on Audit	1
Accredited National Professional Organization of CPAs	1
Public Practice	2

Commerce and Industry	2	
Academe/Education	2	
Government	2	8
Total		14

On the other hand, the AASC is tasked to assist the Board of Accountancy to establish and promulgate auditing standards in the Philippines. The AASC shall be composed of eighteen (18) members with a Chairman, who had been or presently a senior practitioner in public accountancy and seventeen (17) representatives from the following:

Board of Accountancy		1
Securities and Exchange Commission		1
Bangko Sentral ng Pilipinas		1
Commission on Audit		1
Insurance Commission		1
An association or organization of CPAs in active public practice of accountancy		1
Accredited National Professional Organization of CPAs		
Public Practice	9	
Commerce and Industry	1	
Academe/Education	1	11
Total		17

The Chairman and members of the FRSC and AASC shall be appointed by the Professional Regulation Commission upon the recommendation of the Board of Accountancy in coordination with the Accredited Professional Organizations (APO). The Chairman and members of the FRSC and AASC shall have a term of three (3) years renewable for another term.

EDUCATION TECHNICAL COUNCIL
(Republic Act No. 9298 and its Implementing Rules and Regulations)

The Professional Regulation Commission, upon the recommendation of the Board of Accountancy, created an Education Technical Council (ETC) to assist the Board of Accountancy in the attainment of the objective of continuously upgrading the accountancy education in the Philippines to make the Filipino CPAs globally competitive.

The ETC shall be composed of seven (7) members with a Chairman, who had been or presently a senior accounting practitioner in the academe/education and six (6) representatives from the following:

Board of Accountancy		1
Accredited National Professional Organization of CPAs		
Public Practice	1	
Commerce and Industry	1	
Academe/Education	2	
Government	1	5
Total		6

The APO shall equitably distribute the representation of the Academe/Education sector among the private and public schools offering the degree of Bachelor of Science in Accountancy.

The Chairman and members of the ETC shall be appointed by the Professional Regulation Commission upon the recommendation of the Board of Accountancy in coordination with the APO. The ETC shall make an annual review of the composition of the council and may recommend to the Board of Accountancy and the Professional Regulation Commission a more suitable representation thereto as it may deem fit. The Chairman and the members of the ETC shall have a term of three (3) years renewable for another term.

Table 3.3 provides the functions of the ETC.

ETC → BOA → PRC → CHED

TABLE 3.3 Functions of Education Technical Council

The ETC shall have the following functions:

- Determine a minimum standard curriculum for the study of accountancy to be implemented in all schools offering accountancy as an undergraduate degree;
- Establish teaching standards, including the qualifications of members of the faculty of schools and colleges of accountancy;
- Monitor the progress of the program on the study of accountancy and undertaking measures for the attainment of a high quality of accountancy education in the country;
- Evaluate periodically the performance of educational institutions offering accountancy education.

The ETC shall render a report of its findings and recommendations on the foregoing activities to the Board of Accountancy. The Board of Accountancy shall review such report and if found to be meritorious, it shall forward the same to the Professional Regulation Commission which shall make proper representation with the Commission of Higher Education for its appropriate consideration.

CONTINUING PROFESSIONAL DEVELOPMENT
(Professional Regulation Commission Resolutions No. 2019-1146 and 2017-1032)

Continuing Professional Development (CPD) refers to the inculcation of advanced knowledge, skills and ethical values in a post-licensure specialized or in an inter- or multi-disciplinary field of study for assimilation into professional practice, self-directed research and/or lifelong learning.

The CPD program is a set of learning activities accredited by the CPD council such as seminars, workshops, technical lectures or subject matter meetings, non-degree training lectures and scientific meetings, modules, tours and visits which equip the professional with advanced knowledge, skills, and values in specialized or in an inter- or multi-disciplinary fields of study, self-directed research and/or lifelong learning. The CPD program shall have these objectives:

1. Continuously improve the quality of the country's reservoir of registered professionals by updating them on the latest scientific/technological/ethical and other applicable trends in the local and global practice of the professions;
2. Provide support to lifelong learning in the enhancement of competencies of Filipino professionals towards delivery of quality and ethical services both locally and globally; and
3. Deliver quality CPD activities aligned with the Philippine Qualifications Framework (PQF) for national relevance and global comparability and competitiveness.

CPD Credit Units

120 CPD CREDIT UNITS OVER 3 YEARS PAIN:
a. TECHNICAL/PROFESSIONAL SUBJECTS → MAXIMUM OF 120
b. ETHICS / PROFESSIONAL RESPONSIBILITY → 10-15 FROM 120
c. LEADERSHIP, MANAGEMENT, OTHER NON-TOPICS → BALANCE OF 120

The total CPD credit units for registered accounting professionals shall be fifteen (15) credit units for three (3) years. Any excess credit units shall not be carried over to the next three-year period except credit units earned for doctorate and master's degrees or specialty trainings which shall only be credited once during the compliance period.

The maximum creditable units for self-directed and/or lifelong learning shall be determined by the CPD Council as approved by the Board of Accountancy and the Professional Regulation

Commission through their Operational Protocol. As a guide for crediting CPD units and its supporting documents, Annex "K" of Professional Regulation Commission Resolution No. 1032-2017 refers to the Matrix of Activities that earns CPD units.

ACCREDITATION OF ACCOUNTING TEACHERS
(Board of Accountancy Resolution No. 88 Series of 2008)

The accreditation policy shall apply to all CPAs involved in the teaching of accounting, auditing, management advisory services, finance (which shall include working capital management, investment policies and sources of financing for long-term capital projects), business law, taxation, and other technically related subjects. This policy covers those who teach accounting in the primary, secondary, tertiary and graduate levels including CPA board review schools/centers that are school-based. Unless sooner revoked, cancelled or withdrawn, Certificate of Accreditation shall be valid for three (3) years and renewable every three (3) years.

Exhibit 3.6 summarizes the requirements for the accreditation of Accounting Teachers.

EXHIBIT 3.6 **Requirements for the Accreditation of Accounting Teachers**

- Possession of master's degree in business, accounting, taxation, law, education and related fields earned from any graduate school duly recognized by the Commission on Higher Education (CHED).
- Completion of twelve (12) units of relevant education subjects from the CHED recognized schools. CPAs who have passed the Teachers Board Exams and are already licensed Professional Teachers shall be exempt from this requirement.*
- Three (3) years meaningful experience in actual accounting work either in the public practice, commerce and industry or government sector. The three years' experience is total or cumulative and not necessarily continuing.*
- Continuing Professional Development (CPD) of a minimum of one hundred twenty (120) CPD credit units earned for the past immediate three (3) years.

* Shall not apply to those CPAs already engaged in teaching as of June 20, 2008.

CONDUCT OF REFRESHER COURSE
(Professional Regulatory Board of Accountancy Resolution No. 2020-46)

Republic Act (RA) No. 9298 provides that any candidate who fails in two complete Certified Public Accountants (CPA) Board Examinations shall be disqualified from taking another set of examinations unless he/she submit evidence to the satisfaction of the Board of Accountancy that he/she has enrolled and completed at least twenty-four (24) units of subjects given in the licensure examination. Moreover, an examination in which the candidates was conditioned together with the removal examination on the subject in which he/she failed shall be counted as one complete examination.

Qualified Educational Institutions

Only those educational institutions recognized and/or accredited by the Commission on Higher Education (CHED) to offer a degree of Bachelor of Science in Accountancy which obtain an average national passing rate of at least ten percent (10%) and have at least ten (10) examinees in the CPA Licensure Examination for the last five (5) years shall be qualified to be accredited to offer the special refresher course to the candidates. The Certificate of Accreditation shall be valid

for a period of five (5) years from the date of its issuance.

Refresher Course Proper

The accredited educational institution may offer the required twenty-four (24) units of subjects given in the licensure examination in the, at the option of the school, regular course offering or special refresher course. The candidate shall actually enroll and attend the classes and pass the subjects in which he/she failed in two (2) complete licensure examination equivalent to the credits required per subject in the curriculum prescribed by CHED, and any other subjects given in the licensure examination, to complete the twenty-four (24) units, both aligned with the CPA Board Examination Syllabus/Table of Specifications.

Upon completion of the required units, the school shall issue a Transcript of Records (TOR) duly authenticated and signed by the school approving authorities duly certifying that the candidate has competed the required twenty (24) units of the subjects in the licensure examination and thereto qualified to retake the licensure examination. The Certificate of Completion as evidenced by the TOR shall be valid for two (2) years from the date of completion to ensure relevance of the subjects taken in the refresher course. The validity period as well as the Certificate of Accreditation Number of qualified schools shall be printed in the TOR.

ADVERTISING FOR THE PHILIPPINE ACCOUNTANCY PROFESSION
(Board of Accountancy Resolution No. 126 Series of 2008)

The Board of Accountancy adopted these rules and regulations covering advertising to protect the public interest. Such rules shall define the parameters within which advertising and promotion may be considered ethical and hence, permissible.

Acceptable Advertising and Publicity

Generally, advertising and publicity in any medium are acceptable provided:

1. It has as its objective the notification to the public or such sectors of the public as are concerned, of matters of fact (e.g., name, address, contact numbers, services offered) in a manner that is not false, misleading or deceptive.
2. It is in good taste.
3. It is professionally dignified.
4. It avoids frequent repetition of, and any undue prominence being given to the name of the firm or professional accountant in public practice.

All advertisements must have prior review and approval in writing by the Risk Management Partner and Managing Partner or their equivalents.

Prohibited Advertising and Publicity

The following however shall not be allowed:

1. Self-laudatory statements.
2. Discrediting, disparaging, or attacking other firms or CPA practitioners.
3. Referring to, using or citing actual or purported testimonials by third parties.
4. Publishing and comparing fees with other CPAs or CPA firms or comparing those services with those provided by another firm or CPA practitioner.

5. Giving too much emphasis on competitive differences.
6. Using words or phrases which are hard to define and even more difficult to substantiate objectively.
7. Publishing services in billboard (e.g., tarpaulin, streamers, etc.) advertisements.
8. Use of the name of an international accounting firm affiliation/correspondence other than a notation that it is a "member/correspondent firm of that foreign firm".
9. Identify the name of a client or items of a client's business in advertising, public relations or marketing material produced to promote his practice, unless the client gives its written consent.
10. Use the term "Accredited" or any similar words or phrases calculated to convey the same meaning if the claimed accreditation (BOA, SEC, BSP or IC) has expired.

Exhibit 3.7 outlines examples of circumstances in which publicity is acceptable and the matters to be considered in connection therewith subject always to the overriding requirements mentioned in the preceding rules.

EXHIBIT 3.7 — **Examples of Circumstances in Which Publicity is Acceptable and Matters to be Considered in Connection Therewith**

Awards

- Awards or appointments should not be use for the personal professional advantage.

Professional Accountants Seeking Employment or Professional Business

- A professional accountant may inform interested parties through any medium that a partnership or salaried employment of an accountancy nature is being sought.
- The professional accountant should not publicize for subcontract work in a manner which could be interpreted as seeking to procure professional business. Publicity seeking subcontract work may be acceptable if placed only in the professional press and provided that neither the accountant's name, address or telephone number appears in the publicity.
- A professional accountant may write a letter or make a direct approach to another professional accountant when seeking employment or professional business.

Directories

- Entries in a directory may include name, address, telephone number, professional description, services offered and any other information necessary to enable the user of the directory to make contact with the person or organization to which the entry relates.

Books, Articles, Interviews, Lectures, Radio and Television Appearances

- Author of books or articles on professional subjects may state their name and professional qualifications and give the name of their organization but shall not give any information as to the services that firm provides.
- Similar provisions are applicable to participation by a professional accountant in a lecture, interview or a radio or television program on a professional subject.
- What professional accountants write or say, however, should not be promotional of themselves or their firm but should be an objective professional view of the topic under consideration.

Training Courses and Seminars

- A professional accountant may invite clients, staff or other professional accountants to attend training courses or seminars conducted for the assistance of staff.
- Other persons should not be invited to attend such training courses or seminars except in response to an unsolicited request.
- The requirement should in no way prevent professional accountants from providing training services to other professional bodies, associations or educational institutions which run courses for their members or the public.
- Undue prominence should not be given to the name of a professional accountant in any booklets or documents issued in connection therewith.

Booklets and Documents Containing Technical Information

- Booklets and other documents bearing the name of a professional accountant and giving technical information for the assistance of staff or clients may be issued to such persons, other professional accountants or other interested parties.

Staff Recruitment

- Genuine vacancies for staff may be communicated to the public through any medium in which comparable staff vacancies normally appear. The fact that a job specification necessarily gives some detail as to one or more of the services provided to clients by the professional accountant in public practice is acceptable but it should not contain any promotional element.
- There should not be any suggestion that the services offered are superior to those offered by other professional accountants in public practice as a consequence of size, associations, or for any other reason.
- In publications such as those specifically directed to schools and other places of education to inform students and graduates of career opportunities in the profession, services offered to the public may be described in a business-like way.
- More latitude may also be permissible in a section of a newspaper devoted to staff vacancies than would be allowed if the vacancy appeared in a prominent position elsewhere in a newspaper on the grounds that it would be most unlikely that a potential client would use such media to select a professional adviser.

Publicity on Behalf of Clients

- Should ensure that the emphasis in the publicity is directed towards the objectives to be achieved for the client.

Brochures and Firm Directories

- A professional accountant in public practice may issue to clients or, in response to an unsolicited request, to a non-client:
  - ✓ A factual and objectively worded of the services provided.
  - ✓ A directory setting out names of partners, office addresses and names and address of associated firms and correspondents.

Stationery and Nameplates

- Should be of an acceptable professional standard and comply with the requirements of the law and of the member body concerned as to names of partners, principals and others who participate in the practice, use of professional descriptions and designatory letters, cities or countries where the practice is represented, logotypes, etc.
- The designation of any services provided by the practice as being specialist nature should not be permitted.

Announcements

- May be used to inform the public of the establishment of a new practice, of changes in the composition of a partnership of professional accountants in public practice, or of any alteration in the address of a practice.
- Should be limited to a bare statement of facts and consideration given to the appropriateness of the area of distribution of the newspaper or magazine and number of insertions.

Inclusion of the Name of the Professional Accountant in Public Practice in a Document Issued by a Client

- The professional accountant in public practice should take steps to ensure that the context in which the report is published is not such as might result in the public being misled as to the nature and meaning of the report.
- The professional accountant in public practice should advise the client that permission should first be obtained before publication of the document.
- When professional accountants in their private capacity are associated with, or hold in, an organization, the organization may use their name and professional status on stationery and other documents. The professional accountant in public practice should ensure that this information is not used in such a way as might lead the public to believe that there is a connection with organization in an independent professional capacity.

Anniversaries

- Press and other media releases or announcements or newspaper supplements, or other similar publications, or other commemorative media, or the holding of media covered events undertaken only to commemorate their anniversaries in public practice by informing the public of their achievements or accomplishments in contributing towards nation building and in international understanding, goodwill, or relationship or enhancing the image or standards of the accounting profession.
- Announcements or undertakings should only contain factual matters without detailed listing of services.
- Announcements or undertakings should be done only every five years of celebration.

Websites

- In suitable length and style.

- May include announcements, press releases, publications and such other necessary and factual information (e.g., firm's name, partners/principals' name and brief description of their educational attainment, brief listing of services, postal address, telephone, fax and e-mail addresses).

QUALITY CONTROL STANDARDS
(Philippine Standard on Quality Control 1)

Audit firms are required to implement policies and procedures to monitor the firms' practices and ensure that professional standards are being followed. Professional institutes and regulators have established quality assurance systems to inspect the firms' quality control and its personnel compliance with standards and ethics code.

Previously, ISA 220 *Quality Control of Audit Work,* covered quality control policies and procedures to be implemented at both level of the audit firm and on individual audits. In 2004, the IFAC approved two new standards each covering one of these two levels. The International Standards on Quality Control 1 (ISQC 1) *Quality Control for Firms That Perform Audit and Reviews of Historical Financial Information and Other Assurance and Related Services Engagements* establishes a firm's responsibilities for its system of quality control. ISQC 1 applies to audits and reviews of historical financial information as well as other assurance engagements and related services (engagements to perform agreed-upon procedures regarding financial information and engagements to compile financial information). The revised ISA 220 Quality Control for Audits of Historical Information establishes requirements and provides guidance of firm personnel's responsibilities regarding quality control for audit engagements related historical financial information, including audits of financial statements.

There is a public need of quality assurance of the firms' system of quality control and firm's personnel compliance with standards and ethics code. Such quality assurance systems may be instituted by the professional institutes for their members, by regulators for statutory auditors, or by professional institutes and regulators in concert. In many countries, quality assurance systems are a relatively new phenomenon. Two principal systems of quality assurance exist: monitoring and peer review. Monitoring refers to the situation where staff employed by the professional institute or regulator manage the quality assurance system and carry out the quality reviews. Peer review refers to a system where peers in the profession carry out the reviews.

Firms' System of Quality Control

The firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm or engagement partners are appropriate in the circumstances. The requirement applies to all firms. However, the nature of the policies and procedures developed by individual firms to comply with the above requirement will depend on various factors such as the size and operating characteristics of the firm, and whether it is part of a network.

Elements of a System of Quality Control

The firm's system of quality control should include policies and procedures addressing each of the following elements:

- Leadership responsibilities for quality within the firm.

- Ethical requirements.
- Acceptance and continuance of client relationships and specific engagements.
- Human resources.
- Engagement performance.
- Monitoring.

The quality control policies and procedures should be documented and communicated to the firm's personnel. Such communication describes the quality control policies and procedures and the objectives they are designed to achieve, and includes the message that each individual has a personal responsibility for quality and is expected to comply with these policies and procedures. In addition, the firm recognizes the importance of obtaining feedback on its quality control system from its personnel. Therefore, the firm encourages its personnel to communicate their views or concerns on quality control matters.

Exhibit 3.8 defines each of the elements of the firm's system of quality control.

EXHIBIT 3.8 Elements of Quality Control

Leadership Responsibilities for Quality within the Firm. The firm should establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements.

Ethical Requirements. The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.

Independence. The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements (including experts contracted by the firm and network firm personnel), maintain independence where required by the Philippine Code.

Acceptance and Continuance of Client Relationships and Specific Engagements. The firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide it with reasonable assurance that it will only undertake or continue relationships and engagements where it:

- Has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity;
- Is competent to perform the engagement and has the capabilities, time and resources to do so; and
- Can comply with ethical requirements.

Human Resources. The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.

Engagement Performance. The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issue reports that are appropriate in the circumstances.

Monitoring. The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice.

Exhibit 3.9 provides some selected examples of the types of policies and procedures a firm can implement to comply with a sound system of quality control.

EXHIBIT 3.9 **Selected Quality Control Policies and Procedures**

Leadership Responsibilities for Quality within the Firm
- The firm's chief executive officer (or equivalent) or, if appropriate, the firm's managing board of partners (or equivalent), to assume ultimate responsibility for the firm's system of quality control.
- Any person or persons assigned operational responsibility for the firm's system of quality control has sufficient and appropriate experience and ability, and the necessary authority, to assume that responsibility.
- Management responsibilities are assigned so that commercial considerations do not override the quality of work performed.

Ethical Requirements
- Ethical requirements relating to audits and reviews of historical financial information, and other assurance and related services engagements ordinarily comprise Parts A and B of the Philippine Code.
- The firm's policies and procedures emphasize the fundamental principles, which are reinforced in particular by (a) the leadership of the firm, (b) education and training, (c) monitoring and (d) a process for dealing with non-compliance.

Independence
- Individuals who are subject to independence requirements promptly notify the firm of independence breaches of which they become aware.
- At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by the Philippine Code.

Acceptance and Continuance of Client Relationships and Specific Engagements
- Consider the identity and business reputation of the client's principal owner, key management, related parties and those charged with its governance.
- Address circumstances where the firm obtains information that would have caused it to decline the engagement had that information been available earlier.
- On withdrawal from an engagement document significant issues, consultations, conclusions and the basis for the conclusions.

Human Resources
- The advancement of positions of greater responsibility within the firm depends, among other things, on performance of quality and adherence to ethical principles.
- The firm provides the necessary training resources and assistance to enable personnel to develop and maintain the required capabilities and competence.

Engagement Performance
- Supervision of engagements includes identifying matters for consultation or consideration by more experienced engagement team members during the engagement.
- All audits of financial statements of listed entities require an engagement quality control review.

Monitoring
- The firm communicates to relevant engagement partners and other appropriate personnel deficiencies noted as a result of the monitoring process and recommendations for appropriate remedial action.
- Address cases where the results of the monitoring procedures indicate that a report may be inappropriate or that procedures were omitted during the performance of the engagement.
- At least annually, the firm communicates the results of the monitoring of its quality control system to engagement partners and other appropriate individuals within the firm, including the firm's chief executive officer.
- The firm appropriately deals with complaints and allegations of non-compliance with professional standards and regulatory requirements and firm's system of quality control.

REVIEW QUESTIONS

1. What are the objectives of the Philippine Accountancy Act of 2004?
2. What is the composition and term of office of the Professional Regulatory Board of Accountancy?
3. What are the qualifications of members of the Professional Regulatory Board of Accountancy?
4. What are the powers and functions of the Professional Regulatory Board of Accountancy?
5. What the qualifications of any persons applying for the Certified Public Accountant licensure examinations?
6. What are the functions of FRSC and its composition, its members' qualification and term of office?
7. What are the functions of AASC and its composition, its members' qualification and term of office?
8. What are the requirements for the accreditation of Accounting Teachers?
9. What is a firm's system quality control and its elements of a system?

MULTIPLE CHOICE QUESTIONS

1. The Board shall exercise the following specific powers, functions and responsibilities:

	a.	b.	c.	d.
To supervise the registration, licensure and practice of accountancy	Yes	Yes	Yes	Yes
To issue, suspend, revoke, or reinstate the Certificate of Registration for the practice of the accountancy profession	Yes	No	Yes	Yes
To monitor the conditions affecting the practice of accountancy	Yes	Yes	No	Yes
To conduct an oversight into the quality of audits of financial statements	Yes	No	Yes	No
To issue a cease or desist order to any person, association, partnership or corporation engaged in violation of any provision of the Philippine Accountancy Act	Yes	Yes	No	Yes

2. Which of the following is a function of the Board of Accountancy
   a. To issue, suspend, revoke, or reinstate the certificate of registration for the practice of the accountancy profession.
   b. To prescribe and adopt the rules and regulations necessary for carrying out the provisions of the Philippine Accountancy Act of 2004.
   c. To supervise the regulation, licensure, and practice of accountancy in the Philippines.

d. All of the above.

3. The Board of Accountancy has the power to conduct an oversight into the quality of audits if financial statements through a review of the quality control measures instituted by auditors in order to ensure compliance with the accounting and auditing standards and practices. This power of the BOA is called
   a. Appraisal.
   b. Peer review.
   c. Quality control.
   d. Quality review.

4. Which of the following is the least function of the Board of Accountancy?
   a. Determination of the minimum requirements leading to the admission of candidates to the CPA examinations.
   b. Preparation of the contents of the CPA licensure examinations and rating of the examination papers.
   c. Regulation of the practice of accountancy.
   d. Supervision over the accredited professional organization of CPAs.

5. Which of the following is not a qualification of an applicant for the CPA licensure examination?
   a. He/she is of good moral character.
   b. He/she is at least 21 years of age.
   c. He/she is a holder of the degree of Bachelor of Science in Accountancy.
   d. He/she is a Filipino citizen.

6. Which of the following is not a requisite in applying for the CPA licensure examinations?
   a. Good moral character.
   b. Has not been convicted of any criminal offense involving moral turpitude.
   c. Holder of the degree of Bachelor of Science in Accountancy.
   d. Natural-born citizen of the Philippines.

7. Republic Act 9298 is known as the
   a. Code of Ethics for Professional Accountants.
   b. Philippine Accountancy Act of 2004.
   c. Philippine Accountancy Law of 2004.
   d. Revised Accountancy Law.

8. Which of the following is not an objective of the Philippine Accountancy Act of 2004?
   a. The development and improvement of accounting standards that will be generally accepted in the Philippines.
   b. The examination for registration of certified public accountants.
   c. The standardization and regularization of accounting education.
   d. The supervision, control, and regulation of the practice of accountancy in the Philippines.

9. The objectives of the Philippine Accountancy Act of 2004 are the following, except:
   a. Supervision, control and regulation of the practice of accountancy.
   b. Standardization and regulation of accounting education.
   c. Integration of accountancy profession.
   d. Examination for registration of certified public accountants.

10. Which of the following is not one of the specified objectives of the Accountancy Act of 2004?
    a. Supervision, control, and regulation of accounting practice.
    b. Standardization and regulation of accounting education.
    c. Promulgation of accounting and auditing standards.
    d. Examination for registration of CPAs.

11. The following statements relate to RA 9298. Which is incorrect?
    a. A person shall be considered to be in the professional practice of accountancy if, as an officer in a private enterprise, he makes decisions requiring professional accounting knowledge.
    b. After two years, subject to certain conditions, the Board of Accountancy may order the reinstatement of a CPA whose certificate of registration has been revoked.
    c. Insanity is a ground for proceeding against a CPA.
    d. The Professional Regulation Commission has the authority to remove any member of the Board of Accountancy for negligence, incompetence, or any just cause.

12. The members of the Professional Regulatory Board of Accountancy shall be appointed by the
    a. Professional Regulation Commission (PRC).
    b. President of the Philippines.
    c. Philippine Institute of CPAs (PICPA).
    d. Association of CPAs in Public Practice (ACPAPP).

13. The following statements relate to the submission of nominations to the Board of Accountancy. Which is correct?
    a. There should be adequate documentation to show the qualifications and primary field of professional activity of each nominee.
    b. The APO shall submit its nominations to the PRC not later than thirty (30) days prior to the expiry of the term of the incumbent chairman or member.
    c. The Accredited National Professional Organization of CPAs (APO) shall submit its nominations to the president of the Philippines not later than sixty (60) days prior to the expiry of the terms of an incumbent chairman or member.
    d. If APO fails to submit its nominee(s) to the PRC within the required period, the PRC in consultation with the Board of Accountancy shall submit to the president of the Philippines a list of five (5) nominees for each position.

14. The APO shall submit its nominations with complete documentation to the Commission not later than _____ prior to the expiry of the term of an incumbent chairman or member.
    a. 120 days.
    b. 30 days.
    c. 60 days.
    d. 90 days.

15. Which of the following is not a qualification of a member of the Board of Accountancy?
    a. He/she must be a duly registered CPA with at least ten (10) years of work experience in the practice of public accounting.
    b. He/she must be a natural-born citizen and a resident of the Philippines.
    c. He/she must be of good moral character and must not have been convicted of crimes involving moral turpitude.

d. He/she must not be a director of officer of the APO at the time of his/her appointment.

16. The following statements relate to the term of office of the chairman and members of the Board of Accountancy (BOA). Which is false?
    a. The chairman and members of the BOA shall hold office for a term of three (3) years.
    b. No person who has served two successive complete terms as chairman or member shall be eligible for reappointment until the lapse of two (2) years.
    c. Appointment to fill up an unexpired term is not to be considered as a complete term.
    d. Any vacancy occurring within the term of a member shall be filled up for the unexpired portion of the term only.

17. The Professional Regulatory Board of Accountancy shall elect a vice chairman from among its members for a term of
    a. Two (2) years.
    b. Three (3) years.
    c. One (1) year.
    d. Five (5) years.

18. Which statement is incorrect regarding the term of office of the chairman and the members of the Board of Accountancy?
    a. A member of the BOA may continuously serve office for more than nine years.
    b. A person may serve the BOA for not more than twelve years.
    c. No person who has served two (2) successive complete terms shall be eligible for reappointment until the lapse of one (1) year.
    d. The Chairman and members of the Board shall hold office for a term of three years.

19. No person shall serve the Professional Regulatory Board of Accountancy for more than
    a. 12 years.
    b. 3 years.
    c. 6 years.
    d. 9 years.

20. The Board, subject to the approval of the Commission, may revise or exclude any of the subjects and their syllabi, and add new ones as the need arises. Provided that the change shall not be more often than every
    a. 5 years.
    b. 4 years.
    c. 3 years.
    d. 2 years.

21. To pass the CPA licensure examination, a candidate must obtain a
    a. General average of sixty-five percent (65%).
    b. General average of sixty-five percent (65%), with no grades lower than seventy-five percent (75%) in any given subject.
    c. General average of seventy-five percent (75%).
    d. General average of seventy-five percent (75%), with no grades lower than sixty-five percent (65%) in any given subject.

22. A candidate who obtains the rating of seventy-five percent (75%) and above in at least a majority of the subjects shall receive a conditional credit for the subjects passed. He/she shall take an examination in the remaining subjects within
    a. Five (5) years from the preceding examination.
    b. One (1) year from the preceding examination.
    c. Three (3) years from the preceding examination.
    d. Two (2) years from the preceding examination.

23. The following statements relate to CPA examination ratings. Which of the following is incorrect?
    a. Candidates who failed in four complete examinations shall no longer be allowed to take the examinations the fifth time.
    b. Candidates who obtain a rating of 75% and above in at least four subjects shall receive a conditional credit for the subjects passed.
    c. Conditioned candidates shall take an examination in the remaining subjects within two years from the preceding examination.
    d. To pass the examination, candidates should obtain a general weighted average of 75% and above, with no rating in any subject less than 65%.

24. The following are represented both to the Financial Reporting Standards Council and Auditing and Assurance Standards Council, except
    a. Bangko Sentral ng Pilipinas.
    b. Board of Accountancy.
    c. Bureau of Internal Revenue.
    d. Securities and Exchange Commission.

25. The Auditing and Assurance Standards Council (AASC)
    a. Assists the PRC is the establishment and promulgation of auditing standards in the Philippines.
    b. Has fourteen (14) regular members.
    c. Replaced the Auditing Standards and Practices Council (ASPC) which was established by the Board of Accountancy (BOA), upon the recommendation of the Philippine Institute of Certified Public Accountants (PICPA).
    d. Was created by the Professional Regulation Commission (PRC) upon the recommendation of the BOA.

26. Under PSQC 1, the firm should communicate the results of the monitoring of its quality control system to engagement partners and other appropriate individual within the firm at least
    a. Annually.
    b. Monthly.
    c. Quarterly.
    d. Weekly.

27. As defined in PSQC 1, it is a process designed to provide an objective evaluation, before the report is issued, of the significant judgments the engagement team made and the conclusions they reached in formulating the report.
    a. Continuing professional education.
    b. Engagement performance.
    c. Engagement quality control .
    d. Monitoring.

28. A firm system's of quality control should ordinarily provide for the maintenance of
    a. Updated personnel files.
    b. Documentation to provide evidence of the operation of each elements of its system of quality control.
    c. Documentation to demonstrate compliance with regulatory requirements.
    d. A file of minutes of staff meetings.

29. Which of the following is not one of the penalties that can be imposed by the Board of Accountancy?
    a. Suspension of CPA certificate.
    b. Revocation of CPA certificate.
    c. Reprimand.
    d. Fine or imprisonment.

30. The Chairman and the members of the AASC shall have a term of
    a. 2 years.
    b. 3 years.
    c. 5 years.
    d. 7 years.

31. Are the following CPAs required to comply with the requirements on continuing professional education?

	a	b	c	d
CPAs in Public Accountancy	Yes	Yes	Yes	Yes
CPAs in Commerce and Industry	No	Yes	No	Yes
CPAs in Education/Academe	No	Yes	Yes	Yes
CPAs in Government	No	No	Yes	Yes

32. How many CPE credit units must be accumulated by a registered accounting professional within the 3-year period?
    a. 120 credit units
    b. 15 credit units
    c. 60 credit units
    d. 90 credit units

33. The following statements relate to the requirement to complete 12 units of relevant education subjects for the accreditation of accounting teachers. Which is incorrect?
    a. CPAs who have passed the Teachers Board Exams and are licensed Professional Teachers should earned the 12 units through in-service or in-house trainings.
    b. For purposes of compliance, the units may be earned from the undergraduate education program or from a graduate degree program of any Higher Education Institutions (HEI) duly recognized by CHED.
    c. The 12 units may be a combination of in-service trainings and units earned in an undergraduate or graduate education programs.
    d. The 12 units may be earned from in-service or in-house trainings on relevant education subjects offered by schools or training centers.

34. The Certificate of Accreditation issued by the PRC to an accounting teacher shall
    a. Be valid for 2 years and renewable every 2 years.
    b. Be valid for 3 years and renewable every 3 years.

c. Be valid initially for 3 years and renewable annually.
d. Remain in full force and effect unless revoked, cancelled or withdrawn.

35. What is the effectivity date of the BOA Resolution No. 88 (Series 2008) prescribing the rules and regulations for the accreditation of accounting teachers?
a. December 31, 2008
b. June 30, 2008
c. June 20, 2008
d. June 4, 2008

36. It is the communication to the public of facts about a professional accountant which are not designed for the deliberate promotion of that professional accountant.
a. Solicitation.
b. Publicity.
c. Indirect promotion.
d. Advertising.

37. Advertising, as defined in the Code of Ethics for the Professional Accountants, means
a. The communication to the public of information as to the services or skills provided by professional accountants in public practice with a view to procuring professional business.
b. The communication to the public of facts about a professional accountant which are not designed for the deliberate promotion of that professional accountant.
c. The approach to a potential client for the purpose of offering professional services.
d. Any of the given choices.

38. Which of the following is not allowed by the Code of Ethics for the Professional Accountants?
a. The use of the name of an international accounting firm affiliation/correspondence is generally allowed.
b. Booklets and other documents bearing the name of a professional accountant and giving technical information for the assistance of staff or clients may be issued to such persons, other professional accountants or other interested parties.
c. A professional accountant in public practice may issue to client or, in response to an unsolicited request, to a non-client a factual and objectively worded of the services provided.
d. A firm or CPA practitioner can continue to use the term "accredited" or any similar words or phrase calculated to convey the same meaning if the claimed accreditation has not expired.

39. How frequent can a professional accountants have press and other media releases commemorating their anniversaries in public practice by informing the public of their achievements in contributing toward national building or enhancing the image or standards of the accounting profession.
a. 6 years.
b. 5 years.
c. 3 years.
d. 2 years.

40. Which of the following is not allowed to be included in a website of a firm of professional accountants?

a. Names of partners/principals with their educational attainment.
b. Membership in any professional body.
c. Listing of the firm's clients.
d. Awards received.

41. In the marketing and promotion of themselves and their work, professional accountants should
a. Not denigrate the work of other accountants.
b. Not make exaggerated claims for the services they are able to offer, the qualifications they possess, or experience they have gained.
c. Not use means which brings the profession into disrepute.
d. All of the above.

42. The Philippine Standards on Quality Control (PSQCs) are to be applied to
a. Assurance engagements only.
b. Compilation and review engagements only.
c. Review engagements only.
d. All services that fall under the AASC's engagement standards.

43. One of a CPA form's basic objective is to provide professional services that comply with professional standards and regulatory and legal requirements. Reasonable assurance of achieving this basic objective is provided through
a. Continuing Professional Education
b. Compliance with the fundamental principles of the Philippine Code of Ethics.
c. Compliance with generally accepted reporting standards.
d. A system of quality control

44. Quality control policies and procedures should provide the firm with reasonable assurance that the policies and procedures relating to other elements of quality control are being effectively applied. This statement defines the quality control element of
a. Monitoring.
b. Leadership responsibility.
c. Ethical requirements.
d. Acceptance and continuance of client relationships and specific engagements.

45. According to PSQC 1, a firm should establish policies and procedures to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements. The inspection of a selection of completed engagements is ordinarily performed on a cyclical basis. Engagements selected for inspection include
a. At least one engagement for each engagement partner over an inspection cycle, which ordinarily spans no more than two years.
b. At least one engagement for each engagement partner over an inspection cycle, which ordinarily spans no more than one year.
c. At least one engagement for each engagement partner over an inspection cycle, which ordinarily spans no more than three years.
d. At least three engagements for each engagement partner over an inspection cycle, which ordinarily spans no more than five years.

46. The creation of FRSC and AASC is intended to assist the Board of Accountancy in carrying out its function to
    a. To supervise the registration, licensure and practice of accountancy in the Philippines.
    b. To prescribe and adopt the rules and regulations necessary for carrying out the provisions of RA No. 9298.
    c. To prepare, adopt, issue or amend the syllabi of the subjects for examinations.
    d. To monitor the conditions affecting the practice of accountancy and adopt such measures, rules and regulations and best practices as may be deemed proper for the standards.

47. Statements on financial accounting standards constituting GAAP in the Philippines are issued by the
    a. Securities and Exchange Commission.
    b. Philippine Institute of CPAs.
    c. Financial Reporting Standards Council.
    d. Auditing and Assurance Standards Council.

48. Which of the following mostly describes the function of AASC?
    a. To assist the Board of Accountancy in conducting administrative proceedings on erring CPAs in audit practice.
    b. To monitor full compliance by auditors to PSAs.
    c. To promulgate auditing standards, practices and procedures that shall be generally accepted by the accounting profession in the Philippines.
    d. To undertake continuing research on both auditing and financial accounting in order to make them responsive to the needs of the public.

49. Which statement is correct regarding AASC?
    a. The chairman should have been or presently a senior practitioner in public accountancy.
    b. The chairman and members of the AASC shall have a non-renewable term of 3 years.
    c. The chairman and members of the AASC shall be appointed by the President of the Philippines upon the recommendation of PRC.
    d. The AASC shall be composed of 15 members plus a Chairman.

50. The following sectors represented by the PICPA to the membership of AASC have one representative, except
    a. Public practice.
    b. Government.
    c. Commerce and industry.
    d. Academe.

Chapter 4
CODE OF ETHICS FOR PROFESSIONAL ACCOUNTANTS

LEARNING OBJECTIVES

Upon completion of this chapter you will

1. **Understand the basis and the need for professional ethics.**
2. **Know the pertinent provisions of the Code of Professional Ethics.**
3. **Apply the different principles of the Code in practice.**

The Code of Ethics for Professional Accountants establishes ethical requirements for professional accountants. A member body of the International Federation of Accountants (IFAC) or firm shall not apply less stringent standards than those stated in the Code unless prohibited by law or regulation. The Code defines both ideal principles and what acceptable behavior is for auditors. The Code deals primarily with behavior and actions of individual auditors, though firms are also responsible for the conduct of their employees and partners. The standards on quality control, on the other hand, are concerned with a firm's monitoring of its own practice.

The Code of Ethics for Professional Accountants is structured into three main parts. Each part consists of sections. Each section constitutes a set of paragraphs covering specific theme or issue. For example, Part B Section 290 in the Code provides specific guidance on independence requirements for professional accountants in public practice when performing audit engagements. Table 4.1 gives an overview of the content of the Code.

TABLE 4.1 The Content of Code of Ethics for Professional Accountants

Part A: General Application of the Code
100 Introduction and Fundamental Principles
110 Integrity
120 Objectivity
130 Professional Competence and Due Care
140 Confidentiality
150 Professional Behavior

Part B: Professional Accountants in Public Practice
200 Introduction
210 Professional Appointment
220 Conflicts of Interest
230 Second Opinions
240 Fees and Other Types of Remuneration
250 Marketing Professional Services
260 Gifts and Hospitality
270 Custody of Client Assets
280 Objectivity – All Services
290 Independence – Audit and Review Engagements
291 Independence – Other Assurance Engagements

Part C: Professional Accountants in Business
300 Introduction
310 Potential Conflicts
320 Preparation and Reporting of Information
330 Acting with Sufficient Expertise
340 Financial Interests
350 Inducements

Definitions

FUNDAMENTAL PRINCIPLES AND CONCEPTUAL FRAMEWORK

Part A of the Code establishes the fundamental principles of professional ethics for professional accountants and provides a conceptual framework for applying those principles. The fundamental principles are integrity, objectivity, professional competence and due care, confidentiality and professional behavior. The conceptual framework should assist the professional accountant to identify, evaluate and respond to threats to compliance with the fundamental principles. Part A applies to all professional accountants. A professional accountant is an individual who is a member of an IFAC body. IFAC bodies are typical national professional institutes or organizations for the accountancy profession. Table 4.2 outlines the Code's definition of each principle.

TABLE 4.2 Fundamental Principles

A professional accountant shall comply with the following fundamental principles:

Integrity – to be straightforward and honest in all professional and business relationships.

Objectivity – to not allow bias, conflict of interest or undue influence of others to override professional or business judgments.

Professional Competence and Due Care – to maintain professional knowledge and skill at the level required to ensure that a client or employer receives competent professional services based on current developments in practice, legislation and techniques and act diligently and in accordance with applicable technical and professional standards.

Confidentiality – to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose any such information to third parties without proper and specific authority, unless there is a legal or professional right or duty to disclose, nor use the information for the personal advantage of the professional accountant or third parties.

Professional Behavior – to comply with relevant laws and regulations and avoid any action that discredits the profession.

The principle of **integrity** imposes an obligation on all professional accountants to be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness. Specifically, the Code requires that a professional accountant should not be associated with reports, returns, communications or other information where the professional accountant believes that the information contains a materially false or misleading statement, contains statements or information furnished recklessly or omits or obscures information required to be included where such omission or obscurity would be misleading. When a professional accountant becomes aware that the accountant has been associated with such information, the accountant shall take steps to be disassociated from that information. If the professional accountant provides a modified report in respect of such matter, he or she will not be considered to be in breach of the Code.

The principle of **objectivity** imposes an obligation on all professional accountants not to compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others. A professional accountant may be exposed to situations that may impair objectivity. A professional accountant shall not perform a professional service if a circumstance or relationship biases or unduly influences the accountant's professional judgment with respect to that service.

The principle of **professional competence and due care** requires that the professional accountants maintain professional knowledge and skill at the level required to ensure that or employers receive competent professional service and act diligently in accordance with applicable technical and professional standards when providing professional services. Competent professional service requires the exercise of sound judgment in applying professional knowledge and skill in the performance of such service. Such competence should be attained as well as maintained. The maintenance of professional competence requires a continuing awareness and an understanding of relevant technical, professional and business developments. Continuing professional development enables a professional accountant to develop and maintain the capabilities to perform competently within the professional environment. Diligence, on the other hand, encompasses the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis. A professional accountant should also take reasonable steps to ensure that those working under the professional accountant's authority in a professional capacity have appropriate training and supervision. Where appropriate, a professional accountant should make clients, employers or other users of the accountant's professional services aware of the limitations inherent in the services.

The principle of **confidentiality** requires the professional accountants to refrain from disclosing any confidential information acquired as a result of professional and business relationships without proper and specific authority or unless there is a legal or professional right or duty to disclose and using confidential information acquired as a result of professional and business relationships to their personal advantage or the advantage of third parties. Maintenance of confidentiality extends beyond a professional environment, for example, in relation to a close business associate or a close or immediate family member. Confidentiality should also be maintained of information disclosed by a prospective client or employer and continue even after the end of relationships between a professional accountant and a client or employer. Further, the professional accountant should also maintain confidentiality of information within the firm or employing organization. This implies that the professional accountant should take all reasonable steps to ensure that staff under the professional accountant's control and persons from whom advice and assistance is obtained respect the professional accountant's duty of confidentiality. The Code specifies following circumstances where professional accountants are or may be required to disclose confidential information or when such disclosure may be appropriate:

- Disclosure is permitted by law and is authorized by the client or the employer.
- Disclosure is required by law, for example:
  - ✓ Production of documents or other provision of evidence in the course of legal proceedings.
  - ✓ Disclosure to the appropriate public authorities of infringements of the law that come to light.
- There is a professional duty or right to disclose, when not prohibited by law:
  - ✓ To comply with the quality review of a member body or professional body.
  - ✓ To respond to an inquiry or investigation by a member body or regulatory body.
  - ✓ To protect the professional interests of a professional accountant in legal proceedings.
  - ✓ To comply with technical standards and ethics requirements.

The last principle of **professional behavior** imposes an obligation on all professional accountants to comply with relevant laws and regulations and avoid any action that the professional accountant knows or should know may discredit the profession. This includes actions that a reasonable and informed third party, weighing all the specific facts and circumstances available to the professional accountant at that time, would be likely to conclude adversely affects the good

reputation of the profession. In marketing and promoting themselves and their work, professional accountants shall not bring the profession into disrepute. The professional accountants should be honest and truthful. Specifically, the Code states that professional accountants should not make exaggerated claims for the services they are able to offer, the qualifications they possess, or experience they have gained; or make disparaging references or unsubstantiated comparisons to the work of others.

In the performance of professional services, a professional accountant must take into account both the interests of the client and the public's interest. When the two interests are in conflict, the public interest is the most important. The professional accountant is required to resolve a conflict in the application of fundamental principles. In the conflict resolution process, the following factors, either individually or together with other factors, may be relevant to the resolution process:

- Relevant facts.
- Ethical issues involved.
- Fundamental principles related to the matter in question.
- Established internal procedures.
- Alternative courses of action.

Having considered these relevant factors, a professional accountant should determine the appropriate course of action that is consistent with the fundamental principles after weighing the consequences of each possible course of action. If the matter remains unresolved, the professional accountant may wish to consult with other appropriate persons within the firm or employing organization for help in obtaining resolution. It may be in the best interests of the professional accountant to document the substance of the issue, the details of any discussions held, and the decisions made concerning that issue. If a significant conflict cannot be resolved, a professional accountant may consider obtaining professional advice from the relevant professional body or from legal advisors, and thereby obtain guidance on ethical issues without breaching the fundamental principle of confidentiality. For example, a professional accountant may have encountered a fraud, the reporting of which could breach the professional accountant's responsibility to respect confidentiality. The professional accountant may consider obtaining legal advice in that instance to determine whether there is a requirement to report. If, after exhausting all relevant possibilities, the ethical conflict remains unresolved, a professional accountant should, where possible, refuse to remain associated with the matter creating the conflict. The professional accountant shall determine whether, in the circumstances, it is appropriate to withdraw from the engagement team or specific assignment, or to resign altogether from the engagement, the firm or the employing organization.

The conceptual framework provides guidance for applying the fundamental principles. The general application of the conceptual framework to all professional accountants is presented in Part A. The conceptual framework in the Code requires the professional accountants to identify threats to compliance with fundamental principles and to evaluate their significance. If such threats are other than clearly insignificant, the professional accountant shall apply safeguards to eliminate or reduce them to an acceptable level such that compliance with the fundamental principles is not compromised. A matter is clearly insignificant if it is deemed to be both trivial and inconsequential. A professional accountant shall take qualitative as well as quantitative factors into account when evaluating the significance of a threat. If appropriate safeguards are not available or cannot be applied, the professional accountant should decline or discontinue the specific professional service involved or, when necessary, resign from the engagement (in the case of a professional accountant in public practice) or the employing organization (in the case of

a professional accountant in business). In line with the general framework approach presented, the Code categorizes the threats into self-interest threats, self-review threats, advocacy threats, familiarity threats and intimidation threats. These threats are explained in the Code and presented in Table 4.3.

TABLE 4.3 Threats

Threats fall into one or more of the following categories:

Self-interest threat – the threat that a financial or other interest will inappropriately influence the professional accountant's judgment or behavior.

Self-review threat – the threat that a professional accountant will not appropriately evaluate the results of a previous judgment made or service performed by the professional accountant, or by another individual within the professional accountant's firm or employing organization, on which the accountant will rely when forming a judgment as part of providing a current service.

Advocacy threat – the threat that a professional accountant will promote a client's or employer's position to the point that the professional accountant's objectivity is compromised.

Familiarity threat – the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work.

Intimidation threat – the threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the professional accountant.

Safeguards are actions or other measures that may eliminate threats or reduce them to an acceptable level. The Code categorizes safeguards into two broad categories: those created by the profession, legislation or regulation; and those in the work environment. Safeguards for professional accountants created by the profession, legislation or regulation include, but not limited to the following:

- Educational, training and experience requirements for entry into the profession.
- Continuing professional development requirements.
- Corporate governance regulations.
- Professional standards.
- Professional or regulatory monitoring and disciplinary procedures.
- External review by a legally empowered third party of the reports, returns, communications or information produced by a professional accountant.

The Code also states that certain safeguards may increase the likelihood of identifying or deterring unethical behavior. Such safeguards, which may be created by the accounting profession, legislation, regulation, or an employing organization, include:

- Effective, well-publicized complaint systems operated by the employing organization, the profession or a regulator, which enable colleagues, employers and members of the public to draw attention to unprofessional or unethical behavior.
- An explicitly stated duty to report breaches of ethical requirements.

As a final note on the general application of the Code, a professional accountant may inadvertently violate a provision of the Code. Such an inadvertent violation, depending on the nature and significance of the matter, may be deemed not to compromise compliance with the

fundamental principles provided, once the violation is discovered, the violation is corrected promptly and any necessary safeguards are applied.

CONDUCT OF PROFESSIONAL ACCOUNTANTS IN PUBLIC PRACTICE

Part B *Professional Accountants in Public Practice* describes how the conceptual framework contained in Part A applies in certain situations to professional accountants in public practice. As shown in Table 4.1, the sections in Part B covers, beside an introduction, themes as such professional appointment, conflicts of interest, second opinion, fees and other types of remuneration, marketing professional services, gifts and hospitality, custody of client assets, objectivity – all services and independence – assurance engagements.

Part B applies to all professional accountants in public practice. A professional accountant in public practice is defined as a professional accountant that provides professional services irrespective of functional classification (e.g., audit, tax or consulting) in a firm. Professional services are defined as services requiring accountancy or related skills performed by a professional accountant including accounting, auditing, taxation, management consulting and financial management services. A firm is defined as: a sole practitioner or partnership of professional accountants; an entity that controls such parties, through ownership, management or other means and an entity controlled by such parties, through ownership, management or other means.

Table 4.4 provides examples from the Code of circumstances that may create threats to professional accountants. The nature and significance of the threats may differ depending on whether they arise in relation to the provision of services to a financial statement audit client, a non-financial statement assurance client, or a non-assurance client. A professional accountant may also find that specific circumstances give rise to unique threats to compliance with one or more of the fundamental principles. The professional accountant, therefore, should always be alert for such circumstances or threats.

TABLE 4.4 Examples of Circumstances That May Create Threats

Self-interest threats may include:

- A member of the assurance team having a direct financial interest in the assurance client.
- A firm having undue dependence on total fees from a client.
- A member of the assurance team having a significant close business relationship with an assurance client.
- A firm being concerned about the possibility of losing a significant client.
- A member of the audit team entering into employment negotiations with the audit client.
- A firm entering into a contingent fee arrangement relating to an assurance engagement.
- A professional accountant discovering a significant error when evaluating the results of a previous professional service performed by a member of the professional accountant's firm.

Self-review threats may include:

- A firm issuing an assurance report on the effectiveness of the operation of financial systems after designing or implementing the systems.
- A firm having prepared the original data used to generate records that are the subject matter of the assurance engagement.
- A member of the assurance team being, or having recently been, a director or officer of the client.
- A member of the assurance team being, or having recently been, employed by the client in a position to exert significant influence over the subject matter of the engagement.
- The firm performing a service for an assurance client that directly affects the subject matter information of the assurance engagement.

Advocacy threats may include:

- The firm promoting shares in an audit client.
- A professional accountant acting as an advocate on behalf of an audit client in litigation or disputes with third parties.

Familiarity threats may include:

- A member of the engagement team having a close or immediate family member who is a director or officer of the client.
- A member of the engagement team having a close or immediate family member who is an employee of the client who is in a position to exert significant influence over the subject matter of the engagement.
- A director or officer of the client or an employee in a position to exert significant influence over the subject matter of the engagement having recently served as the engagement partner.
- A professional accountant accepting gifts or preferential treatment from a client, unless the value is trivial or inconsequential.
- Senior personnel having a long association with the assurance client.

Intimidation threats may include:

- A firm being threatened with dismissal from a client engagement.
- An audit client indicating that it will not award a planned non-assurance contract to the firm if the firm continues to disagree with the client's accounting treatment for a particular transaction.
- A firm being threatened with litigation by the client.
- A firm being pressured to reduce inappropriately the extent of work performed in order to reduce fees.
- A professional accountant feeling pressured to agree with the judgment of a client employee because the employee has more expertise on the matter in question.
- A professional accountant being informed by a partner of the firm that a planned promotion will not occur unless the accountant agrees with an audit client's inappropriate accounting treatment.

As noted, the Code divides safeguards into those created by profession, legislation, or regulation and those in the work environment. Safeguards created by the profession, legislation, or regulation for all professional accountants were presented in the preceding section of this chapter. Safeguards in the work environment include firm-wide safeguards, engagement-specific safeguards and safeguards within the client's systems and procedures. Table 4.5 presents examples from the Code of safeguards in the work environment for professional accountants. Note that the Code states that it is not possible to rely solely on safeguards within the client's systems and procedures to reduce threats to an acceptable level.

TABLE 4.5 Examples of Safeguards in the Work Environment

Firm-wide safeguards

- Leadership of the firm that stresses the importance of compliance with the fundamental principles.
- Leadership of the firm that establishes the expectation that members of an assurance team will act in the public interest.
- Policies and procedures to implement and monitor quality control of engagements.
- Documented policies regarding the need to identify threats to compliance with the fundamental principles, evaluate the significance of those threats, and apply safeguards to eliminate or reduce the threats to an acceptable level or, when appropriate safeguards are not available or cannot be applied, terminate or decline the relevant engagement.
- Documented internal policies and procedures requiring compliance with the fundamental principles.
- Policies and procedures that will enable the identification of interests or relationships between the firm or members of engagement teams and clients.
- Policies and procedures to monitor and, if necessary, manage the reliance on revenue received from a single client.
- Using different partners and engagement teams with separate reporting lines for the provision of non-assurance services to an assurance client.
- Policies and procedures to prohibit individuals who are not members of an engagement team from inappropriately influencing the outcome of the engagement.

- Timely communication of a firm's policies and procedures, including any changes to them, to all partners and professional staff, and appropriate training and education on such policies and procedures.
- Designating a member of senior management to be responsible for overseeing the adequate functioning of the firm's quality control system.
- Advising partners and professional staff of assurance clients and related entities from which independence is required.
- A disciplinary mechanism to promote compliance with policies and procedures.
- Published policies and procedures to encourage and empower staff to communicate to senior levels within the firm any issue relating to compliance with the fundamental principles that concerns them.

Engagement-specific safeguards

- Having a professional accountant who was not involved with the non-assurance service review the non-assurance work performed or otherwise advise as necessary.
- Having a professional accountant who was not a member of the assurance team review the assurance work performed or otherwise advise as necessary.
- Consulting an independent third party, such as a committee of independent directors, a professional regulatory body or another professional accountant.
- Discussing ethical issues with those charged with governance of the client.
- Disclosing to those charged with governance of the client the nature of services provided and extent of fees charged.
- Involving another firm to perform or re-perform part of the engagement.
- Rotating senior assurance team personnel.

Safeguards within the client's systems and procedures

- The client requires persons other than management to ratify or approve the appointment of a firm to perform an engagement.
- The client has competent employees with experience and seniority to make managerial decisions.
- The client has implemented internal procedures that ensure objective choices in commissioning non-assurance engagements.
- The client has a corporate governance structure that provides appropriate oversight and communications regarding the firm's services.

Professional Appointment

Professional appointment covers:

- Client acceptance.
- Engagement acceptance.
- Changes in professional appointments.

These situations may create threats that, if not clearly insignificant, must be mitigated by appropriate safeguards. If it is not possible to reduce the threats to an acceptable level, the practitioner should decline to enter into the client relationship, decline the engagement, or not undertake the work.

For example, potential threats to integrity or professional behavior may be created from a potential new client that has been involved in illegal activities (such as money laundering). Possible safeguards in this client acceptance situation include obtaining knowledge and understanding of the client, its owners, managers and those responsible for its governance and business activities and securing the client's commitment to improve corporate governance practices or internal controls. The Code recommended that a professional accountant in public practice periodically review acceptance decisions for recurring client engagements.

In other situations, a self-interest threat to professional competence and due care is created if the engagement team does not possess, or cannot acquire, the competencies necessary to properly

carry out the engagement. Possible safeguards include assigning sufficient staff with the necessary competencies, using experts where necessary and agreeing on a realistic time frame for the performance of the engagement. When a professional accountant in public practice intends to rely on the advice or work of an expert, the professional accountant in public practice shall determine whether such reliance is warranted. The Code advises on other applicable safeguards.

Turning to changes in professional appointments, there may be a threat to professional competence and due care if a professional accountant in public practice is asked to replace another professional accountant in public practice or considering tendering for an engagement currently held by another professional accountant in public practice before knowing all the pertinent facts. For example, the apparent reasons for the change in appointment may not fully reflect the facts and may indicate disagreements with the existing accountant that may influence the decision to accept the appointment. In evaluating the threat, direct communications with the existing accountant may be required to establish the facts and circumstances regarding the proposed change. A possible safeguard will be to include a request in the submission of the tender offer for direct contact with the existing accountant. The Code advises on further applicable safeguards. If the threats cannot be reduced to an acceptable level through application of safeguards, and there is no satisfaction as to necessary facts by other means, the accountant should decline the engagement. Finally, a professional accountant in public practice may be asked to undertake work that is complementary or additional to the work of the existing accountant. Such circumstances may create threats to professional competence and due care resulting from, for example, a lack of or incomplete information. Safeguards against such threats include notifying the existing accountant of the proposed work, which would give the existing accountant the opportunity to provide any relevant information needed for the proper conduct of the work.

Conflicts of Interest

A professional accountant in public practice should take reasonable steps to identify circumstances that could pose a conflict of interest. Such circumstances may create threats to compliance with the fundamental principles. For example, a threat to objectivity may be created when:

- The professional accountant in public practice competes directly with a client or has a joint venture or similar arrangement with a major competitor of a client.
- The professional accountant in public practice performs services for clients whose interests are in conflict.
- The clients are in dispute with each other in relation to the matter or transaction in question.

Depending upon the circumstances giving rise to the conflict, the safeguards should ordinarily include notifying the client of the firm's business interest or activities that may represent a conflict of interest and obtaining their consent to act.

Thus, a possible threat to objectivity or confidentiality exists if an audit firm competes directly with an existing or new client when both parties are offering consulting services. When causing a conflict of interest, the practitioner should in this case notify the client of the firm's consulting services, and ask for their consent to perform such activities. Additional safeguards may be the use of separate engagement teams, procedures to prevent access to information (e.g., strict physical separation of such teams, confidential and secure data filing), and clear guidelines for members of the engagement team on issues of security and confidentiality. The Code advises on

other applicable safeguards. The outcome may be that it is not appropriate to accept a specific engagement or that resignation from conflicting engagements is required.

The Code requires that where a professional accountant in public practice has requested consent from a client to act for another party (which may or may not be an existing client) in respect of a matter where the respective interests are in conflict and that consent has been refused by the client, then they must not continue to act for one of the parties in the matter giving rise to the conflict of interest.

Second Opinions

A professional accountant in public practice may be asked to provide a second opinion on the application of accounting, auditing, reporting or other standards or principles to specific circumstances or transactions by or on behalf of a company or an entity that is not an existing client. Such situations may create threats to compliance with the fundamental principles.

For example, there may be a threat to professional competence and due care in circumstances where the second opinion is not based on the same set of facts that were made available to the existing accountant or is based on inadequate evidence. The existence and significance of any threat will depend on the circumstances of the request and all the other available facts and assumptions relevant to the expression of a professional judgment. Safeguards may include seeking client permission to contact the existing accountant, describing the limitations surrounding any opinion in communications with the client and providing the existing accountant with a copy of the opinion. If the company or entity seeking the opinion will not permit communication with the existing accountant, a professional accountant in public practice shall determine whether, taking all the circumstances into account, it is appropriate to provide the opinion sought.

Fees and Other Types of Remuneration

When entering into negotiations regarding professional services, a professional accountant in public practice may quote whatever fee is deemed appropriate. The fact that one professional accountant in public practice may quote a fee lower than another is not in itself unethical. Nevertheless, there may be threats to compliance with the fundamental principles arising from the level of fees quoted. For example, a self-interest threat to professional competence and due care is created if the fee quoted is so low that it may be difficult to perform the engagement in accordance with applicable technical and professional standards for that price. The existence and significance of such threats will depend on factors such as the level of fee quoted and the services to which it applies. Available safeguards include assigning appropriate time and qualified staff to the task and making the client aware of the terms of the engagement and, in particular, the basis on which fees are charged and which services are covered by the quoted fee.

Contingent fees are fees calculated on a predetermined basis relating to the outcome of a transaction or the result of the services performed by the firm. Such fees are widely used for certain types of non-assurance engagements. They may, however, create threats to compliance with the fundamental principles and self-interest threat to objectivity. The existence and significance of such threats will depend on factors such as the nature of the engagement, the range of possible fee amounts, the basis for determining the fee, and whether the outcome or result of the transaction is to be reviewed by an independent third party. Safeguards include an advance written agreement with the client as to the basis of remuneration, disclosure to intended users of the work performed by the professional accountant in public practice and the basis of

remuneration, quality control policies and procedures and review by an independent third party of the work performed by the professional accountant in public practice.

In certain circumstances, a professional accountant in public practice may receive a referral fee or commission relating to a client. For example, where the professional accountant in public practice does not provide the specific service required, a fee may be received for referring a continuing client to another professional accountant in public practice or other expert. Similarly, a professional accountant in public practice may also pay a referral fee to obtain a client, for example, where the client continues as a client of another professional accountant in public practice but requires specialist services not offered by the existing accountant. In other situations, a professional accountant in public practice may receive a commission from a third party (e.g., a software vendor) in connection with the sale of goods or services to a client. The acceptance and payment of such a referral fee or commission may create a self-interest threat to objectivity and professional competence and due care. Possible safeguards when accepting or paying such a referral fee or commission include disclosing to the client any arrangements to pay or receive a referral fee and obtaining advance agreement from the client for commission arrangements in connection with the sale by a third party of goods or services to the client.

A professional accountant in public practice may purchase all or part of another firm on the basis that payments will be made to individuals formerly owning the firm or to their heirs or estates. Such payments are not regarded as commissions or referral fees.

Marketing Professional Services

When a professional accountant in public practice solicits new work through advertising or other forms of marketing, there may be a threat to compliance with the fundamental principles. For example, a self-interest threat to compliance with the principle of professional behavior is created if services, achievements, or products are marketed in a way that is inconsistent with that principle. The professional accountant in public practice should be honest and truthful and not make exaggerated claims for services they are able to offer, the qualifications they possess, or experience they gain; or make disparaging references or unsubstantiated comparisons to the work of another. If the professional accountant in public practice is in doubt about whether a proposed form of advertising or marketing is appropriate, the professional accountant in public practice shall consider consulting with the relevant professional body.

Gifts and Hospitality

A professional accountant in public practice, or an immediate (a spouse, spouse equivalent or dependent) or close family member (parent, child, or sibling who is not an immediate family member) may be offered gifts and hospitality from a client. Such an offer may create threats to compliance with the fundamental principles. For example, a self-interest or familiarity threat to objectivity may be created if a gift from a client is accepted and intimidation threat to objectivity may result from the possibility of such offers being made public.

The existence and significance of any threat will depend on the nature, value, and intent of the offer. Where gifts or hospitality are offered that a reasonable and informed third party, weighing all the specific facts and circumstances, would consider trivial and inconsequential, a professional accountant in public practice may conclude that the offer is made in the normal course of business without the specific intent to influence decision making or to obtain information. In such cases, the professional accountant in public practice may generally conclude that any threat to compliance with the fundamental principles is at an acceptable level. If evaluated threats are other

than clearly insignificant and cannot be eliminated or reduced to an acceptable level through the application of safeguards, a professional accountant in public practice shall not accept such an offer.

Custody of Client Assets

A professional accountant in public practice should not assume custody of client monies or other assets unless permitted to do so by law and, if so, in compliance with any additional legal duties imposed on a professional accountant in public practice holding such assets. The holding of client assets creates threats to compliance with the fundamental principles. For example, there is a self-interest threat to professional behavior and may be a self-interest threat to objectivity arising from holding client assets. To safeguard against such threats, the professional accountant in public practice entrusted with money (or other assets) belonging to others should keep such assets separately from personal or firm assets, use such assets only for the purpose for which they are intended, at all times be ready to account for those assets and any income, dividends, or gains generated, to any persons entitled to such accounting and comply with all relevant laws and regulations relevant to the holding of and accounting for such assets.

As part of client and engagement acceptance procedures for services that may involve the holding of client assets, a professional accountant in public practice shall make appropriate inquiries about the source of such assets and consider legal and regulatory obligations. For example, if the assets were derived from illegal activities, such as money laundering, a threat to compliance with the fundamental principles would be created. In such situations, the professional accountant may consider seeking legal advice.

Objectivity – All Services

A professional accountant in public practice should determine when providing any professional service whether there are threats to compliance with the fundamental principle of objectivity resulting from having interests in, or relationships with, a client or its directors, officers or employees. For example, a familiarity threat to objectivity may be created from a family or close personal or business relationship.

The existence of threats to objectivity when providing any professional service will depend upon the particular circumstances of the engagement and the nature of the work that the professional accountant in public practice is performing. Safeguards may include withdrawing from the engagement team, supervisory procedures, terminating the financial or business relationship giving rise to the threat, discussing the issue with higher levels of management within the firm and discussing the issue with those charged with governance of the client.

A professional accountant in public practice who provides an assurance service is required to be independent of the assurance client. Independence of mind and in appearance is necessary to enable the professional accountant in public practice to express a conclusion, without bias, conflict of interest, or undue influence of others. The following presents the Code's guidance on independence requirements for professional accountants in public practice when performing assurance engagements.

Independence – Audit and Review Engagements

The Code requires that practitioners should be both independent in mind and in appearance for all audit and review engagements. Independence comprises:

- **Independence of Mind.** The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.

- **Independence in Appearance.** The avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a firms, or a member of the audit team's, integrity, objectivity or professional skepticism has been compromised.

Independence is related to the basic principles of integrity and objectivity as well as professional skepticism. An attitude of professional skepticism means that the practitioner makes a critical assessment, with questioning mind, of the validity of evidence obtained and is alert to evidence that contradicts or brings into question the reliability of documents or representations by the responsible party. Independence in mind relates to the practitioner's state of mind in exercising professional judgment. Independence is appearance relates to observable facts and circumstances and third parties' perceptions about the practitioner's integrity, objectivity, and professional skepticism, given these facts and circumstances.

The Code recognizes that it is impossible and unnecessary for a person exercising professional judgment to be free from all economic, financial and other relationships with clients. Therefore, the significance of the economic, financial and other relationships should be evaluated in light of what a reasonable and informed third party having knowledge of all relevant information would reasonably conclude to be unacceptable.

In deciding whether to accept or continue an engagement, or whether a particular individual may be a member of the audit team, a firm shall identify and evaluate threats to independence. The obligation to evaluate threats to independence and take action arises when one could reasonably be expected to know of circumstances or relationships that might compromise independence. The evaluation of subsequent action should be supported by evidence obtained before accepting the engagement and while it is being performed.

When threats to independence that are not clearly insignificant are identified, and the firm decides to accept or continue the assurance engagements, the decision should be documented. The documentation should include a description of the threats identified and the safeguards applied to eliminate or reduce the threats to an acceptable level.

If the threats are not at an acceptable level, and the decision is whether to accept an engagement or include a particular individual on the audit team, the firm shall determine whether safeguards are available to eliminate the threats or reduce them to an acceptable level. If the decision is whether to continue an engagement, the firm shall determine whether any existing safeguards will continue to be effective to eliminate the threats or reduce them to an acceptable level or whether other safeguards will need to be applied or whether the engagement needs to be terminated. Whenever new information about a threat to independence comes to the attention of the firm during the engagement, the firm shall evaluate the significance of the threat in accordance with the conceptual framework approach.

Financial Interests

Holding a financial interest in an audit client may create a self-interest threat. The nature of the financial interest affects the significance of the threat and the appropriate safeguards to be applied. This includes an evaluation of:

- The role of the person holding the financial interest.
- Whether the financial interest is direct or indirect.
- The materiality of the financial interest.

Financial interests may be held through an intermediary (e.g. a collective investment vehicle, estate or trust). The determination of whether such financial interests are direct or indirect will depend upon whether the beneficial owner has control over the investment vehicle or the ability to influence its investment decisions. When control over the investment vehicle or the ability to influence investment decisions exists, this Code defines that financial interest to be a direct financial interest. Conversely, when the beneficial owner of the financial interest has no control over the investment vehicle or ability to influence its investment decisions, this Code defines that financial interest to be an indirect financial interest.

A member of the audit team, their immediate family member (i.e., spouse or dependent), or a firm should not have a direct financial interest or a material indirect financial interest in the audit client or in an entity that has a controlling interest in the audit client and the client is material to the entity. The self-interest threat created would be so significant that no safeguards could reduce the threat to an acceptable level. This prohibition extends to other circumstances:

- To other partners, or their immediate family members, in the office in which the engagement partner practices in connection with the audit engagement.
- To other partners and managerial employees, or their immediate family members, who provide non-audit services to the audit client, except those whose involvement is minimal.

The holding of a financial interest in an audit client by an immediate family member in the two above cases is deemed not to compromise independence if the financial interest is received as a result of the immediate family member's employment rights (e.g., through pension or share option plans). However, when the immediate family member has or obtains the right to dispose of the financial interest or, in the case of a stock option, the right to exercise the option, the financial interest shall be disposed of or forfeited as soon as practicable.

Close family (e.g., a parent, child or sibling) is more distant than immediate family. When a member of the audit team knows that his or her close family member has a direct financial interest or a material indirect financial interest in the audit client, a self-interest threat is created. The significance of the threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level.

As a special case, the holding by a firm, or a member of the audit team, or a member of that individual's immediate family, of a direct financial interest or a material indirect financial interest in the audit client as a trustee creates a self-interest threat. The Code prescribes conditions under which it is acceptable to hold such as interest. The Code also establishes the conditions under which inadvertent violation of the provisions would not impair independence and advises on applicable safeguards.

Finally, the holding by a firm's retirement benefit plan of a direct or material indirect financial interest in an audit client creates a self-interest threat. The significance of the threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level.

Table 4.6 presents examples from the Code of threats and safeguards for financial interests.

TABLE 4.6 Threats and Safeguards for Financial Interests

Threats	Safeguards
The following parties are not allowed to own a direct financial interest or an indirect material financial interest in a client: ▪ The assurance firm ▪ A member of the assurance team ▪ An immediate family member of a member of the assurance team	▪ Disposing of the interest ▪ Removing the individual from the team ▪ Keep the client's audit committee informed ▪ Using an independent partner or review work Note: If the firm has a direct financial interest in an audit client, disposal of the interest is the only acceptable action.
Definitions from Code of Ethics for Professional Accountants ▪ Immediate family means spouse (or equivalent) or dependent. ▪ Close family means a parent, child or sibling who is not an immediate family member.	

Loans and Guarantees

A loan or a guarantee of a loan, to a member of the audit team, or a member of that individual's immediate family, or the firm from an audit client that is a bank or a similar institution may create a threat to independence. If the loan or guarantee is not made under normal lending procedures, terms and conditions, a self-interest threat would be created that would be so significant that no safeguards could reduce the threat to an acceptable level. Deposits with an audit client may create similar threats. The provisions in the Code for deposits with an audit client are parallel to those for loans and are not further commented on in the following discussion.

Loans from bank or similar institution made under normal lending procedures, terms and conditions and it is material to the audit client or firm receiving the loan are considered less exposed to independence risk and are therefore acceptable under certain circumstances. For example, home mortgages, bank overdrafts, car loans and credit card balances under normal lending procedures, terms and conditions to a member of the audit team or their immediate family would not create a threat to independence.

If the firm or a member of the audit team, or a member of that individual's immediate family, accepts a loan from, or has a borrowing guaranteed by, an audit client that is not a bank or similar institution, the self-interest threat created would be so significant that no safeguards could reduce the threat to an acceptable level, unless the loan or guarantee is immaterial to both the firm or the member of the audit team and the immediate family member, and the client.

Table 4.7 presents examples from the Code of threats and safeguards for loans and guarantees.

TABLE 4.7 Threats and Safeguards for Loans and Guarantees

Threats	Safeguards
Clients that are banks or similar institutions: ▪ Loans or guarantees to the firm ▪ No threat if immaterial and on normal terms ▪ If material, apply safeguards ▪ Loans to members of the assurance team ▪ Not a threat to independence if on normal commercial terms	Review by an additional professional accountant from outside the firm
Clients that are not banks or similar institutions ▪ Loans or guarantees to/from the assurance firm or members of the assurance team.	No safeguard can reduce the threat unless the loan is immaterial to client and firm/team member

Business Relationships

A close business relationship between a firm, or a member of the audit team, or a member of that individual's immediate family, and the audit client or its management, arises from a commercial relationship or common financial interest and may create self-interest or intimidation threats. For example, a common financial interest exists if a member of the audit team has a material financial interest in a joint venture with either the client or a controlling owner, director, officer or other individual who performs senior managerial activities for that client.

Unless any financial interest is immaterial and the business relationship is insignificant to the firm and the client or its management, the threat created would be so significant that no safeguards could reduce the threat to an acceptable level. The only possible courses of action are to:

- Terminate the business relationship.
- Reduce the magnitude of the relationship so that the financial interest is immaterial and the business relationship is insignificant.
- Refuse to perform the audit engagements.

Unless any such financial interest is immaterial and the relationship is insignificant to the member of the audit team, the only appropriate safeguard is to remove the individual from the audit team.

A business relationship involving the holding of an interest by the firm, or a member of the audit team, or a member of that individual's immediate family, in a closely-held entity when the audit client or a director or officer of the client, or any group thereof, also holds an interest in that entity does not create threats to independence if:

- The business relationship is insignificant to the firm, the member of the audit team and the immediate family member, and the client;
- The financial interest is immaterial to the investor or group of investors; and
- The financial interest does not give the investor, or group of investors, the ability to control the closely-held entity.

The purchase of goods and services from an audit client by the firm, or a member of the audit team, or a member of that individual's immediate family, does not generally create a threat to independence if the transaction is in the normal course of business and at arm's length. However, such transactions may be of such a nature or magnitude that they create a self-interest threat.

Possible safeguards include eliminating or reducing the magnitude of the transaction and removing the individual from the audit team.

Table 4.8 presents examples from the Code of threats and safeguards for close business relationships.

TABLE 4.8 Threats and Safeguards for Close Business Relationships

Threats	Safeguards
Inappropriate close business relationships between an audit firm and an audit client which create a self-interest threat include: ▪ Having a material financial interest in a joint venture with the assurance client ▪ Arrangements to combine one or more services or products of the firm with one or more services or products of the assurance client and to market the package with reference to both parties ▪ Distribution or marketing arrangements under which the firm acts as distributor or marketer of the assurance client's products or services or vice versa	Unless the interest is clearly insignificant, an assurance provider should not participate in such a venture with an assurance client. If an individual member of an assurance team had such an interest, he should be removed from the assurance team.

Family and Personal Relationships

Family and personal relationships between a member of the audit team and a director or officer or certain employees (depending on their role) of the audit client may create self-interest, familiarity or intimidation threats. The existence and significance of such threats will depend on a number of factors, including:

- The individual's responsibilities on the audit team.
- The role of the family member or other individual within the client.
- The closeness of the relationship.

When an immediate family member of a member of the audit team is a director or officer of the audit client or an employee in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion, or was in such a position during any period covered by the engagement or the financial statements, the threats to independence can only be reduced to an acceptable level by removing the individual from the audit team.

Threats to independence are created when an immediate family member of a member of the audit team is an employee in a position to exert significant influence over the client's financial position, financial performance or cash flows. The significance of the threat shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level.

Threats to independence may also be created when a member of the audit team has a close relationship with a person who is not an immediate or close family member, but who is a director or officer or an employee in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion. A member of the audit team who has such a relationship shall consult in accordance with firm policies and procedures. Consideration should also be given to whether threats may be created by a personal or family relationship between a partner or employee of the firm who is not a member

of the audit team and a director, an officer, or an employee of the audit client in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion.

The Code states when an inadvertent violation of the provisions as it relates to family and personal relationships occurs would not compromise the independence of a firm or a member of the audit team and advises on possible safeguards.

Table 4.9 presents examples from the Code of threats and safeguards for family and personal relationships.

TABLE 4.9 Threats and Safeguards for Family and Personal Relationships

Threats	Safeguards
Family or close personal relationships between members of the assurance firm and client staff could create self-interest, familiarity or intimidation threats. Each situation has to be evaluated individually. Factors to consider are: ▪ The individual's responsibilities on the assurance engagement ▪ The closeness of the relationship ▪ The role of the other party at the assurance client	When an immediate family member of the assurance team is a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter information of the assurance engagement, the individual should be removed from the assurance team. If a firm inadvertently violates the rules concerning family and personal relationships they should apply additional safeguards such as undertaking a quality control review of the audit and discussing the matter with the audit committee of the client, if there is one.

Employment with an Audit Client

Familiarity or intimidation threats may be created if a director or officer of the audit client, or an employee in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion, has been a member of the audit team or partner of the firm.

If a former member of the audit team or partner of the firm has joined the audit client in such a position and a significant connection remains between the firm and the individual, the threat would be so significant that no safeguards could reduce the threat to an acceptable level. Independence would be deemed to be compromised if a former member of the audit team or partner joins the audit client as a director or officer, or as an employee in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion, unless:

- The individual is not entitled to any benefits or payments from the firm, unless made in accordance with fixed pre-determined arrangements, and any amount owed to the individual is not material to the firm.
- The individual does not continue to participate or appear to participate in the firm's business or professional activities.

Familiarity or intimidation threats are created when a key audit partner joins the audit client that is a public entity as: a director or officer of the entity; or an employee in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion. Independence would be deemed to be

compensated unless, subsequent to the partner ceasing to be a key audit partner, the public interest entity had issued audited financial statements covering a period of not less than twelve months and the partner was not a member of the audit team with respect to the audit of those financial statements.

When it is known, or there is reason to believe, that a member of the audit team will, or may, join the client sometime in the future, the threat can be reduced to an acceptable level if policies and procedures exists that require members of an audit team to notify the firm when entering employment negotiations with the client, and the individual is removed from the audit team. In addition, when it is known that a member of the audit team is to join the audit client, consideration should be given in performing an independent review of any significant judgments made by that individual while on the team.

Table 4.10 presents examples from the Code of threats and safeguards for employment.

TABLE 4.10 Threats and Safeguards for Employment

Threats	Safeguards
Director, officer or employee of client in a position to exert direct and significant influence on the subject matter of the assurance engagement has been a member of the assurance team or partner in the firm. This may create self-interest, familiarity and intimidation threats. The significance of the threat will depend on: ▪ The position taken at the assurance client ▪ The involvement the individual will have with the assurance team ▪ The length of time that has passed since the individual was a member of the assurance team or firm ▪ The former position of the individual within the assurance team or firm	Safeguards might include: ▪ Considering the necessity of modifying the plan for the assurance engagement ▪ Assigning an assurance team with sufficient experience in relation to the individual who has joined the client ▪ Involving an additional professional accountant who was not a member of the assurance team to review the work done ▪ Quality control review ▪ The individual concerned is not entitled to any benefits or payments from the firm unless these are made in accordance with fixed pre-determined arrangements ▪ The individual does not continue to participate or appear to participate in the firm's business or professional activities A key audit partner should not accept a key management position with their audit client unless at least two years have elapsed since the conclusion of the audit.
Former officer, director or employee of client has joined the assurance firm. This may create self-interest, self-review and familiarity threats.	If during the period covered by the assurance report or the preceding two years, the individual was in a position to exert influence over the financial statements, the individual should not be assigned to the audit team.
Serving as an officer or director on the board of assurance client. If a partner or employee of the firm performs this role, the self-review and self-interest threats are so significant that no safeguards could reduce the threat to acceptable level.	The only course of action is to refuse to perform, or withdraw from the assurance engagement.

Temporary Staff Assignments to Audit Clients

The lending of staff by a firm to an audit client may create a self-review threat. Such assistance may be given, but only for a short period of time and the firm's personnel shall not be involved in:

- Providing prohibited non-assurance services.
- Assuming management responsibilities.

In all circumstances, the audit client shall be responsible for directing and supervising the activities of the loaned staff.

Recent Service with an Audit Client

Self-interest, self-review or familiarity threats may be created if a member of the audit team has recently served as a director, officer, or employee of the audit client. This would be the case when, for example, a member of the audit team has to evaluate elements of the financial statements for which the member of the audit team had prepared the accounting records while with the client. The Code restricts individuals from assigning to the audit team if, during the period covered by the audit report, a member of the audit team had served as a director or officer of the audit client, or was an employee in a position to exert significant influence over the preparation of the client's accounting records or the financial statements on which the firm will express an opinion. If the service with the audit client was performed before the period covered by the audit report, the Code advises on relevant factors affecting the evaluation of the significance of the threats and applicable safeguards.

Serving as a Director or Officer of an Audit Client

If a partner or employee of the firm serves as a director or officer of an audit client, the self-review and self-interest threats created would be so significant that no safeguards could reduce the threats to an acceptable level. Accordingly, no partner or employee shall serve as a director or officer of an audit client.

Generally, it is not acceptable to serve in the position of Company Secretary for the client. However, routine administrative services to support a company secretarial function or providing advice in relation to company secretarial administration matters does not generally create threats to independence, as long as client management makes all relevant decisions.

Long Association of Senior Personnel (Including Partner Rotation) with an Audit Client

Familiarity and self-interest threats are created by using the same senior personnel on an audit engagement over a long period of time. For all audit engagements, the Code advises on factors affecting the significance of threats and possible safeguards, including rotating the senior personnel of the audit team.

When the audit client becomes a public interest entity, the length of time the individual has served the audit client as a key audit partner before the client becomes a public interest entity shall be taken into account in determining the timing of the rotation. If the individual has served the audit client as a key audit as a key audit partner for:

- Five (5) years or less when the client becomes a public interest entity, the number of years the individual may continue to serve the client in that capacity before rotating off the engagement is seven (7) years less the number of years already served.

- Six (6) or more years when the client becomes a public interest entity, the partner may continue to serve in that capacity for a maximum of two (2) additional years before rotating off the engagement.

If the individual has two (2) or more years remaining on the maximum service period when the client becomes a public interest entity, the number of years the individual may continue to serve the client in that capacity before rotating off the engagement is the maximum service period allowed less the number of years already served (i.e., if maximum is seven (7) years, then seven years less the number of years already served). If the individual has less than two (2) years remaining or has exceeded the maximum service period allowed when the client becomes a public interest entity, the partner may continue to serve in that capacity for a maximum period of two (2) additional years before rotating off the engagement.

However, when a firm has only a few people with the necessary knowledge and experience to serve as a key audit partner on the audit of a public interest entity, rotation of key audit partners may not be an available safeguard. If an independent regulator in the relevant jurisdiction has provided an exemption from partner rotation in such circumstances, an individual may remain a key audit partner for more than the maximum allowed number of years, in accordance with such regulation, provided, the independent regulator has specified alternative safeguards which are applied such as a regular independent external review.

A familiarity threat may also be created with respect to an audit client that is a public interest entity by prolonged service of partners other than the engagement partner or the individual responsible for the engagement quality control review, for example, partners serving as client relationship partners or those serving as partners responsible for material subsidiaries.

Table 4.11 presents examples from the Code of threats and safeguards for long associations.

TABLE 4.11 Threats and Safeguards for Long Association

Threats	Safeguards
Using the same senior personnel on an assurance engagement over a long period of time may create a familiarity threat. The significance of the threat will depend on: ▪ Length of time the person has been a member of the team ▪ Role of the team ▪ Structure of the firm ▪ Nature of the assurance engagement	Safeguards might include: ▪ Rotation of senior personnel ▪ Involving another professional accountant who was not a member of the assurance team to review the work done ▪ Independent quality control reviews Note: For listed and other public interest entities: ▪ Engagement partner should be rotated after no more than 5 years and should not return until 5 years have elapsed. ▪ Other key audit partners should be rotated after no more than 7 years and should not return until 2 years (5 years if returning as engagement partner) have elapsed.

Provision of Non-assurance Services to Audit Clients

Firms have traditionally provided to their audit clients a range of non-assurance services that are consistent with their skills and expertise. Providing non-assurance services may, however, create self-review, self-interest and advocacy threats to the independence of the firm or members of the audit team. The Code addresses the provision of a number of specific non-assurance services and specific situations creating such threats. These include:

- Preparing accounting records and financial statements.
- Valuation services.
- Provision of taxation services to audit clients.
- Provision of internal audit services to audit clients.
- Provision of IT systems services to audit clients.
- Provision of litigation support services to audit clients.
- Provision of legal services to audit client.
- Provision of recruiting services to audit clients.
- Provision of corporate finance services to audit clients.
- Fees, pricing and partner compensation.
- Gifts and hospitality.
- Actual or threatened litigation.

Table 4.12 gives a summary of provisions in the Code for selected non-assurance services to audit clients.

TABLE 4.12 Summary of Code Provisions for Selected Non-Assurance Services to Audit Clients

Type of Services	Provisions
Preparing accounting records and financial statements	The accountant should not assume the audit client's responsibility for keeping accounting records, preparing financial statements and making management decisions. Independence may not be impaired, given application of necessary safeguards, if the assistance in preparing accounting records and financial statements is: ▪ Technical assistance within the normal part of the audit process. ▪ Accounting and bookkeeping services of routine or mechanical nature for non-listed entities. ▪ Accounting and bookkeeping services of routine or mechanical nature to divisions or subsidiaries of listed entities provided certain specific conditions are met. ▪ An emergency situation.
Valuation services	The accountant should not provide valuation services that involve valuation of matters material to the financial statements and a significant degree of subjectivity. Independence may not be impaired, given application of necessary safeguards, if the valuation services are: ▪ Neither separately, nor in the aggregate, material to the financial statements, or do not involve a significant degree of subjectivity. ▪ Certain valuation services for tax purposes.
Internal audit services	The accountant should not assume audit client responsibility for internal audit activities or make management decisions. Independence may not be impaired if the internal audit service is:

	▪ An extension of the firm's audit service required to conduct an audit in accordance with generally accepted auditing standards. ▪ Assistance in the performance of an audit client's internal audit activities or undertaking the outsourcing of some of the activities, given certain specific conditions are met.
IT systems services	The accountant should not assume management IT system functions and make management decisions. Independence may not be impaired for IT systems services that involve: ▪ Design or implementation of IT systems that is unrelated to internal control over financial reporting. ▪ Design or implementation of IT systems that do not generate information forming a significant part of the accounting records or financial statements. ▪ Implementation of "off-the-shelf" accounting or financial information reporting software that was not developed by the firm if the customization required to meet the client's needs is not significant. ▪ Evaluating and making recommendations with respect to a system designed, implemented or operated by another service provider or the client.
Legal services	The accountant should not act for an audit client in the resolution of a dispute or litigation when the amounts involved are material in relation to the financial statements of the audit client. Independence may not be impaired, given application of necessary safeguards, for legal services that involve: ▪ Matters that would be expected to have an immaterial effect on the financial statements. ▪ Supporting an audit client in the execution of a transaction.

For some activities, the threats are so significant that no safeguards are available to reduce the threat to an acceptable level. This means that the activity should be avoided or the assurance engagements refused. Such activities include:

- Acting in the capacity of management by authorizing, executing or consummating a transaction, or otherwise exercising authority on behalf of the assurance client, or having the authority to do so (except when the matters involved are of a routine or administrative nature and are performed at the request of management).
- Making decisions on behalf of management such as determining which recommendation of the firm should be implemented.
- Reporting in a management role to those charged with governance.

The provision of non-assurance services to audit clients is generally more restricted than to other assurance clients. Potential threats to independence typically arise more frequently and are of greater significance when a non-assurance service is provided to an audit client. A number of the non-assurance services addressed in the following are therefore discussed in the context of audit clients. The provision of otherwise prohibited services to a related entity, division or in respect of a discrete financial statement item of audit clients may be permissible under certain specific conditions outlined in the Code.

Table 4.13 provides examples from the Code of safeguards that are particularly relevant in reducing threats created by the provision of non-assurance services to assurance clients to an acceptable level.

TABLE 4.13 Examples of Safeguards Related to Provision of Non-Assurance Services to Assurance Clients

- Policies and procedures to prohibit professional staff from making management decisions for the assurance client, or assuming responsibility for such decisions.
- Discussing independence issues related to the provision of non-assurance services with those charged with governance, such as the audit committee.
- Policies within the assurance client regarding the oversight responsibility for provisions of non-assurance services by the firm.
- Involving an additional professional accountant to advice on the potential impact of the non-assurance engagement on the independence of the member of the assurance team and the firm.
- Involving an additional professional accountant outside of the firm to provide assurance on a discrete aspect of the assurance engagement.
- Obtaining the assurance client's acknowledgement of responsibility for the results of the work performed by the firm.
- Discussing with those charged with governance, such as the audit committee, the nature and extent of fees charged.
- Making arrangements so that personnel providing non-assurance services do not participate in the assurance engagement.

Threats to independence may also arise when a firm provides a non-assurance service related to the subject matter information on a non-audit assurance engagement, and in some other situations referred to in the Code. For example, a self-review threat would be created if the firm developed and prepared prospective financial information and subsequently provided assurance on this prospective financial information.

Table 4.14 summarizes below at a high level prohibitions applicable to audits of public interest entities.

TABLE 4.14 High Level Summary of Prohibitions Applicable to Audits of Public Interest Entities

The Code of Ethics for Professional Accountants contains prohibitions, summarized below at a high level, that apply when a professional accountants audits a public interest entity. If a service, interest, or relationship is not covered by one of the prohibitions below, the professional accountant is required to apply the conceptual framework set out in the Code to evaluate it. The conceptual framework entails a rigorous analysis of the service, interest, or relationship from the perspective of a reasonable and informed third party to determine whether it is permissible or should not be entered into because there are no adequate safeguards.

Prohibited Non-Assurance Services	Prohibited Interests and Relationships
Prohibited Without Regard to Materiality ▪ Assuming a management responsibility. ▪ Serving as General Counsel. ▪ Accounting services.* ▪ Bookkeeping services.* ▪ Payroll services.* ▪ Preparing the financial statements and related financial information.* ▪ Promoting, dealing in, or underwriting client shares. ▪ Negotiating for the client. ▪ Recruiting directors/officers, or senior management who will have significant influence over accounting records or financial statements. ▪ Evaluating or compensating a key audit partner based on that partner's success in selling non-assurance services to that partner's audit client. *Prohibited if Material to the Financial Statements* ▪ Valuation services. ▪ Calculations of current/deferred taxes.	▪ Financial interests in the client. ▪ Financial interests in an entity in which the client has a material interest, and can significantly influence. ▪ Loans from a client lending institution that have not been made under normal lending procedures, terms, and conditions, or from a client that is not a lending institution and that are material. ▪ Material loans to a client. ▪ Deposits with a client not held under normal terms. ▪ Close business relationships with a client that are significant or entail a material financial interest. ▪ Audit team members whose immediate family member is a client director/officer, or an employee able to significantly influence the accounting records or financial statements. ▪ Former audit team members or a partner joining the client if significant connections with the firm remain. ▪ A key audit partner or senior/managing partner

▪ Tax or corporate finance advice that depends on a particular accounting treatment/financial statement presentation with respect to which there is a reasonable doubt as to its appropriateness. ▪ Acting as an advocate before public tribunal or court to resolve a tax matter. ▪ Internal audit services relating to internal controls over financial reporting, financial accounting systems, or financial statement amounts/disclosures. ▪ Designing/implementing financial reporting IT systems. ▪ Estimating damages or other amounts as part of litigation support services. ▪ Acting as an advocate to resolve dispute. *Can be provided to divisions/related entities if routine/mechanical, or in an emergency, if specified conditions are met.	joining a client before a defined period of time. ▪ A key audit partner serving for more than 7 years. ▪ An individual being on the audit team if, during the period covered by the audit, the person was a client director/officer, or an employee able to significantly influence the accounting records or financial statements. ▪ Partners/employees serving as client director or officer. ▪ Contingent fees for an audit or assurance engagement or, when material to the firm, for a non-assurance service to the audit client. ▪ Accepting gifts or hospitality from the client that are other than trivial and inconsequential.

Preparing Accounting Records and Financial Statements

Providing an audit client with accounting and bookkeeping services, such as preparing accounting records or financial statements, creates a self-review threat when the firm subsequently audits the financial statements. If firms providing assistance assume managerial responsibilities, the self-review threat created could not be reduced to an acceptable level by any safeguards.

The Code guides on types of assistance in preparing accounting records or financial statements that will:

- Be considered a normal part of the audit process that ordinarily does not threaten independence.
- Impair independence.
- Create threats to independence which may be safeguarded against.

Examples of assistance considered to be a normal part of the audit process are responding to management's request on input regarding accounting principles, financial disclosures and the appropriateness of controls. Similarly, the financial statement audit process may involve assisting an audit client in resolving account reconciliation problems and analyzing and accumulating information for regulatory reporting.

Examples of unacceptable managerial decision-making impairing independence are:

- Determining or changing journal entries or the classifications for accounts or transaction or other accounting records without obtaining the approval of the audit client.
- Preparing or changing source documents, or originating data (including decisions on valuable assumptions).

The independence of the firm or network firm is also, with some limited exceptions, considered impaired if the assistance to an audit client that is public interest entity includes provision of accounting and bookkeeping services (including payroll services) and the preparation of financial statements or financial information which forms the basis of the financial statements on which the audit report is provided. The exceptions are emergency situations when it is impractical for the audit client to make other arrangements; and, when specific conditions are met, provision of

accounting and bookkeeping services of a routine or mechanical nature to divisions or subsidiaries of the audit client.

If the client is not a public interest entities, accounting and bookkeeping services, including payroll services, should not be provided unless the services are a routine or mechanical nature. Examples of such possible acceptable services include:

- Recording transactions for which the client has determined or approved the appropriate account classification.
- Posting transactions coded by the client to the general ledger.
- Posting client-approved entries to the trial balance.
- Preparing financial statements based on information in the trial balance.

The significance of any threat created by the provision of such services will depend on the magnitude of the services provided. In all cases, the underlying assumptions should be originated and approved by the audit client, and the audit client's approval should be obtained for any proposed journal entries or other changes affecting the financial statements.

Provision of Valuation Services to Audit Clients

A valuation comprises the making of assumptions with regard to future developments, the application of appropriate methodologies and techniques, and the combination of both to compute a certain value, or range of values, for an asset, a liability or for a business as a whole. Performing valuation services for an audit client may create a self-review threat.

If the valuation service has a material effect on the financial statements on which the firm will express an opinion and the valuation involves a significant degree of subjectivity, the valuation services should not be provided or alternatively, the firm should withdraw from the audit engagement.

Safeguards may reduce the self-review threat to an acceptable level when performing valuation services that are neither separately, nor in the aggregate, material to the financial statements, or that do not involve a significant degree of subjectivity. The Code advises on factors affecting the significance of the threats and on safeguards under such circumstances. Applicable safeguards include:

- Having a professional who was not involved in providing the valuation service review the audit or valuation work performed.
- Making arrangements so that personnel providing such services do not participate in the audit engagement.

Firms may be requested to perform a valuation to assist an audit client with its tax reporting obligations or for tax planning purposes. Such services would not create a significant threat to independence since the valuations are generally subject to external review, for example by a tax authority.

Provision of Taxation Services to Audit Clients

The firm may be asked to provide taxation services to an audit client. Taxation services comprise a broad range of services, including tax return preparation, tax calculations for the purpose of preparing the accounting entries, tax planning and other tax advisory services and assistance in

the resolution of tax disputes. Many such assignments do not create threats to independence. Before accepting an engagement to provide a taxation service to an audit client consideration should, however, be given to whether the provision of such a service would create a threat to independence. The Code advises on factors affecting the significance of the threats and on applicable safeguards.

Provision for Internal Audit Services to Audit Clients

Internal audit services involve assisting the audit client in the performance of its internal audit activities. The provision of internal audit services to an audit client creates a self-review threat to independence if the firm uses the internal audit work in the course of a subsequent external audit.

Performing a significant part of the client's internal audit activities increases the possibility that firm personnel providing internal audit services will assume a management responsibility. If the firm's personnel assume a management responsibility when providing internal audit services to an audit client, the threat created would be so significant that no safeguards could reduce the threat to an acceptable level. Examples of internal audit services that involve assuming management responsibilities include:

- Setting internal audit policies or the strategic direction of internal audit activities.
- Directing and taking responsibility for the actions of the entity's internal audit employees.
- Deciding which recommendations resulting from internal audit activities shall be implemented.
- Reporting the results of the internal audit activities to those charged with governance on behalf of management.
- Performing procedures that form part of the internal control, such as reviewing and approving changes to employee data access privileges.
- Taking responsibility for designing, implementing and maintaining internal control.
- Performing outsourced internal audit services, comprising all or a substantial portion of the internal audit function, where the firm is responsible for determining the scope of the internal audit work and may have responsibility for one or more of the matters enumerated above.

To avoid assuming a management responsibility, the firm shall only provide internal audit services to an audit client if it is satisfied that:

- The client designates an appropriate and competent resource, preferably within senior management, to be responsible at all times for internal audit activities and to acknowledge responsibility for designing, implementing, and maintaining internal control.
- The client's management or those charged with governance reviews, assesses and approves the scope, risk and frequency of the internal audit services.
- The client's management evaluates the adequacy of the internal audit services and the findings resulting from their performance.
- The client's management evaluates and determines which recommendations resulting from internal audit services to implement and manages the implementation process.
- The client's management reports to those charged with governance the significant findings and recommendations resulting from the internal audit services.

Provision of IT Systems Services to Audit Clients

Firms provide services that involve the design and implementation of hardware or software systems. The systems may aggregate source data, form part of the internal control over financial reporting or generate information that affects the accounting records or financial statements, or the systems may be unrelated to the audit client's accounting records, the internal control over financial reporting or financial statements. Provision of such services may create a self-review threat when (a) form a significant part of the internal control over financial reporting or (b) generate information that is significant to the client's accounting records or financial statements on which the firm will express an opinion. The Code states that such a threat is likely to be too significant to allow the provision of such services to an audit client unless:

- The client acknowledges its responsibility for establishing and monitoring a system of internal controls.
- The client assigns the responsibility to make all management decisions with respect to the design and implementation of the hardware or software system to a competent employee, preferably within senior management.
- The client makes all management decisions with respect to the design and implementation process.
- The client evaluates the adequacy and results of the design and implementation of the system.
- The client is responsible for operating the system (hardware or software) and for the data it uses or generates.

Consideration should also be given to whether such non-assurance services should be provided only with personnel who are not members of the audit team and who have different reporting lines within the firm.

Provision for Litigation Support Services to Audit Clients

Litigation support services may include activities such as acting as an expert witness, calculating estimated damages or other amounts that might become receivable or payable as the result of litigation or other legal dispute, and assistance with document management and retrieval. These services may create a self-review or advocacy threat.

A self-review threat may be created if the firm provides a litigation support service to an audit client and the service involves estimating damages or other amounts that affect the financial statements on which the firm will express an opinion. The significance of such a threat depends on factors such as the materiality of the amount involved, the degree of subjectivity inherent in the matter concerned and the nature of the engagement. The Code advises on possible safeguards.

In the case of other litigation support services, the significance of any threat created shall be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level.

Provision for Legal Services to Audit Services

Legal services are defined as any services for which the person providing the services must either be admitted to practice law before the courts of the jurisdiction in which such services are to be provided or have the required legal training to practice law. Legal services may include a wide and diversified range of areas including both corporate and commercial services to clients, such

as contract support, litigation, mergers and acquisition legal advice and support and assistance to clients' internal legal departments. Providing legal services to an entity that is an audit client may create both self-review and advocacy threats. The existence and significance of any threat will depend on the nature of the service, whether the service is provided by a member of the audit team and the materiality of any matter in relation to the client's financial statements.

The Code makes a distinction between advice and advocacy. Firms provide legal services to support an audit client in the execution of a transaction (e.g., contract support, legal advice, legal due diligence and restructuring).

The firm should not act for an audit client in resolving a dispute or litigation when the amounts involved are material to the financial statements on which the firm will express an opinion. However, if the amounts are not material, the firm shall evaluate the significance of any advocacy and self-review threats created and apply the following safeguards when necessary to eliminate the threat or reduce it to an acceptable level:

- Using professionals who are not members of the audit team to perform the service.
- Having a professional who was not involved in providing the legal services provide advice to the audit team on the service and review any financial statement treatment.

The appointment of a partner or an employee of the firm as General Counsel for legal affairs of an audit client would create self-review and advocacy threats that are so significant that no safeguards could reduce the threats to an acceptable level. The position of General Counsel is generally a senior management position with broad responsibility for the legal affairs of a company, and consequently, no member of the firm shall accept such an appointment for an audit client.

Provision of Recruiting Services to Audit Clients

Providing recruiting services to an audit client may create self-interest, familiarity or intimidation threats. The existence and significance of any threat will depend on factors such as the nature of the requested assistance and the role of the person to be recruited.

The firm may generally provide such services as reviewing the professional qualifications of a number of applicants and providing advice on their suitability for the post. In addition, the firm may interview candidates and advice on a candidate's competence for financial accounting, administrative or control positions. In all cases, the firm should not assume management responsibilities, including acting as a negotiator on the client's behalf, and the hiring decision shall be left to the client.

Provision of Corporate Finance Services to Audit Clients

Providing corporate finance services may create advocacy and self-review threats. However, certain corporate finance services are not compatible with providing audit services. Example of such service include promoting, dealing in, or underwriting an audit client's shares.

Safeguards may be available to reduce threats to an acceptable level for other corporate finance services. Safeguards that should be considered include using professionals who are not members of the audit team to provide the services and having a professional who was not involved in providing the corporate finance service advise the audit team on the service and review the accounting treatment and any financial statement treatment.

Fees, Pricing and Compensation

The relative size of the fee, fees overdue, the level of the fee quoted, and contingent fees for non-audit engagements may create self-interest or intimidation threat. When the total fees generated from an audit client represent a large proportion of the revenue from an individual partner's clients or a large proportion of the revenue of an individual office of the firm, the dependence on that client group and concern about the possibility of losing the client may create a self-interest or intimidation threat. The Code advises on factors affecting the significance of the threat and possible safeguards.

A self-interest threat may be created if fees due from an audit client remain unpaid for a long time, especially if a significant part is not paid before the issue of the audit report for the following year. Generally, the payment of such fees should be required before the audit report is issued. The Code advises on applicable safeguards in this case. The firm should also determine whether the overdue fees might be regarded as being equivalent to a loan to the client and whether, because of the significance of the overdue fees, it is appropriate for the firm to be re-appointed or continue the audit engagement.

A contingent fee charged directly or indirectly, for example through an intermediary, by a firm in respect of an audit engagement creates a self-interest threat that is so significant that no safeguards could reduce the threat to an acceptable level. Moreover, contingent fee charged directly or indirectly, for example through an intermediary, by a firm in respect of a non-assurance service provided to an audit client may also create a self-interest threat. For other contingent fee arrangements charged by a firm for a non-assurance service to an audit client, the Code advises on the significance of the threats created and relevant safeguards.

Compensating a member of the audit team for selling non-assurance services to that audit client may create a self-interest threat. The significance of the threat will depend on the proportion of the individual's compensation or performance evaluation that is based on the sale of such services, the role of the individual on the audit team and whether promotion decisions are influenced by the sale of such services.

The Code advises on applicable safeguards, including revision of the compensation for the individual.

Table 4.15 presents examples from the Code of threats and safeguards for fees and pricing.

TABLE 4.15 Threats and Safeguards for Fees and Pricing

Threats	Safeguards
▪ Dependence where the total fees from an assurance client represent a large portion of a firm's total fees, the dependence on that client and concern about the possibility of losing that client may create a self-interest threat.	▪ Discussing the extent and nature of the fees with the audit committee ▪ Taking steps to reduce dependency ▪ External quality control ▪ Consulting regulatory bodies or another professional accountant
▪ Overdue fees (threat is similar to that of a loan)	▪ Discuss with the audit committee, including the possibility of resigning if overdue fees are not paid.
▪ Contingent fees A fee arrangement under which the amount of the	No safeguards can reduce these threats to an acceptable level.

fee is contingent on the result of the audit work creates self-interest and advocacy threats.	
▪ Pricing If a firm has obtained an assurance engagement at a fee lower than charged by their predecessor or quoted by other firms ("lowballing"), a self-interest threat is created.	The firm must be able to demonstrate that: ▪ Appropriate time and quality staff have been assigned, and ▪ All applicable standards are being complied with

Gifts and Hospitality

Accepting gifts or hospitality from an audit client may create self-interest and familiarity threats. If a firm or a member of the audit team accepts gifts or hospitality, unless the value is trivial and inconsequential, the threats created would be so significant that no safeguards could reduce the threats to an acceptable level. Consequently, a firm or a member of the audit team shall not accept such gifts or hospitality.

Table 4.16 presents examples from the Code of threats and safeguards for gifts and hospitality.

TABLE 4.16 Threats and Safeguards for Gifts and Hospitality

Threats	Safeguards
Accepting gifts or hospitality from the client mat create self-interest and familiarity threats.	A firm or member of the assurance team should not accept gifts or hospitality unless the value is clearly insignificant.

Actual or Threatened Litigation

When litigation takes place, or appears likely, between the firm or a member of the audit team and the audit client, self-interest and intimidation threats are created. The relationship between client management and the members of the audit team must be characterized by complete candor and full disclosure regarding all aspects of a client's business operations. When the firm and the client's management are placed in adversarial positions by actual or threatened litigation, affecting management's willingness to make complete disclosures, self-interest and intimidation threats are created. The Code guides on factors affecting significance of the threats and possible safeguards.

Table 4.17 presents examples from the Code of threats and safeguards for actual and threated litigation.

TABLE 4.17 Threats and Safeguards for Actual and Threatened Litigation

Threats	Safeguards
When litigation takes place or appears likely between the firm or member of the assurance team and the assurance client, a self-interest or intimidation threat may be created.	▪ Disclose to the audit committee ▪ Removal of individual involved in litigation from the assurance team ▪ Refuse to perform the assurance engagement

CONDUCT OF PROFESSIONAL ACCOUNTANTS IN BUSINESS

Part C of the Code describes how the conceptual framework contained in Part A applies in certain situations to professional accountants in business. Recall that a professional accountant in business is defined as an accountant who is employed or engaged in an executive or non-executive capacity in such areas as commerce, industry, service, the public sector, education, the not for profit sector, regulatory bodies or professional bodies, or a professional accountant contracted by such entities.

Accountants in business have varied responsibilities and perform a broad range of services. Key roles are providing assurance, facilitating management decision making and strategic development, and serving as the gatekeeper of corporate integrity. A major challenge is to balance their roles of meeting corporate objectives and shareholders' needs. Accountants in business will often be involved in the preparation and reporting of financial and other information. Thus, in their work the integrity of the numbers produced becomes a key issue. Accountants in business deal with ongoing pressure over ethics, based largely on aggressive earnings management.

Professional accountants in business must comply with the fundamental principles and apply the conceptual framework when threats to the principles exist. In those extreme situations where all available safeguards have been exhausted and it is not possible to reduce the threat to an acceptable level, a professional accountant in business may conclude that it is appropriate to resign from the employing organization.

The Code focuses on five specific situations that may create threats to compliance with the fundamental principle. These are:

- Potential conflicts.
- Preparation and reporting of information.
- Acting with sufficient expertise.
- Financial interests.
- Inducements.

Potential conflicts may be caused by responsibilities to or pressure from the employing organization. For example, a conflict as well as threat to appropriate preparation of the financial statements is present if the accountant faces pressure from a supervisor to facilitate improper earnings management. Next, the fundamental principle of professional competence and due care is challenged if the accountant acts without sufficient expertise in undertaking the task. Further, if the accountant holds financial interests in employing business, self-interest threats to objectivity or confidentiality may be present. Finally, an accountant being offered or offering inducements such as gifts or preferential treatment may face similar threats. The Code advises on relevant safeguards in these and other situations, and prescribes appropriate actions when safeguards cannot reduce the threats to an acceptable level.

REVIEW QUESTIONS

1. How does auditor's independence relate to auditor's objectivity?

2. Describe the five fundamental principles in the IFAC Code of Ethics?

3. Generally an accountant is not allowed to disclose confidential client information without the consent of the client. Identify at least three circumstances in which confidential client information can be disclosed under the IFAC Code of Ethics without the client's permission?

4. An accountant is allowed to advertise as long as the accountant is honest and truthful. Provide three examples of advertising that are forbidden by the IFAC Code of Ethics.

5. For each of the five categories of threats to practitioner give three examples of circumstances that may create threats, and two applicable safeguards for each of these circumstances.

6. What types of personal loans from a financial institution, that is the assurance client of the practitioner, are allowed by the IFAC Code of Ethics?

7. When it is acceptable for the practitioner to perform valuation services for an audit client? Give three examples of safeguards that may be applied to reduce independence risk to acceptable level.

8. Give examples of three corporate finance services that are acceptable to perform for practitioners (for an audit client) and on possible applicable safeguards when providing such services.

MULTIPLE CHOICE QUESTIONS

1. Which of the following is incorrect regarding professional competence?
   a. The maintenance of professional competence requires a continuing awareness of development in the accountancy profession.
   b. The attainment of professional competence requires initially a high standard of general education.
   c. Professional competence may be divided into two separate phases.
   d. Professional accountants may portray themselves as having expertise or experience they do not possess.

2. A professional accountant has a professional duty or right to disclose confidential information in each of the following, except
   a. To comply with technical standards and ethics requirements.
   b. To comply with the quality review of a member body or professional body
   c. To disclose to BIR fraudulent scheme committed by the client on payment of income tax.
   d. To respond to an inquiry or investigation by a member body or regulatory body.

3. Which of the following is the least required in attaining professional competence?

a. Continuing awareness of development in the accountancy profession.
b. High standard of general education.
c. Period of meaningful work experience.
d. Specific education, training and examination in professionally relevant subjects.

4. Which of the following is incorrect regarding confidentiality?
   a. Confidentiality requires that professional accountant acquiring information in the course of performing professional services neither uses nor appear to use that information for personal advantage or for the advantage of a third party.
   b. Confidentiality should always be observed by a professional accountant unless specific authority has been given to disclose information or there is a legal or professional duty to disclose.
   c. Professional accountants have an obligation to respect the confidentiality of information about a client's or employer's affairs acquired in the course of professional services.
   d. The duty of confidentiality ceases after the end of the relationship between the professional accountant and the client or employer.

5. Which of the following is incorrect regarding the professional accountants' tax practice?
   a. A professional accountant may hold out to a client or an employer the assurance that the tax return prepared and the tax advice offered are beyond challenge.
   b. A professional accountant rendering professional tax services is entitled to put forward the best position in favor of a client, or an employer.
   c. Doubt may be resolved in favor of the client or the employer if there is reasonable support for the position.
   d. Professional accountants should ensure that the client or the employer are aware of the limitations attaching to tax advice and services so that they do not misinterpret an expression of opinion as an assertion of fact.

6. A professional accountant may be associated with a tax return that
   a. Uses of estimates if such use is generally acceptable or if it is impractical under the circumstances to obtain exact data.
   b. Omits or obscures information required to be submitted and such omission or obscurity would mislead the revenue authorities.
   c. Contains statements or information furnished recklessly or without any real knowledge of whether they are true or false.
   d. Contains a false or misleading statement.

7. When a professional accountant learns of a material error or omission in a tax return of a prior year, or of the failure to file a required tax return, the professional accountant has a responsibility to do the following, except
   a. Take reasonable steps to ensure that the error is not repeated in subsequent tax returns if the professional accountant concludes that a professional relationship with the client or employer can be continued.
   b. Promptly advise the client or employer of the error or omission and .recommend that disclosure be made to the revenue authorities.
   c. Inform the client or the employer that it is not possible to act for them in connection with that return or other related information submitted to the authorities if the client or the employer does not correct the error.
   d. Immediately inform the revenue authorities.

8. When a professional accountant performs services in a country other than the home country and differences on specific matters exist between ethical requirements of the two countries, the following provisions should be applied
   a. When the ethical requirements of the home country are mandatory for services performed outside that country and are stricter, then the ethical requirements of the home country should be applied.
   b. When the ethical requirements of the country in which the services are being performed are less strict than the Code of Ethics of the Philippines, then the Code of Ethics of the Philippines should be applied.
   c. When the ethical requirements of the country in which services are being performed are stricter than the Code of Ethics of the Philippines, then the ethical requirements in the country where services are being performed should be applied.
   d. Any of the above.

9. In the marketing and promotion of themselves and their work, professional accountants should
   a. Not denigrate the work of other accountants.
   b. Not make exaggerated claims for the services they are able to offer, the qualifications they possess, or experience they have gained.
   c. Not use means which brings the profession into disrepute.
   d. All of the above.

10. Not all engagements performed by professional accountants are assurance engagements. Other engagements frequently performed by professional accountants that are not assurance engagements include the following, except
   a. Agreed-upon procedures.
   b. Compilation of financial or other information.
   c. Examination of prospective financial information.
   d. Management consulting.

11. A CPA-lawyer, acting as a legal counsel to one of his audit client, is an example of
   a. Advocacy threat.
   b. Familiarity threat.
   c. Self-interest threat.
   d. Self-review threat.

12. Occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or a member of the assurance team becomes too sympathetic to the client's interests.
   a. Advocacy threat.
   b. Familiarity threat
   c. Self-interest threat.
   d. Self-review threat.

13. Examples of circumstances that may create familiarity threat least likely include
   a. Dealing in, or being a promoter of, share or other securities in an assurance client.
   b. A member of the assurance team having an immediate family member or close family member who is a director or officer of the assurance client.
   c. A member of the assurance team having an immediate family member or close family member who, as an employee of the assurance client, is in a position to exert direct and significant influence over the subject matter of the assurance engagement.

d. A former partner of the firm being a director, officer of the assurance client or an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement.

14. Intimidation threat
    a. Occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or a member of the assurance team becomes too sympathetic to the client's interests.
    b. Occurs when a member of the assurance team may be deterred from acting objectively and exercising professional skepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client.
    c. Occurs when a firm, or a member of the assurance team, promotes, or may be perceived to promote, an assurance client's position or opinion to the point that objectivity may, or may be perceived to be, compromised.
    d. Is not a threat to independence.

15. Certain corporate finance services may create advocacy or self-review threats; however, safeguards may be available to reduce these threats to an acceptable level. Examples of such services include the following, except
    a. Providing structuring advice and assisting a client in analyzing the accounting effects of proposed transactions.
    b. Committing the assurance client to the terms of a transaction or consummating a transaction on behalf of the client.
    c. Assisting in identifying or introducing a client to possible sources of capital that meet the client specifications or criteria.
    d. Assisting a client in developing corporate strategies.

16. Which of the following is not likely to create a threat to independence?
    a. A court or other public authority established fees.
    b. A firm obtains an assurance engagement at a significantly lower fee level than that charged by the predecessor firm, or quoted by other firms.
    c. Fees due from an assurance client for professional services remain unpaid for a long time.
    d. The total fees generated by an assurance client represent a large proportion of a firm's total fees.

17. A client company has not paid its 2018 audit fees. According to the Code of Professional Conduct, for the auditor to be considered independent with respect to the 2019 audit, the 2018 audit fees must be paid before the
    a. 2018 field work is started.
    b. 2018 report is issued.
    c. 2019 field work is started.
    d. 2019 report is issued.

18. Fees calculated on a predetermined basis relating to the outcome or result of a transaction or the result of the work performed.
    a. Retainer fees.
    b. Per diem fees.
    c. Flat sum fees.
    d. Contingent fees.

19. Which of the following is least likely to create a threat to independence?
    a. When litigation takes place, or appears likely, between the firm or a member of the assurance team and the assurance client.
    b. The firm charges a contingent fee to an assurance client.
    c. The fees generated by the assurance client represent a large proportion of the revenue of an individual partner.
    d. Accepting gifts or hospitality, the value of which is clearly insignificant, from an assurance client.

20. Which statement is incorrect regarding Professional Competence and Responsibilities Regarding the Use of Non-Accountants?
    a. Professional accountants in public practice should refrain from agreeing to perform professional services which they are not competent to carry out.
    b. In situations where in a professional accountant sought technical advice from experts, although the professional accountant is relying on the technical competence of the expert, the knowledge of the ethical requirements cannot be automatically assumed.
    c. If at any time the professional accountant is not satisfied that proper ethical behavior can be respected or assured, the engagement should not be accepted unless the engagement has commenced in which case the auditor is allowed to finish the engagement.
    d. If a professional accountant does not have the competence to perform a specific part of the professional service, technical advice may be sought from experts.

21. Which statement is incorrect regarding professional fees?
    a. The appropriate rates should be based on the fundamental premise that the organization and conduct of the professional accountant in public practice and the services provided to clients are well planned, controlled and managed.
    b. Professional fees should normally be computed on the basis of appropriate rates per hour or per day for the time of each person engaged in performing professional services.
    c. It is not proper for a professional accountant in public practice to charge a client a lower fee than has previously been charged for similar services.
    d. It is for each professional accountant in public practice to determine the appropriate rates.

22. The Rules of Conduct will ordinarily be considered to have been violated when the professional accountant represents that specific consulting services will be performed for a stated fee and it is apparent at the time of the representation that the
    a. Professional accountant would not be independent.
    b. Fee was a competitive bid.
    c. Actual fee would be substantially lower than the fees charged by other professional accountants for comparable services
    d. Actual fee would be substantially higher.

23. Which of the following is not likely a threat to independence?
    a. Threat of replacement over a disagreement with the application of an accounting principle.
    b. Owning immaterial indirect financial interest in an audit client.
    c. Long association of a senior member of the assurance team with the assurance client.
    d. Acting as an advocate on behalf of an assurance client in litigation or in resolving disputes with third parties.

24. When threats to independence that are not clearly insignificant are identified, the following are appropriate, except
    a. When the firm decides to accept or continue the assurance engagement, the decision need not be documented provided the threats identified were eliminated.
    b. The evaluation of the significance of any threats to independence and the safeguards necessary to reduce any threats to an acceptable level, takes into account the public interest.
    c. Professional judgment is used to determine the appropriate safeguards to eliminate threats to independence or to reduce them to an acceptable level.
    d. In situations when no safeguards are available to reduce the threat to an acceptable level, the only possible actions are to eliminate the activities or interest creating the threat, or to refuse to accept or continue the assurance engagement.

25. Safeguards created by the profession, legislation or regulation, include the following, except
    a. Policies and procedures that emphasize the assurance client's commitment to fair financial reporting.
    b. Legislation governing the independence requirements of the firm.
    c. Educational, training and experience requirements for entry into the profession.
    d. Continuing education requirements.

26. Safeguards within the assurance client, include the following, except
    a. The assurance client has competent employees to make managerial decisions.
    b. Professional standards and monitoring and disciplinary processes.
    c. Internal procedures that ensure objective choices in commissioning non-assurance engagements.
    d. A corporate governance structure, such as an audit committee, that provides appropriate oversight and communications regarding a firm's services.

27. Safeguards within the firm's own systems and procedures, include the following, except
    a. Policies and procedures to implement and monitor quality control of assurance engagements.
    b. Policies and procedures that will enable the identification of interests or relationships between the firm and members of the assurance team and assurance clients.
    c. Firm leadership that stresses the importance of independence and the expectation that member of assurance teams will act in the public interest.
    d. External review of a firm's quality control system.

28. If a member of the assurance team or their immediate family member receives, by way of, for example, an inheritance, gift or, as a result of a merger, a direct financial interest or a material indirect financial interest in the assurance client, a self-interest threat would be created. The following safeguards should be applied to eliminate the threat or reduce it to an acceptable level:
    a. Removing the member of the assurance team from the assurance engagement.
    b. Disposing of the financial interest at the earliest practical date.
    c. Either a or b.
    d. Neither a nor b.

29. When the safeguards available are insufficient to eliminate the threats to independence or to reduce them to an acceptable level, or when a firm chooses not to eliminate the activities or interest creating the threat, the only course of action available will be the

a. Refusal to perform, or withdrawal from, the assurance engagement.
b. Issuance of unqualified opinion with explanatory paragraph.
c. Issuance of qualified opinion or disclaimer of opinion.
d. Issuance of an adverse opinion.

30. Which of the following is incorrect regarding engagement period?
a. When an entity becomes an audit client during or after the period covered by the financial statements that the firm will report on, the firm should consider whether any threats to independence may be created by previous services provided to the audit client.
b. The period of the engagement starts when the assurance team begins to perform assurance services and ends when the assurance report is issued, except when the assurance engagement is of a recurring nature.
c. In the case of an audit engagement, the engagement period includes the period covered by the financial statements reported on by the firm.
d. If the assurance engagement is expected to recur, the period of the assurance engagement ends with the notification by either party that the professional relationship has terminated or the issuance of the final assurance report, whichever is earlier.

31. If a member of the assurance team, or their immediate family member, has a direct financial interest, or a material indirect financial interest, in the assurance client, the self-interest threat created would be so significant the only safeguards available to eliminate the threat or reduce it to an acceptable level would be to (choose the incorrect one)
a. Limit the participation of the member of the assurance team.
b. Dispose of the indirect financial interest in total prior to the individual becoming a member of the assurance team.
c. Dispose of the direct financial interest prior to the individual becoming a member of the assurance team.
d. Dispose of a sufficient amount of the indirect financial interest so that the remaining interest is no longer material prior to the individual becoming a member of the assurance team.

32. When a member of the assurance team knows that his or her close family member has a direct financial interest or a material indirect financial interest in the assurance client, a self-interest threat may be created. Safeguards least likely include:
a. The close family member disposing of all or a sufficient portion of the financial interest at the earliest practical date.
b. Removing the individual from the assurance engagement.
c. Involving a professional accountant who took part in the assurance engagement to review the work done by the member of the assurance team with the close family relationship or otherwise advise as necessary.
d. Discussing the matter with those charged with governance, such as the audit committee.

33. When a firm or a member of the assurance team holds a direct financial interest or a material indirect financial interest in the assurance client as a trustee, a self-interest threat may be created by the possible influence of the trust over the assurance client. Accordingly, such an interest cannot be held when:
a. The trust is not able to exercise significant influence over the assurance client.

b. The member of the assurance team, an immediate family member of the member of the assurance team, and the firm are beneficiaries of the trust.
c. The member of the assurance team or the firm does not have significant influence over any investment decision involving a financial interest in the assurance client.
d. The interest held by the trust in the assurance client is not material to the trust.

34. An inadvertent violation of the Independence rules as it relates to a financial interest in an assurance client would not impair the independence of the firm, the network firm or a member of the assurance team when:
a. The firm, and the network firm, promptly notifies the professional that the financial interest should be disposed of.
b. The firm, and the network firm, has established policies and procedures that require all professionals to report promptly to the firm any breaches resulting from the purchase, inheritance or other acquisition of a financial interest in the assurance client.
c. The disposal occurs at the earliest practical date after identification of the issue, or the professional is removed from the assurance team.
d. All of the above.

35. If a firm, or a network firm, has a direct financial interest in an audit client of the firm, the self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level. The action appropriate to permit the firm to perform the engagement would be to
a. Dispose of a sufficient amount of it so that the remaining interest is no longer material.
b. Dispose of the financial interest.
c. Either a or b.
d. Neither a nor b.

36. The following self-interest threat created would be so significant no safeguard could reduce the threat to an acceptable level, except
a. If a firm, or a network firm, has a direct financial interest in an audit client of the firm.
b. If a firm, or a network firm, has a material financial interest in an entity that has a controlling interest in an audit client.
c. If a firm, or a network firm, has a material indirect financial interest in an audit client of the firm.
d. If the retirement benefit plan of a firm, or network firm, has a financial interest in an audit client.

37. Which of the following will least likely impair independence?
a. A member of the assurance team participates in the assurance engagement while knowing, or having reason to believe, that he or she is to, or may, join the assurance client sometime in the future.
b. A partner or employee of the firm or a network firm serves as Company Secretary for an audit client, the duties and functions undertaken are limited to those of a routine and formal administrative nature as such as the preparation of minutes and maintenance of statutory returns.
c. A partner or employee of the firm serves as an officer or as a director on the board of an assurance client.

d. An immediate family member of a member of the assurance team is a director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement.

38. Using the same senior personnel on an assurance engagement over a long period of time may create a familiarity threat. The significance of the threat will least likely depend upon
    a. The length of time that the individual has been a member of the assurance team.
    b. The nature of the assurance engagement.
    c. The role of the individual on the assurance team.
    d. The structure of the client.

39. Which statement is incorrect regarding long association of senior personnel with audit clients that are listed entities?
    a. Using the same lead engagement partner on an audit over a prolonged period may create a familiarity threat.
    b. A partner rotating after a pre-defined period should not resume the lead engagement partner role until a further period of time, normally two years, has elapsed.
    c. The lead engagement partner should be rotated after a pre-defined period, normally no more than seven (7) years.
    d. When audit client becomes a listed entity the length of time the lead engagement partner has served the audit client in that capacity should be considered in determining when the partner should be rotated.

40. The partner may continue to serve as the lead engagement partner before rotating off the engagement for how many years after audit client becomes a listed entity?
    a. One year.
    b. Two years.
    c. Three years.
    d. Four years.

41. While the lead engagement partner should be rotated after such a pre-defined period, some degree of flexibility over timing of rotation may be necessary in certain circumstances. Examples of such circumstances include:
    a. Situations when, due to the size of the firm, rotation is not possible or does not constitute an appropriate safeguard.
    b. Situations when the lead engagement partner's continuity is especially important to the audit client, for example, when there will be major changes to the audit client's structure that would otherwise coincide with the rotation of the lead engagement partner.
    c. Both a and b.
    d. Neither a nor b.

42. If firm, or network firm, personnel providing such assistance make management decisions, the self-review threat created could not be reduced to an acceptable level by any safeguards. Examples of such managerial decisions include the following, except
    a. Preparing source documents or originating data (including decisions on evaluation assumptions), or making changes to such documents or data.
    b. Determining or changing journal entries, or the classifications for accounts or transactions or other accounting records without obtaining the approval of the audit clients
    c. Authorizing or approving transactions.

d. Assisting an audit client in resolving account reconciliation problems.

43. These following services are considered to be a normal part of the audit process and do not, under circumstances, threaten independence, except
    a. Having custody of an assurance client's assets.
    b. Drafting disclosure items.
    c. Assisting in the preparation of consolidated financial statements.
    d. Analyzing and accumulating information for regulatory reporting.

44. If the firm is involved in the preparation of accounting records or financial statements and those financial statements are subsequently the subject matter of an audit engagement of the firm, this will most likely create
    a. Familiarity threat.
    b. Intimidation threat.
    c. Self-interest threat.
    d. Self-review threat.

45. The firm, or a network firm, may provide an audit client that is not a listed entity with accounting and bookkeeping services, including payroll services, of a routine or mechanical nature, provided any self-review threat created is reduced to an acceptable level. Examples of such services least likely include:
    a. Recording transactions for which the audit client has determined or approved the appropriate account classification.
    b. Posting coded transactions to the audit client's general ledger.
    c. Determining and posting journal entries without obtaining the approval of the audit client.
    d. Preparing financial statements based on information in the trial balance.

46. The safeguards necessary to reduce the threat created by providing accounting and bookkeeping services to an audit client that is not a listed entity, to an acceptable level might include the following, except
    a. Implementing policies and procedures to prohibit the individual providing such services from making any managerial decisions on behalf of the audit client.
    b. Making arrangements so such services are not performed by a member of the assurance team.
    c. Obtaining audit client approval for any proposed journal entries or other changes affecting the financial statements.
    d. Requiring the source data for the accounting entries to be originated by the assurance team.

47. The provision of accounting and bookkeeping services of a routine or mechanical nature to divisions or subsidiaries of listed audit clients would not be seen as impairing independence with respect to the audit client provided that the following conditions are met, except
    a. The services do not involve the exercise of judgment.
    b. The divisions or subsidiaries for which the service is provided are collectively immaterial to the audit client.
    c. The fees to the firm, or network firm, from such services are collectively significant.
    d. The services provided are collectively immaterial to the division or subsidiary.

48. The provision of accounting and bookkeeping services to audit clients in emergency or other unusual situations, when it is impractical for the audit client to make other arrangements, would not be considered to pose an unacceptable threat to independence provided:
    a. Personnel providing the services are not members of the assurance team.
    b. The audit client accepts responsibility for the results of the work.
    c. The firm, or network firm, does not assume any managerial role or make any managerial decisions.
    d. All of the above.

49. If the valuation services involves the valuation of matters material to the financial statements and the valuation involves a significant degree of subjectivity, the self-review threat created (choose the incorrect one)
    a. Could be reduced to an acceptable level by the application of safeguards.
    b. Could not be reduced to an acceptable level by the application of any safeguard.
    c. Such valuation services should not be provided.
    d. The assurance team should withdraw from the audit engagement, if the team opted to perform the valuation services.

50. The following would not generally create a significant threat to independence, except
    a. When a firm, or a network firm, performs a valuation service for an audit client for the purposes of making a filing or return to a tax authority.
    b. The firm provides formal taxation opinions and assistance in the resolution of tax disputes to an audit client.
    c. When the firm, or a network firm, provides assistance in the performance of a client's internal audit activities or undertakes the outsourcing of some of the activities.
    d. The firm renders internal services involving an extension of the procedures required to conduct an audit in accordance with Philippine Standards on Auditing to an audit client.

51. The provision of services by a firm or network firm to an audit client that involve the design and implementation of financial information technology systems that are used to generate information forming part of a client's financial statements may most likely create
    a. Self-interest threat.
    b. Intimidation threat.
    c. Self-review threat.
    d. Familiarity threat.

52. Which of the following is least likely considered to create a threat to independence?
    a. The provision of services by a firm or network firm to an audit client which involve either the design or the implementation of financial information technology systems that are used to generate information forming part of a client's financial statements.
    b. The lending of staff by a firm, or network firm, to an audit client when the individual is in a position to influence the preparation of a client's accounts or financial statements.
    c. The provision of services in connection with the assessment, design and implementation of internal accounting controls and risk management controls.
    d. The provision of litigation support services to an audit client, which include the estimation of the possible outcome and thereby affects the amounts or disclosures to be reflected in the financial statements.

53. Legal services are defined as

a. The making of assumptions with regard to future developments, the application of certain methodologies and techniques, and the combination of both in order to compute a certain value, or range of values, for an asset, a liability or for a business as a whole.
b. A broad range of services, including compliance, planning, provision of formal taxation opinions and assistance in the resolution of tax disputes.
c. Any services for which the person providing the services must either be admitted to practice before the Courts of the jurisdiction in which such services are to be provided, or have the required legal training to practice law.
d. May include such activities as acting as an expert witness, calculating estimated damages or other amounts that might become receivable or payable as the result of litigation or other legal dispute, and assistance with document management and retrieval in relation to a dispute or litigation.

54. Which of the following threats to independence can be eliminated or reduced to an acceptable level?
a. Acting for an audit client in the resolution of a dispute or litigation in such circumstances when the amounts involved are material in relation to the financial statements of the audit client.
b. The appointment of a partner or an employee of the firm or network firm as General Counsel for legal affairs to an audit client.
c. When a firm is asked to act in an advocacy role for an audit client in the resolution of a dispute or litigation in circumstances when the amounts involved are not material to the financial statements of the audit client.
d. Both a and c.

55. The recruitment of senior management for an assurance client, such as those in a position to affect the subject of the assurance engagement may least likely create
a. Self-interest threat.
b. Intimidation threat.
c. Advocacy threat.
d. Familiarity threat.

56. Which of the following fee arrangements would violate the Code of Professional Conduct?
a. A per hour fee that includes out-of-pocket expenses.
b. A fee based on the outcome of a bankruptcy proceeding.
c. A fee based on the complexity of the engagement.
d. A fee based on the approval of a bank loan.

57. Which of the following actions by a professional accountant in public practice will not result in violation of the Code of Ethics regarding commissions?
a. Receipt of referral fees by the referring accountant when no services are performed by the referring accountant.
b. Entering into an arrangement for the purchase of the whole or part of an accounting practice requiring payments to individuals formerly engaged in the practice or payments to their heirs or estates.
c. Accepting commission for the referral of the products or services of others.
d. Accepting commission for referring a client to a third party.

58. Which statement is incorrect regarding activities incompatible with the practice of public accountancy?

a. The simultaneous engagement in another business, occupation or activity unrelated to professional services which has the effect of not allowing the professional accountant in public practice properly to conduct a professional practice in accordance with the fundamental ethical principles of the accountancy profession should be regarded as inconsistent with the practice of public accountancy.
b. The rendering of two or more types of professional services concurrently does by itself impair integrity, objectivity or independence.
c. A professional accountant in public practice should not concurrently engage in any business, occupation or activity which impairs or might impair integrity, objectivity or independence, or the good reputation of the profession.
d. A professional accountant in public practice should not concurrently engage in any business, occupation or activity which would be incompatible with the rendering of professional services.

59. Which statement is incorrect regarding clients' monies?
a. The professional accountants in public practice should not hold clients' monies if there is reason to believe that they were obtained from, or are to be used for, illegal activities.
b. Monies may only be drawn from the client account on the instructions of the client.
c. Fees due from a client may be drawn from client's monies without the need of notifying the client.
d. A professional accountant in public practice should maintain one or more bank accounts for clients' monies.

60. Which statement is incorrect regarding relations with other professional accountants in public practice?
a. When a professional accountant in public practice is asked to provide services or advice, inquiries should be made as to whether the prospective client has an existing accountant.
b. The wishes of the client should be paramount in the choice of professional advisers, whether or not special skills are involved.
c. The receiving accountant may express any criticism of the professional services of the existing accountant without giving the latter an opportunity to provide all relevant information.
d. Professional accountants in public practice should only undertake the services which they can expect to complete with professional competence.

61. Which statement is incorrect regarding the Code of Ethics for Professional Accountants in the Philippines?
a. Where a national statutory requirement is in conflict with a provision of the IFAC Code, the IFAC Code requirement prevails.
b. The Code of Ethics for Professional Accountants in the Philippines is mandatory for all CPAs and is applicable to professional services performed in the Philippines on or after January 1, 2004.
c. Professional accountants should consider the ethical requirements as the basic principles which they should follow in performing their work.
d. Professional accountants refer to persons who is Certified Public Accountants (CPA) and who hold a valid certificate issued by the Board of Accountancy.

62. Which statement is correct regarding the Code of Ethics for Professional Accountants in the Philippines?

a. All CPAs are expected to comply with the ethical requirements of the Code and other ethical requirements that may be adopted and approved by IFAC. Apparent failure to do so may result in an investigation into the CPA's conduct.
b. It is practical to establish ethical requirements which apply to all situations and circumstances that professional accountants may encounter.
c. Professional accountants refer to persons who are Certified Public Accountants (CPA) in public practice and who hold a valid certificate issued by the Board of Accountancy.
d. Professional accountants should consider the ethical requirements as the ideal principles which they should follow in performing their work.

63. Which statement is incorrect regarding the Code of Code of Ethics for Professional Accountants in the Philippines?
a. Part A applies to all professional accountants unless otherwise specified.
b. Part B applies only to those professional accountants in public practice.
c. The Code is divided into two parts, Part A and Part B.
d. The objectives as well as the fundamental principles are of a general nature and are not intended to be used to solve a professional accountant's ethical problems in a specific case.

64. Which of the following is incorrect regarding integrity and objectivity?
a. Integrity implies not merely honesty but fair dealing and truthfulness.
b. Professional accountants serve in many different capacities and should demonstrate their objectivity in varying circumstances.
c. Professional accountants should neither accept nor offer any gifts or entertainment.
d. The principle of objectivity imposes the obligation on all professional accountants to be fair, intellectually honest and free of conflicts of interest.

65. Professional accountants may encounter problems in identifying unethical behavior or in resolving an ethical conflict. When faced with significant ethical issues, professional accountants should do the following, except
a. Follow the established policies of the employing organization to seek a resolution of such conflict.
b. If the problem is not resolved with the immediate superior and the professional accountant determines to go to the next higher managerial level, the immediate superior need not be notified of the decision.
c. Review the conflict problem with the immediate superior if the organization's policies do not resolve the ethical conflict.
d. Seek counseling and advice on a confidential basis with an independent advisor or the applicable professional accountancy body or regulatory body to obtain an understanding of possible courses of action.

66. This occur when a firm or a member of the assurance team could benefit from a financial interest in, or other self-interest conflict with, an assurance client.
a. Advocacy threat.
b. Familiarity threat.
c. Self-interest threat.
d. Self-review threat.

67. Examples of circumstances that may create self-interest threat include
a. A direct financial interest or material indirect financial interest in an assurance client.

b. A loan or guarantee to or from an assurance client or any of its directors or officers.
c. Contingent fees relating to assurance engagements.
d. All of the above.

68. Which of the following least likely create "self-interest threat"
a. Concern about the possibility of losing the engagement.
b. Having a close business relationship with an assurance client.
c. Pressure to reduce inappropriately the extent of work performed in order to reduce fees.
d. Undue dependence on total fees from an assurance client.

69. Occurs when any product or judgment of a previous assurance engagement or non-assurance engagement needs to be re-evaluated in reaching conclusions on the assurance engagement or when a member of the assurance team was previously a director or officer of the assurance client, or was an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement.
a. Advocacy threat.
b. Familiarity threat.
c. Self-interest threat.
d. Self-review threat.

70. Examples of circumstances that may create self-review threat least likely include
a. A member of the assurance team being, or having recently been, an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement.
b. Performing services for an assurance client that directly affect the subject matter of the assurance engagement.
c. Potential employment with an assurance client.
d. Preparation of original data used to generate financial statements or preparation of other records that are the subject matter of the assurance engagement.

71. Occurs when a firm, or a member of the assurance team, promotes, or may be perceived to promote, an assurance client's position or opinion to the point that objectivity may, or may be perceived to be, compromised. Such may be the case if a firm or a member of the assurance team were to subordinate their judgment to that of the client.
a. Advocacy threat.
b. Familiarity threat.
c. Self-interest threat.
d. Self-review threat.

72. The following loans and guarantees would not create a threat to independence, except
a. If the firm, or a member of the assurance team, makes a loan to an assurance client that is not a bank or similar institution, or guarantees such an assurance client's borrowing.
b. Deposits made by, or brokerage accounts of, a firm or a member of the assurance team with an assurance client that is a bank, broker or similar institution, provided the deposit or account is held under normal commercial terms.
c. A loan from, or a guarantee thereof by, an assurance client that is a bank or a similar institution, to the firm, provided the loan is made under normal lending procedures, terms and requirements and the loan is immaterial to both the firm and the assurance client.

d. A loan from, or a guarantee thereof by, an assurance client that is a bank or a similar institution, to a member of the assurance team or their immediate family, provided the loan is made under normal lending procedures, terms and requirements.

73. Examples of close business relationships that may create self-interest and intimidation threat least likely include
   a. The purchase of goods and services from an assurance client by the firm (or from an audit client by a network firm) or a member of the assurance team, provided the transaction is in the normal course of business and on an arm's length basis.
   b. Having a material financial interest in a joint venture with the assurance client or a controlling owner, director, officer or other individual who performs senior managerial functions for that client.
   c. Distribution or marketing arrangements under which the firm acts as a distributor or marketer of the assurance client's products or services, or the assurance client acts as the distributor or marketer of the products or services of the firm.
   d. Arrangements to combine one or more services or products of the firm with one or more services or products of the assurance client and to market the package with reference to both parties.

74. Family and personal relationships between a member of the assurance team and a director, an officer or certain employees, depending on their role, of the assurance client, least likely create
   a. Self-review threat.
   b. Self-interest threat.
   c. Intimidation threat.
   d. Familiarity threat.

75. An inadvertent violation of the rules on family and personal relationships would not impair the independence of a firm or a member of the assurance team when:
   a. Additional care is given to reviewing the work of the professional.
   b. Either the responsibilities of the assurance team are re-structured so that the professional does not deal with matters that are within the responsibility of the person with whom he or she is related or has a personal relationship, or, if this is not possible, the firm promptly removes the professional from the assurance engagement.
   c. The firm has established policies and procedures that require all professionals to report promptly to the firm any breaches resulting from changes in the employment status of their immediate or close family members or other personal relationships that create threats to independence.
   d. All of the above.

76. A director, an officer or an employee of the assurance client in a position to exert direct and significant influence over the subject matter of the assurance engagement has been a member of the assurance team or partner of the firm. This situation least likely create
   a. Advocacy threat.
   b. Familiarity threat.
   c. Intimidation threat.
   d. Self-interest threat.

77. If a member of the assurance team, partner or former partner of the firm has joined the assurance client, the significance of the self-interest, familiarity or intimidation threats created is least likely affected by

a. The position the individual has taken at the assurance client.
b. The length of time that the individual was a member of the assurance team or firm.
c. The former position of the individual within the assurance team or firm.
d. The amount of any involvement the individual will have with the assurance team.

78. A former officer, director or employee of the assurance client serves as a member of the assurance team. This situation will least likely create
a. Familiarity threat
b. Intimidation threat.
c. Self-interest threat.
d. Self-review threat.

79. Communication between the receiving accountant and existing accountant is not intended
a. To restrict the client's freedom to choose their professional advisers and to change to others.
b. To protect the minority proprietors of a business who may not be fully informed of the circumstances in which the change is proposed.
c. To protect the interests of the existing accountant when the proposed change arises from, or is an attempt to interfere with, the conscientious exercise of the existing accountant's duty to act as an independent professional.
d. To protect a professional accountant in public practice from accepting an appointment in circumstances where all the pertinent facts are not known.

80. The existing accountant, on receipt of the communication from the proposed professional accountant in public practice, should not
a. Disclose all information needed by the proposed professional accountant in public practice to be able to decide whether or not to accept the appointment, if permission is not granted.
b. Ensure that the client has given permission to give details of this information to the proposed professional accountant in public practice.
c. Reply, preferably in writing, advising whether there are any professional reasons why the proposed professional accountant in public practice should not accept the appointment.
d. Report the fact, that the permission is not granted, to the proposed professional accountant in public practice.

81. Which of the following is true regarding advertising and solicitation?
a. A professional accountant in public practice in the Philippines, where advertising is prohibited, may advertise in a newspaper or magazine published in a country where advertising is permitted.
b. Advertising, but not solicitation, by individual professional accountants in public practice is permitted in the Philippines.
c. It is clearly desirable that the public should be aware of the range of services available from a professional accountant.
d. Solicitation, but not advertising, by individual professional accountants in public practice is permitted in the Philippines.

82. Which of the following is not acceptable?
a. A professional accountant is listed in a directory that could reasonably be regarded as a promotional advertisement for those listed therein.

b. A professional accountant writes a letter to another professional accountant seeking employment or professional business.
c. A professional accountant, who authored an article on professional subject, stated his name and professional qualifications and gave the name of his organization.
d. An appointment of a professional accountant in a matter of national importance was publicized.

83. Which of the following is acceptable?
a. A professional accountant developed a website that contains self-laudatory statements designed to solicit clients.
b. A professional accountant in public practice indicated in his stationery that he is a tax expert.
c. A professional accountant invited a potential client to attend training courses or seminars conducted for the assistance of staff.
d. Job specification that gives some detail as to one or more of the services provided to clients by the professional accountant in public practice was communicated to the public through the classified ads section of a newspaper.

84. Which statement is incorrect regarding employed professional accountants?
a. A professional accountant is expected to present financial information fully, honestly and professionally and so that it will be understood in its context.
b. A professional accountant, particularly one having authority over others, should give due weight for the need for them to develop and hold their own judgment in accounting matters and should deal with difference of opinion in a professional way.
c. Employed professional accountants owe a duty of loyalty to their employer as well as to the profession; therefore there may be no time that the two will be in conflict.
d. When undertaking significant tasks for which a professional accountant has not had sufficient specific training or experience, he or she should not mislead the employer as to the degree of expertise or experience he or she possesses, and where appropriate, expert advice and assistance should be sought.

85. The Code of Ethics for Professional Accountants in the Philippines is based on the International Code of Ethics for Professional Accountants developed by
a. AICPA Auditing Standards Board (ASB).
b. International Accounting Standards board (IASB).
c. International Auditing and assurance Standard Board (IAASB).
d. International Federation of Accountants (IFAC.)

COMPREHENSIVE CASES

CASE 1

You are the audit manager of De Leon & Associates and you are planning the audit of Connect Corporation, which has been an audit client for four years and specializes in manufacturing luxury mobile phones. During the planning stage of the audit you have obtained the following information. The employees of Connect Corporation are entitled to purchase mobile phones at a discount of 10%. The audit team has in previous years been offered the same level of staff discount.

During the year the financial controller of Connect Corporation was ill and hence unable to work. The company had no spare staff able to fulfill the role and hence a qualified audit senior of De Leon & Associates was seconded to the client for three months. The audit partner has recommended that the audit senior work on the audit as he has good knowledge of the client. The fee income derived from Connect Corporation was boosted by this engagement and along with the audit and tax fee, now accounts for 16% of the firm's total fees.

From a review of the correspondence files you note that the partner and the finance director have known each other socially for many years and in fact went on holiday together last summer with their families. As a result of this friendship the partner has not yet spoken to the client about the fee for last year's audit, 20% of which is still outstanding.

Required:

1. Explain the ethical threats which may affect the independence of De Leon and Associates' audit of Connect Corporation. For each threat explain how it might be avoided.

CASE 2

You are a manager in the audit firm of Asuncion & Company; and this is your first time you have worked on one of the firm's established clients, Thrift Corporation. The main activity of Thrift Corporation is providing investment advice to individuals regarding saving for retirement, purchase of shares and securities and investing in tax efficient savings schemes. Thrift Corporation is regulated by the relevant financial services authority.

You have been asked to start the audit planning for Thrift Corporation, by Mr. Caballero, a partner in Asuncion & Company. Mr. Caballero has been the engagement partner for Thrift Corporation, for the previous nine years and so has excellent knowledge of the client. Mr. Caballero has informed you that he would like his daughter Beverly to be part of the audit team this year; Beverly is currently studying for her Philippine CPA examination. Mr. Caballero also informs you that Mr. Lopez, the audit senior, received investment advice from Thrift Corporation during the year and intends to do the same next year.

In an initial meeting with the finance director of Thrift Corporation, you learn that the audit team will not be entertained on Thrift Corporation's yacht this year as this could appear to be an attempt to influence the opinion of the audit. Instead, he has arranged a balloon flight costing less than one-tenth of the expense of using the yacht and hopes this will be acceptable. The director also states that the fee for taxation services this year should be based on a percentage of tax saved and trusts that your firm will accept a fixed fee for representing Thrift Corporation in a dispute regarding the amount of sales tax payable to the taxation authorities.

Required:

1. Explain the ethical threats which may affect the auditor of Thrift Corporation. For each ethical threat, discuss how the effect of the threat can be mitigated.

CASE 3

You are the audit manager in the audit firm of Diaz & Associates. One of your audit clients is Active Company, a company specializing in the manufacture and supply of sporting equipment. Active Company has been an audit client for five years and you have been audit manager for the past three years while the audit partner has remained unchanged.

You are now planning the audit for the year ending December 31, 2021. Following an initial meeting with the directors of Active Company, you have obtained the following information:

a. Active Company is attempting to obtain a listing on a recognized stock exchange. The directors have established an audit committee, as required by corporate governance regulations, although no further action has been taken in this respect. Information on the listing is not yet public knowledge.

b. You have been asked to continue to prepare the company's financial statements as in previous years.

c. As the company's auditors, Active Company would like you and the audit partner to attend an evening reception in a hotel, where Active Company will present their listing arrangements to banks and existing major shareholders.

d. Active Company has indicated that the fee for taxation services rendered in the year to December 31, 2021 will be paid as soon as the taxation authorities have agreed the company's taxation liability. You have been advising Active Company regarding the legality of certain items as 'allowable' for taxation purposes and the taxation authority is disputing these items.

Finally, you have just inherited about 5% of Active Company's share capital as an inheritance on the death of a distant relative.

Required:

1. Identify, and explain the relevance of, any factors which may threaten the independence of Diaz & Associates' audit of Active Company's financial statements for the year ending December 31, 2021. Briefly explain how each threat should be managed.

Chapter 5
ACCEPTING THE ENGAGEMENT AND PLANNING THE AUDIT

LEARNING OBJECTIVES

Upon completion of this chapter you will

1. **Know the auditor's requirements for client acceptance and continuance.**
2. **Understand what is required to establish the terms of engagement.**
3. **Understand the types of information that are included in an engagement letter.**
4. **Understand the steps that are involved in preplanning.**
5. **Identify the steps that are performed in planning an audit engagement.**

This chapter introduces the audit process and part of it is audit planning. Auditing standards require that the audit is properly planned. If the audit is not properly planned, the auditor may perform an inefficient audit or may issue an inaccurate audit report.

MAJOR PHASES OF AN AUDIT

The audit process is the sequence of different activities involved in an audit and can be broken down into number of audit phases (Figure 5.1). These phases are cumulative and interrelated in nature.

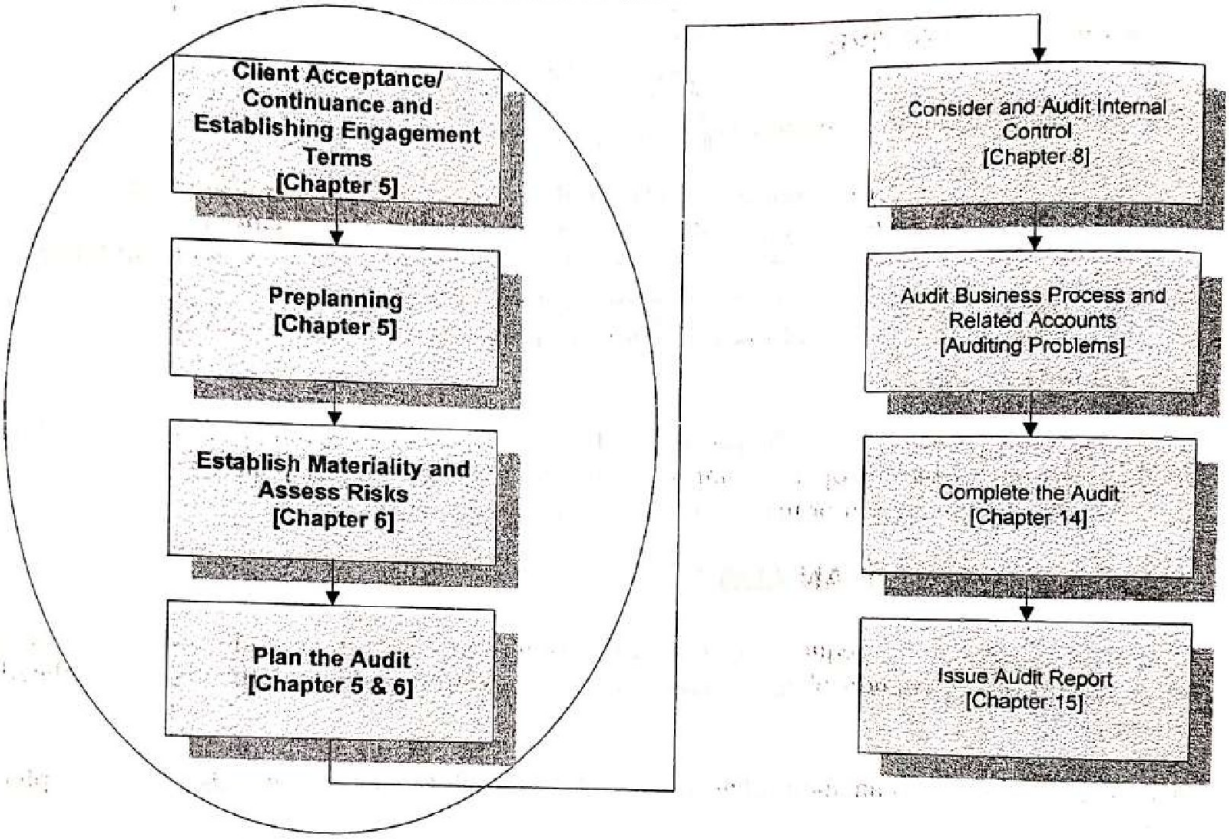
The first four phases of an audit relate to audit planning. This chapter covers the following phases of the audit:

1. Client acceptance and continuance and establishing an understanding of the terms of the engagement.
2. Preplanning.
3. Planning the audit.

CLIENT ACCEPTANCE AND CONTINUANCE

The first phase of the audit process that relates to audit planning is client acceptance and continuance. An auditor is not obligated to perform a financial statement audit for any entity requesting the service. In accepting an engagement, an auditor takes on professional responsibilities to the public, the client, and other members of the public accounting profession. The auditor must sustain the public's confidence in the profession by maintaining independence, integrity, and objectivity. The client's best interests must be served with competence and professional concern. And to the other members of the profession, the auditor has a responsibility to enhance the stature of the profession and its ability to serve the public. Thus, a decision to accept a new audit client or continue a relationship with an existing client should not be taken lightly. The importance of this decision is reflected in the inclusion of acceptance and continuation of clients as one of the quality control elements for CPA firms as previously discussed in Chapter 3.

Figure 5.1 Major Phases of an Audit



An auditor should investigate a prospective client prior to accepting an engagement. The procedures that a firm might conduct to evaluate a prospective client are presented in Exhibit 5.1.

EXHIBIT 5.1 Procedures that a Firm Might Conduct to Evaluate a Prospective Client

1. Obtain and review available financial information such as annual reports, interim financial statements, income tax returns, news items in the financial press, and others.

2. Inquire third parties about any information concerning the ***integrity*** of the prospective client and its management. It involves making inquiries of appropriate parties such as prospective client's bankers and lawyers, credit agencies and other members of the business community who may have such knowledge. In some cases, making an inquiry of the local chamber of commerce may also be helpful.

3. Communicate with the predecessor auditor about:
   - Any disagreement between the predecessor auditor and the client about accounting principles and auditing procedures, or other similarly significant matters.
   - Any facts that might have a bearing on the integrity of the prospective client's management.
   - Communications with those charged with governance regarding fraud, non-compliance with laws and regulations, internal control-related matters, and quality of accounting principles.
   - The predecessor auditor's understanding of the reasons for the change of auditors.

Before accepting the engagement, the successor auditor should take the initiative to communicate, either orally or in writing, with the predecessor auditor. The successor auditor should obtain client's permission to communicate with the predecessor auditor. This is a necessary procedure because the code of ethics refrain an auditor from disclosing any confidential client information without specific consent of the client, unless there is a legal or professional duty to disclose.

Given the consent of the client, the predecessor auditor advises the successor auditor whether there are any professional reasons not to accept the engagement. If the client's consent is not given or the predecessor auditor does not respond fully, the successor auditor should consider the implications in deciding to accept the engagement.

4. Consider whether the prospective client has any circumstances that will require special attention or that may represent unusual business or audit risks, such as litigation or going-concern problems. Matters pertaining to this step in accepting an engagement include identifying the intended users of the audited financial statements, making a preliminary assessment of the prospective client's legal and financial stability, identifying scope limitations, and evaluating the entity's auditability.

5. Determine if the audit team is independent of the client and able to provide the desired service.

6. Determine if the audit team has the necessary technical skills and knowledge of the industry to complete the engagement. In making assignments, the nature and extent of supervision to be provided should also be taken into account. Generally, the more able and experienced the personnel assigned to a particular engagement, the less is the need for a direct supervision.

   The typical audit team consists of:

   - A partner, who has both overall and final responsibility for the engagement.
   - One or more managers, who usually have significant expertise in the industry and who coordinate and supervise the execution of the audit program.
   - One or more seniors, who may have responsibility for planning the audit, executing parts of the audit programs, and supervising and reviewing the work of staff assistants.
   - Staff assistants, who perform many of the required audit procedures.

   The key members of the audit team are generally identified prior to acceptance of the engagement to ensure their availability. In addition, when a prospective client has invited a firm to submit a proposal to obtain the engagement, it is common practice to include the resumes of the key members of the proposed audit team. This allows the prospective client to assess the credentials of the individuals who will be assigned to the engagement.

7. Determine if acceptance of the client would violate any applicable regulatory or ethical requirements.

The information that the auditor collects during the acceptance and continuance process provides valuable understanding of the entity and its environment, thus helping the auditor assess risk and plan the audit. Upon acceptance and continuance, the auditor establishes an understanding with the client regarding the services to be performed and the terms of the engagement.

An auditor should address the acceptability and continuation of audit clients the same way it address the acceptance of new clients. Ideally, the auditor's evaluation of whether to retain their clients should be done periodically. It may take place at or near the completion of an audit or when some significant event occurs (such as changes in management, directors, nature of client's business, etc.).

Circumstances that cause a firm to withdraw from an audit engagement might include the following:

- Concerns about the integrity of the client's management or the withholding of evidence that is requested during the audit.
- The audit client's refusal to correct material misstatements in the financial statements.
- The audit client's refusal to take appropriate steps to remedy fraud or illegal acts discovered during the audit.
- Disagreements over increase in the audit fees.
- Conflicts over accounting and auditing issues that the audit client refuses to correct in the financial statements.

ESTABLISHING AN UNDERSTANDING OF THE TERMS OF THE ENGAGEMENTS

The auditor and the client must agree on the terms of the engagement. Such agreed terms need to be recorded in an engagement letter and other suitable form of contract. (*PSA 210, Terms of Audit Engagement, and amended by PSA 700 as revised)*

The Engagement Letter

The *engagement letter* serves as a written contract between the auditor and the client outlining and communicating clearly the respective responsibilities of the client and the auditor thus, preventing misunderstanding between the two parties. It confirms the auditor's acceptance of the engagement and includes the objective and the scope of the engagement, management responsibilities, auditor's responsibilities, the form of any reports and the limitations of the engagement. Exhibit 5.2 shows a sample engagement letter.

EXHIBIT 5.2 **Sample Engagement Letter**

JHI & Co. [Audit Firm]

[Date]

To the Appropriate Representative Senior Management
MNO Company [Client]

Sir/Madam:

[The objective and scope of the audit]

You have requested that we audit the financial statements of _____ which comprise the balance sheet as at _____, and the income statement, statement of changes in equity and statement of cash flows for then ended, and the summary of significant accounting policies and other explanatory notes. We are pleased to confirm our acceptance and our understanding of this audit engagement by means of this letter. Our audit will be conducted in accordance with the objective of our expressing an opinion on the financial statements.

[The responsibilities of the auditor]

We will conduct our audit in accordance with Philippine Standards in Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement. The audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates

made by the management, as well as evaluating the overall presentation of the financial statements.

Because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements may remain undiscovered.

In making our risk assessment, we consider internal control relevant to the entity's preparation and presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. However, we will communicate to you in writing concerning any significant deficiencies in internal control relevant to the audit of financial statements that we have identified during the audit.

[The responsibilities of the management]

Our audit will be conducted on the basis that the management and, where appropriate, those charge with governance acknowledge and understand their responsibility:

a. For the preparation and presentation of the financial statements in accordance with Philippine Financial Reporting Standards: this includes the design , implementation and maintenance of the internal control relevant to the preparation and fair presentation of the financial statements that are free from material misstatement, whether due to fraud or error.

b. To provide us with:

   i. All information, such as records and documentation , and other matters that are relevant to the preparation and fair presentation of the financial statements;

   ii. Any additional information that the auditor may request from management and, where appropriate, those charged with governance ; and

   iii. Unrestricted access to those within the entity from whom we determine it necessary to obtain audit evidence.

As part of our audit process, we will request from management and, where appropriate, those charged with governance, written confirmation concerning representations made to us in connection with the audit.

We look forward to full cooperation from your staff during our audit.

[Other relevant information]

[Insert other information, such as fee arrangement, billings and other specific terms, as appropriate.]

[Reporting]

We expect to report as follows:

[Insert text of sample report or include as an attachment]

Please sign and return the attached copy of this letter to indicate your acknowledgement of, and agreement with, the arrangements for our audit of the financial statements including our respective responsibilities.

JHI & Co.

Acknowledged and agreed on behalf of MNO Company

Name and Title
Date

In addition to the items enumerated in Exhibit 5.2, the engagement letter may also include the following:

- Arrangements involving the use of experts or internal auditors.
- Explanation of the auditor's responsibilities to communicate audit matters of governance interest with those charged with governance.
- Any limitation of the liability of the auditor or client.
- Arrangements to be made with the predecessor auditor in the case of an initial audit.
- Additional services to be provided relating to regulatory requirements.
- Arrangements regarding other services such as assurance, tax or consulting services.

PREPLANNING

Preplanning activities generally includes the following: (1) obtaining an understanding of the entity and its environment, (2) determining the audit engagement team requirements, and (3) ensuring the independence of the audit team and audit firm.

Together with client acceptance and continuance and establishing an understanding of the terms of the engagement, the purpose of performing these preliminary engagement activities is to help ensure that the auditor has considered any events or circumstances that may adversely affect the auditor's ability to plan and perform the audit engagement to reduce audit risk to an acceptably low level. Performing these preliminary engagement activities helps to ensure that the auditor plans an audit engagement for which:

- The auditor maintains the necessary independence and ability to perform the engagement.
- There are no issues with management integrity that may affect the auditor's willingness to continue the engagement.
- There is no misunderstanding with the client as to the terms of the engagement.

Obtaining an Understanding of the Entity and its Environment

The auditor begins by updating or deepening his understanding of the entity and its environment. The auditor then combines this knowledge with other information obtained in the audit to develop expectation of what should be reported in the financial statements. It is also important for the auditor to understand the client's business risks, as these are the risks that the client must control. The likelihood of misstatements in accounting estimates also relates directly to the client business risks. The auditor's understanding of the entity and its environment should include information on each of the following categories:

- Industry, regulatory and other external factors.
- Nature of the entity, including the entity's application of accounting policies.
- Objectives and strategies and related business risks, including the entity's risk assessment process.
- Measurement and review of the entity's financial performance.
- Internal control.

Chapter 6 provides detailed discussion of these categories.

Determine the Audit Engagement Team Requirements

Audit firms need to ensure that their engagements are completed by auditors having the proper degree of technical training and proficiency and competence to handle the engagement. Factors that should be considered to determine staffing requirements include engagement size and complexity, level of risk, any special expertise, personnel availability and timing of the work to be performed.

In determining whether to accept an engagement, it is appropriate for an auditor to consider the use of consultants and specialists to assist the audit team in performing the audit. An auditor is not expected to have the expertise of a person trained for, or qualified to engage in, the practice of another profession or occupation. PSA 620, *Using the Work of an Expert*, recognizes that the auditor may use the work of experts to obtain competent evidential matter. Chapter 13 extensively discusses matters required when using the work of an expert.

Ensuring the Independence of the Audit Team and Audit Firm

As part of preplanning activities, the auditor should evaluate compliance with ethical requirements, including independence. Auditing standards (i.e., PSA 220/PSA 200) requires auditor to consider whether there are any threats to audit team's and audit firm's independence and objectivity. The engagement partner should ensure that all individuals assigned to the engagement are independent of the client. This can be accomplished by reviewing the annual independence reports of each member of the audit team. The engagement partner should also form a conclusion on compliance with independence requirements that apply to the audit engagement. In doing so, the engagement partner should:

- Obtain relevant information from the firm and to identify and evaluate circumstances and relationships that create threats to independence.
- Evaluate information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for the audit engagement.
- Take appropriate action to eliminate such threats or reduce them to an acceptable low level by applying safeguards.
- Document conclusions on independence and any relevant discussions with the firm that support these conclusions.

ASSESS RISKS AND ESTABLISH MATERIALITY

To plan the audit properly, the audit team must make a preliminary assessment of the client's business risks and determine the materiality. The team relies on these judgments to assess risk relating to the likelihood of material misstatements in the financial statements.

Chapter 6 provides a detailed discussion of the process used to assess the client's business risks and to establish materiality.

PLANNING THE AUDIT

A vital phase of every audit engagement is planning. Planning serves much the same purpose in auditing that it does in personal planning for college or in business planning for the development of a new product like a personal computer. In each instance, planning results in an orderly arrangement of the parts or steps to achieve the desired objective.

Auditing standards (i.e., PSA 300) require the auditor to plan the audit so that the engagement will be performed in an effective manner. Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan in order to reduce audit risk to an acceptably low level. The auditor should plan the audit with an attitude of professional skepticism about such matters as the integrity of management, errors or irregularities, and illegal acts. The amount of planning required in an engagement will vary with the size and complexity of the client, and the auditor's knowledge of and experience with the client. As to be expected, considerably more effort is needed to adequately plan an initial audit than a recurring audit. Planning involves the engagement partner and other key members of the engagement team to benefit from their experience and insight and to enhance the effectiveness and efficiency of the planning process.

Audit planning helps ensure that appropriate attention is devoted to important areas of the audit, identify potential problems, ensure that the audit is performed effectively and efficiently, and aids in the proper assignment and coordination of work. In developing the audit plan, the auditor should be guided by the following:

1. The procedures performed to gain and document an understanding of the entity.
2. The results of the risk assessment process (discussed in Chapter 6).

Additional steps that should be performed by the auditor when planning an audit include:

1. Assessing a preliminary level for control risk by account and assertion.
2. Considering the possibility of non-compliance with laws and regulations.
3. Identifying related parties.
4. Conducting preliminary analytical procedures.
5. Developing an overall strategy and prepare an audit plan.
6. Considering additional value-added services.

ASSESS A PRELIMINARY LEVEL FOR CONTROL RISK BY ACCOUNT AND ASSERTION

Control risk is the risk that material misstatements that could occur in an account balance or class of transactions will not be detected or prevented by internal controls. The auditor evaluates the effectiveness of internal control for preventing material misstatements in the financial statements and prepares a preliminary assessment of control risk. A preliminary assessment of control risk is necessary for the auditor to plan the nature, timing, and extent of testing.

CONSIDER THE POSSIBILITY OF NON-COMPLIANCE WITH LAWS AND REGULATIONS

Auditing standards (i.e., PSA 250 as revised) require that the auditor plans the audit 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 the framework. In obtaining this general understanding, the auditor would particularly recognize that some laws and regulations may have

a fundamental effect on the operations of the entity. That is, noncompliance with certain laws and regulations may cause the entity to cease operations, or call into question the entity's continuance as a going concern. For example, noncompliance with the requirements of the entity's license or other title to perform its operations could have such an impact (for example, for a bank, noncompliance with capital or investment requirements) on the entity's undertakings.

The auditor should recognize that non-compliance with laws and regulations may materially affect the financial statements. The term "noncompliance" refers to acts of omission or commission by the entity, intentional or unintentional, committed by the entity, or by those charged with governance, by management or by other individuals working for or under the direction of the entity, which are contrary to the prevailing laws or regulations. The auditor should obtain sufficient appropriate audit evidence about compliance with those laws and regulations generally recognized by the auditor to have an effect on the determination of material amounts and disclosures in financial statements. The auditor should have a sufficient understanding of these laws and regulations in order to consider them when auditing the assertions related to the determination of the amounts to be recorded and the disclosures to be made.

Generally, the further removed noncompliance is from the events and transactions ordinarily reflected in financial statements, the less likely the auditor is to become aware of it or to recognize its possible noncompliance. The auditor should be alert to the fact that procedures applied for the purpose of forming an opinion on the financial statements may bring instances of possible noncompliance with laws and regulations to the auditor's attention. However, an audit cannot be expected to detect noncompliance with all laws and regulations.

Exhibit 5.3 presents examples of the type of information that may come to the auditor's attention that may indicate that noncompliance with laws or regulations have occurred.

EXHIBIT 5.3 Indications That Noncompliance May Have Occurred

- Investigation by government departments or payment of fines or penalties.
- Payments for unspecified services or loans to consultants, related parties, employees or government employees.
- Sales commissions or agent's fees that appear excessive in relation to those ordinarily paid by the entity or in its industry or to the services actually received.
- Purchasing at prices significantly above or below market price.
- Unusual payments in cash, purchases in the form of cashiers' checks payable to bearer or transfers to numbered bank accounts.
- Unusual transactions with companies registered in tax havens.
- Payments for goods or services made other than to the country from which the goods or services originated.
- Payments without proper exchange control documentation.
- Existence of an accounting system which fails, whether by design or by accident, to provide an adequate audit trail or sufficient evidence.
- Unauthorized transactions or improperly recorded transactions
- Media comment.

If a non-compliance act has occurred or is likely to have occurred, the auditor should consider its implications for other aspects of the audit, particularly the reliability of management representations. The auditor should ensure that those charged with governance are adequately informed about significant non-compliance acts. The auditor should also recognize that, under the

circumstances noted previously, he or she may have to notify parties outside the client such as regulatory and enforcement authorities.

Identify Related Parties

Management is responsible for identifying and disclosing related party relationships and transactions in accordance with the applicable financial reporting framework. The auditor should attempt to identify all related parties during the planning phase of the audit because transactions between the entity and related parties may not be at arm's length. The auditor can identify related parties by evaluating the client's procedures for identifying related parties, requesting a list of related parties from management, and review third party confirmations.

Conduct Preliminary Analytical Procedures

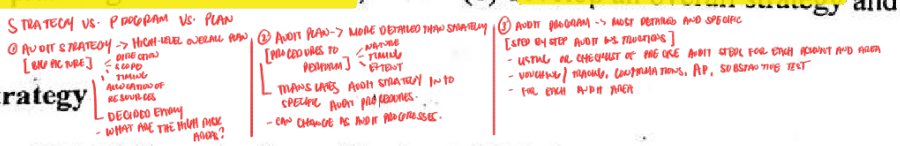
Analytical procedures involve analysis and evaluation of significant financial information made by a study of relationships among both financial and non-financial data. Such procedures range from simple comparisons to the use of complex mathematical and statistical models involving many relationships and data elements. Analytical procedures are used in auditing for the following purposes:

- In the planning phase of the audit, to assist the auditor in planning the nature, timing, and extent of other auditing procedures.
- In the testing phase, as a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions.
- At the conclusion of the audit, in a final review of the overall reasonableness of the audited financial statements.

Auditing standards (i.e., PSA 520) require the auditor to use analytical procedures in the planning phase for all audits and overall review stages of the audit. The objectives of preliminary analytical procedures (i.e., in the planning phase) are (1) to enhance the auditor's understanding of the entity and its environment, and (2) to identify unusual relationships and unexpected fluctuations in financial statement accounts that may indicate areas of greater misstatement.

Develop an Overall Strategy and Prepare an Audit Plan

The auditor, as part of planning the audit activities, should (1) develop an overall strategy and (2) prepare an audit plan.



The Overall Audit Strategy

Auditing standards (i.e., PSA 300) require the auditor to establish the overall audit strategy for the audit. Once the auditor has obtained a sufficient understanding about the entity and its environment, including its internal control, the auditor prepares an overall audit strategy. The **overall audit strategy** sets the scope, timing and direction of the audit, and guides the development of the more detailed audit plan. The establishment of the overall audit strategy involves:

1. Determining the characteristics of the engagement that define its scope, such as

a. The financial reporting framework used.
b. Industry-specific reporting requirements.
c. The locations of the components of the entity.

2. Ascertaining the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required, such as

a. Deadlines for interim and final reporting.
b. Key dates for expected communications with management and those charged with governance.

3. Considering the important factors that will determine the focus of the engagement team's efforts, such as

a. Determination of appropriate materiality levels.
b. Preliminary identification of areas where there may be higher risks of material misstatement.
c. Preliminary identification of material components and account balances.
d. Evaluation of whether the auditor may plan to obtain evidence regarding the effectiveness of internal control.
e. Identification of recent significant entity-specific, industry, financial reporting or other relevant developments.

Exhibit 5.4 shows examples of matters the auditor may consider in establishing the overall strategy for an engagement.

EXHIBIT 5.4 Examples of Matters the Auditor May Consider in Establishing the Overall Audit Strategy

Scope of the Audit Engagement

- The financial reporting framework on which the financial information to be audited has been prepared, including any need for reconciliations to another financial reporting framework.
- Industry-specific reporting requirements such as reports mandated by industry regulators.
- The expected audit coverage, including the number and locations of components to be included.
- The nature of the control relationships between a parent and its components that determine how the group is to be consolidated.
- The extent to which components are audited by other auditors.
- The nature of the business segments to be audited, including the need for specialized knowledge.
- The reporting currency to be used, including any need for currency translation for the financial information audited.
- The need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes.
- The availability of the work of internal auditors and the extent of the auditor's potential reliance on such work.
- The entity's use of service organizations and how the auditor may obtain evidence concerning the design or operation of controls performed by them.
- The expected use of audit evidence obtained in prior audits, for example, audit evidence related to risk assessment procedures and tests of controls.
- The effect of information technology on the audit procedures, including the availability of data and the expected use of computer-assisted audit techniques.
- The coordination of the expected coverage and timing of the audit work with any reviews of interim financial information and the effect on the audit of the information obtained during such reviews.
- The discussion of matters that may affect the audit with firm personnel responsible for

performing other services to the entity.
- The availability of client personnel and data.

Reporting Objectives, Timing of the Audit and Communications Required

- The entity's timetable for reporting, such as at interim and final stages.
- The organization of meetings with management and those charged with governance to discuss the nature, extent and timing of the audit work.
- The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor's report, management letters and communications to those charged with governance.
- The discussion with management regarding the expected communications on the status of audit work throughout the engagement and the expected deliverables resulting from the audit procedures.
- Communication with auditors of components regarding the expected types and timing of reports to be issued and other communications in connection with the audit of components.
- The expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.
- Whether there are any other expected communications with third parties, including any statutory or contractual reporting responsibilities arising from the audit.

Direction of the Audit

- With respect to materiality:
  - ✓ Setting materiality for planning purposes.
  - ✓ Setting and communicating materiality for auditors of components.
  - ✓ Reconsidering materiality as audit procedures are performed during the course of the audit.
  - ✓ Identifying the material components and account balances.
- Audit areas where there is a higher risk of material misstatement.
- The impact of the assessed risk of material misstatement at the overall financial statement level on direction, supervision and review.
- The selection of the engagement team (including, where necessary, the engagement quality control reviewer) and the assignment of audit work to the team members, including the assignment of appropriately experienced team members to areas where there may be higher risks of material misstatement.
- Engagement budgeting, including considering the appropriate amount of time to set aside for areas where there may be higher risks of material misstatement.
- The manner in which the auditor emphasizes to engagement team members the need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence.
- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified weaknesses and action taken to address them.
- Evidence of management's commitment to the design and operation of sound internal control, including evidence of appropriate documentation of such internal control.
- Volume of transactions, which may determine whether it is more efficient for the auditor to rely on internal control.
- Importance attached to internal control throughout the entity to the successful operation of the business.
- Significant business developments affecting the entity, including changes in information technology and business processes, changes in key management, and acquisitions, mergers and divestments.
- Significant industry developments such as changes in industry regulations and new reporting requirements.
- Significant changes in the financial reporting framework, such as changes in accounting standards.
- Other significant relevant developments, such as changes in the legal environment affecting the entity.

The auditor compiles his knowledge about the client's business objectives, strategies, and related business and audit risk. The auditor records how the client is managing the risks and then documents the effect of the risks and controls on the planned audit procedures. The auditor must

consider carefully the appropriate levels of materiality and the risk assessment process when developing the audit strategy. Chapter 6 provides detailed discussion of these two concepts.

The process of developing the overall audit strategy helps the auditor to ascertain the nature, timing and extent of resources necessary to perform the engagement. The overall audit strategy sets out clearly, in response to the matters identified in above mentioned overall strategy, and subject to the completion of the auditor's risk assessment procedures:

1. The resources to deploy for specific audit areas, such as the use of appropriately experienced team members for high risk areas or the involvement of experts on complex matters;

2. The amount of resources to allocate to specific audit areas, such as the number of team members assigned to observe the inventory count at material locations, the extent of review of other auditors' work in the case of group audits, or the audit budget in hours to allocate to high risk areas;

3. When these resources are deployed, such as whether at an interim audit stage or at key cut-off dates; and

4. How such resources are managed, directed and supervised, such as when team briefing and debriefing meetings are expected to be held, how engagement partner and manager reviews are expected to take place (for example, on-site or off-site), and whether to complete engagement quality control reviews.

The Audit Plan

After the audit strategy has been established, the auditor is able to start developing a more detailed audit plan to address the matters identified in the audit strategy. Auditing standards (i.e., PSA 300) require the auditor to develop an audit plan for the audit in order to reduce audit risk to an acceptably low level. The **audit plan** is more detailed than the overall audit strategy and includes the nature, timing and extent of audit procedures to be performed by engagement team members in order to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. Documentation of the audit plan also serves as a record of the proper planning and performance of the audit procedures that can be reviewed and approved prior to the performance of further audit procedures.

The audit plan includes:

- A description of the nature, timing and extent of planned risk assessment procedures sufficient to assess the risks of material misstatement, as determined under **PSA 315** (revised), *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*;

- A description of the nature, timing and extent of planned further audit procedures at the assertion level for each material class of transactions, account balance, and disclosure, as determined under **PSA 330**, *The Auditor's Procedures in Response to Assessed Risks*. The plan for further audit procedures reflect the auditor's decision whether to test the

operating effectiveness of controls, and the nature, timing and extent of planned substantive procedures; and

- Such other audit procedures required to be carried out for the engagement in order to comply with PSAs (for example, seeking direct communication with the entity's lawyers).

Planning for these audit procedures take place over the course of the audit as the audit plan for the engagement develops. For example, planning of the auditor's risk assessment procedures ordinarily occurs early in the audit process. However, planning of the nature, timing and extent of specific further audit procedures depend on the outcome of those risk assessment procedures. In addition, the auditor may begin the execution of further audit procedures for some classes of transactions, account balances and disclosures before completing the more detailed audit plan of all remaining further audit procedures.

CONSIDER ADDITIONAL VALUE-ADDED SERVICES

The auditor should look for opportunities to recommend additional value-added services during the planning process. Value-added services include tax compliance and planning, transaction support, consultancy, and internal reporting processes. With auditors taking a more global view of the entity and its environment, there are new opportunities to provide valuable services to its clients. Proper consideration of value added- services during the planning process should alert the audit team to proactively identify opportunities to improve client service.

RISK ASSESSMENT PROCEDURE VS FURTHER AUDIT PROCEDURES VS SPECIFIC AUDIT PROCEDURES
RAP -> IDENTIFY AND ASSESS RAM
-> UNDERSTAND THE ENTITY
-> NOT YET GATHERING SUFFICIENT/APPROPRIATE EVIDENCE
FAP -> DONE TO RESPOND TO THE ASSESSED RISK
a. TEST OF CONTROLS
b. SUBSTANTIVE PROCEDURES
-> ACTUALLY PROVIDE AUDIT EVIDENCE
SAP -> ACTUAL DETAILED STEPS YOU WILL PERFORM
-> INDIVIDUAL PROCEDURES FOUND IN THE AUDIT PROGRAM

REVIEW QUESTIONS

1. What topics should be discussed in a preliminary meeting with a prospective audit client?
2. What information should a CPA firm seek in its investigation of a prospective client?
3. State the purpose and nature of an engagement letter.
4. Are auditors justified in relying upon the accuracy of working papers prepared for them by employees of the client?
5. Define and differentiate between ***audit plan*** and an ***audit program.***
6. Should a separate audit program be prepared for each audit engagement, or can a standard program be used for most engagements?
7. "An audit program is desirable when new staff members are assigned to an engagement, but an experienced auditor should be able to conduct an audit without reference to an audit program." Do you agree? Discuss.

MULTIPLE CHOICE QUESTIONS

1. Before accepting an audit engagement, a successor auditor should make specific inquiries of the predecessor auditor regarding:
   a. The predecessor's evaluation of matters of continuing accounting significance.
   b. The predecessor's assessments of inherent risk and judgments about materiality.
   c. The degree of cooperation the predecessor received concerning the inquiry of the client's legal counsel.
   d. Disagreements which the predecessor had with the client concerning auditing procedures and accounting principles.

2. Before accepting an engagement to audit a client, a CPA is required to obtain
   a. The prospective client's signature to the engagement letter.
   b. An understanding of the prospective client's control environment. ~> PAP
   c. A representation letter from the prospective client.
   d. A preliminary understanding of the prospective client's industry and business.

3. When a CPA is approached to perform an audit for the first time, the CPA should make inquiries of the predecessor auditor. This is a necessary procedure because the predecessor auditor may be able to provide the incoming auditor with information that will assist the incoming auditor in determining
   a. Whether the predecessor auditor's work should be utilized.
   b. Whether the engagement should be accepted.
   c. Whether the company follows the policy of rotating its auditor.
   d. Whether in the predecessor's opinion the internal control of the company has been satisfactory.

4. Preliminary knowledge about the client's business and industry must be obtained prior to the acceptance of the engagement primarily to
   a. Gather evidence about the fairness of the financial statements.
   b. Determine the degree of knowledge and expertise required by the engagement.
   c. Determine whether the firm is independent with the client.
   d. Determine the integrity of management.

5. A CPA firm's quality control procedures pertaining to the acceptance of a prospective audit client would most likely include
   a. Inquiry of third parties, such as the prospective client's bankers and attorneys, about information regarding the prospective client and its management.
   b. Inquiry of management as to whether disagreements between the predecessor auditor and the prospective client were resolved satisfactorily.
   c. Consideration of whether the internal control structure is sufficiently effective to permit a reduction in the required substantive tests.
   d. Consideration of whether sufficient competent evidential matter may be obtained to afford a reasonable basis for an opinion.

6. Prior to the acceptance of an audit engagement with a client who has terminated the services of the predecessor auditor, the CPA should
   a. Not communicate with the predecessor auditor because this would in effect be asking the auditor to violate the confidential relationship between the auditor and client.
   b. Contact the predecessor auditor without advising the prospective client and request a complete report of the circumstance leading to the termination with the understanding that all information disclosed will be kept confidential.
   c. Advise the client of the intention to contact the predecessor auditor and request permission for the contact.
   d. Accept the engagement without contacting the predecessor auditor since the CPA can include audit procedures to verify the reason given by the client for the termination.

7. Bonjo, CPA, has been retained to audit the financial statements of Joven Co. Joven's predecessor auditor was Pamela, CPA, who has been notified by Joven that Pamela's services have been terminated. Under these circumstances, which party should initiate the communication between Bonjo and Pamela?
   a. The chairman of Joven's board of directors.
   b. Pamela, the predecessor auditor.
   c. Joven's controller
   d. Bonjo, the incoming auditor.

8. In an audit, communication between the predecessor auditor and incoming auditor should be
   a. Written and included in the working papers.
   b. Either written or oral.
   c. Authorized in an engagement letter.
   d. Acknowledged in a representation letter.

9. Ram, CPA, is succeeding Rox, CPA, on the engagement Lang Corporation. Ram plans to consult Rox's prior year working papers. Ram may do so if
   a. Rox consents.
   b. Rox and Ram consent.

c. Rox and Lang consent.
d. Lang consents.

10. Upon discovering material misstatements in a client's financial statements that the client would not revise, the auditor withdrew from the engagement. If asked by the incoming auditor about the termination of the engagement, the predecessor should
a. Suggest that the incoming auditor obtain the client's permission to discuss the reasons.
b. Suggest that the incoming auditor ask the client.
c. State the he found material misstatements that the client would not revise.
d. Indicate that a misunderstanding occurred.

11. Before accepting an audit engagement, an incoming auditor should make specific inquiries of the predecessor auditor regarding the predecessor's
a. Understanding as to the reasons for the change of auditors.
b. Opinion of any subsequent events occurring since the predecessor's audit report was issued.
c. Evaluation of all matters of continuing accounting significance.
d. Awareness of the consistency in the application GAAP between periods.

12. An incoming auditor most likely would make specific inquiries of the predecessor auditor regarding
a. Disagreements with management as to auditing procedures.
b. Specialized accounting principles of the client's industry.
c. The competency of the client's internal audit staff.
d. The uncertainty inherent in applying sampling procedures.

13. Which of the following should an auditor obtain from the predecessor auditor prior to accepting an audit engagement
a. Facts that might bear on the integrity of management.
b. Analysis of income statement accounts.
c. Analysis of balance sheet accounts.
d. All matters of continuing accounting significance.

14. What information should an incoming auditor obtain during the inquiry of the predecessor auditor prior to the acceptance of the audit?
I. Facts that bear on the integrity of management.
II. Whether statistical or non-statistical sampling was used to gather evidence.
III. Disagreements with management concerning audit procedures.
IV. The effects of the client's internal audit function on the scope of the independent auditor's examination.

a. III and IV
b. I and IV
c. I and III
d. I and II

15. Engagement letter that documents and confirms the auditor's acceptance of the engagement would normally be sent to the client
    a. Before the commencement of the engagement.
    b. Before the audit report is issued.
    c. At the end of the fieldwork.
    d. After the audit report is issued.

16. An engagement letter should ordinarily include information on the objectives of the engagement and

	CPAs responsibility	Client's responsibility	Limitation of engagement
a.	YES	NO	NO
b.	NO	NO	YES
c.	YES	YES	YES
d.	YES	NO	NO

17. Which of the following would be least likely to be included in the auditor's engagement letter?
    a. Type of opinion to be issued.
    b. Objectives and scope of the audit.
    c. Forms of the report.
    d. Extent of his responsibilities to his client.

18. Which of the following is not one of the principal contents of an engagement letter?
    a. Unrestricted access to records and documents.
    b. Objective of the financial statements.
    c. Management's responsibility for the financial statements.
    d. Limitations of the engagement.

19. An engagement letter would not normally include
    a. Expectation of receiving a representation letter from management.
    b. Details of the procedure that will be performed.
    c. Billing arrangement.
    d. Arrangement concerning client's assistance.

20. The audit engagement letter should generally include a reference to each of the following except
    a. The risk that material misstatements may remain undiscovered.
    b. The expectation of receiving a written management representation letter.
    c. A request for the client to confirm the terms of the engagement.
    d. A description of the auditor's method of sample selection.

21. After preliminary audit arrangements have been made, an engagement confirmation letter should be sent to the client. The letter usually would not include
    a. An estimate of the time to be spent on the audit work by audit staff and management.
    b. A statement that management advisory services would be made available upon request.
    c. A statement that a management letter will be issued outlining comments and suggestions as to any procedures requiring the client's attention.
    d. A reference to the auditor's responsibility for the detection of errors or irregularities.

22. Arrangements concerning which of the following are least likely to be included in engagement letter?
    a. Auditor's responsibilities.
    b. CPA investment in client securities.
    c. Fees and billing.
    d. Other forms of reports to be issued in addition to the audit report.

23. The use of an engagement letter is the best method of documenting the following except
    I. The required communication of significant deficiencies in internal control structure.
    II. Significantly lower materiality levels than those used in the prior audit.
    III. The description of any letters or reports that the auditor expects to issue.
    IV. Notification of any changes in the original arrangements of the audit.
    a. III and IV
    b. II and III
    c. I and IV
    d. I and II

24. In which of the following situations would the auditor be unlikely to send a new engagement letter to a continuing client?
    a. A significant change in the nature or size of the client's business.
    b. A recent change of client management.
    c. A recent change in the partner and/or staff in the audit engagement.
    d. A change in terms of the engagement.

25. In a continuing engagement, the continuing auditor would most likely send a new engagement letter when
    a. There is a recent change in client's management.
    b. There is a change in the partner assigned to the engagement.
    c. There are new accounting pronouncements affecting the client's financial statements.
    d. There are expected minor changes in the nature or size of the client's business.

26. When the auditor of a parent entity is also the auditor of its subsidiary, branch or division (component); which of the following factors would least likely influence the auditor's decision to send separate letter to a component of a parent entity?
    a. Legal requirements.
    b. Geographical location of the component.
    c. Degree of ownership by parent.
    d. Degree of independence of component's management.

27. With respect to planning an audit, which of the following statements is always true?
    a. An engagement should not be accepted after the client's year-end.
    b. An inventory count must be observed at year-end.
    c. Final staffing decision must be made prior to completion of the planning stage.
    d. It is acceptable to perform a portion of the audit of a continuing client at interim dates.

28. The element of the audit planning process most likely to be agreed upon with the client before implementation of the audit strategy is the determination of the

a. Timing of inventory observation procedures to be performed.
b. Procedures to be undertaken to discover litigation, claims, and assessments.
c. Pending legal matters to be included in the inquiry of the client's attorney.
d. Evidence to be gathered to provide a sufficient basis for the auditor's opinion.

29. The audit plan should (select the exception)
a. Be cost-beneficial.
b. Be flexible.
c. Precede performance of procedures.
d. Succeed action.

30. Which of the following is least likely considered by the auditor in establishing the overall audit strategy and developing the audit plan?
a. Risk and materiality.
b. The involvement of other auditors in the audit of major subsidiaries.
c. The terms of payment pertaining to other auditors and their respective clients.
d. Understanding the accounting and internal control systems.

31. Which of the following is not considered by the CPA when he makes an overall audit plan?
a. Identification of complex accounting areas including those involving accounting estimates.
b. The content of the representation letter.
c. The effect of information technology on audit.
d. The nature and timing of reports and other communication with the entity that are expected under the engagement.

32. In relation to audit planning, the auditor should document the following:
a. Significant changes made during the engagement.
b. The detailed audit plan.
c. The overall audit strategy.
d. All of the answers.

33. This is the listing of all things which the a auditor will use to gather sufficient appropriate audit evidence:
a. Audit risk model.
b. Audit program.
c. Audit procedures.
d. Audit plan.

34. The auditor should design the written audit program so that:
a. The audit procedures selected will achieve specific audit objectives.
b. Substantive tests prior to the balance sheet date will be minimized.
c. Each account balance will be tested under either tests of controls or tests of transactions.
d. All material transactions will be selected for substantive testing.

35. The audit program usually cannot be finalized until the
a. Search for unrecorded liabilities has been performed and documented.
b. Reportable conditions have been communicated to the audit committee.

c. Engagement letter has been signed by the auditor and the client.
d. Consideration of the entity's internal control has been completed.

36. Which of the following is the correct order of steps in the audit process?
A. ③ Perform test of control.
B. ② Develop an overall strategy for the expected conduct and scope of the audit.
C. ⑤ Obtains client's written representation.
D. ① Prepare engagement letter.
E. ④ Perform substantive tests.
a. D, B, E, A, C
b. D, B, C, A, E
c. D, B, A, E, C
d. D, A, B, E, C

37. Which of the following would an auditor least likely perform as part of the auditor's preliminary engagement activities?
a. Perform procedures regarding the continuance of the client relationship and the specific audit engagement.
b. Obtain understanding of the legal and regulatory framework applicable to the entity.
c. Evaluate compliance with ethical requirements, including independence.
d. Establish an understanding of the terms of the engagement.

38. Which of the following is not one of the reasons why auditor should perform preliminary engagement activities?
a. To ensure that sufficient appropriate evidence will be obtained to support the auditor's opinion on the financial statements.
b. To ensure that the auditor maintains the necessary independence and ability to perform preliminary engagement.
c. To ensure that there is no misunderstanding with the client as to terms of the engagement.
d. To help ensure that there are no issues with management integrity that may affect the auditor's willingness to continue the engagement.

39. Which of the following is not normally performed in the preplanning or pre-engagement phase?
a. Deciding whether to accept or reject an audit engagement.
b. Inquiring from predecessor auditor.
c. Making a preliminary estimate of materiality.
d. Preparing an engagement letter.

40. In making a decision to accept or continue with a client, the auditor should consider:

	A	B	C	D
Its competence	YES	YES	YES	YES
Its independence	YES	NO	YES	NO
Its ability to serve the client properly	YES	YES	YES	NO
The integrity of the client's management	YES	YES	NO	YES

41. An incoming auditor should request the new client to authorize the predecessor auditor to allow a review of the predecessor's

	Engagement letter	Working paper
a.	No	Yes
b.	No	No
c.	Yes	Yes
d.	Yes	No

42. Which of the following factors most likely would cause an auditor not to accept a new engagement?
   a. An inability to perform preliminary analytical procedures before assessing control risk.
   b. An inadequate understanding of the entity's internal control structure.
   c. Concluding that the entity's management probably lacks integrity.
   d. The close proximity to the end of the entity's fiscal year.

43. Which of the following factors most likely influence an auditor's determination of the auditability of the entity's financial statements
   a. The adequacy of the accounting records.
   b. The complexity of the accounting system.
   c. The existence of related party transactions.
   d. The operating effectiveness of control procedures.

44. Emmanne requested permission to communicate with the predecessor auditor and review certain portions of the predecessor's working papers. The prospective client's refusal to permit this will bear directly on Emmanne's decision concerning the:
   a. Integrity of management.
   b. Apparent scope limitation.
   c. Adequacy of the preplanned audit program.
   d. Ability to establish consistency in application of accounting principles between years.

45. Before performing any audit procedures, the auditor and the client should agree on the

	Type of opinion to be expressed	Terms of engagement
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

46. According to PSA 210, the auditor and the client should agree on the terms of engagement. The agreed terms would need to be recorded in a(n)
   a. Memorandum to be placed in the permanent section of the audit working papers.
   b. Engagement letter
   c. Comfort letter
   d. Client representation letter

47. The objective and the scope of the audit and the extent of the auditor's responsibilities to client are best documented in:
   a. Independent auditor's report.
   b. Client's representation letter.
   c. Audit program.
   d. Audit engagement letter.

48. Engagements letter are widely used in practice for:
    a. Assurance engagements only.
    b. Audits only.
    c. Professional engagements of all types.
    d. Related services only.

49. The primary purpose of the engagement letter is to:
    a. Satisfy the requirements of the CPAs liability insurance policy.
    b. Remind management that the primary responsibility for the financial statements rests with management.
    c. Provide a written record of the agreement with the client as to the services to be provided.
    d. Provide a starting point for the auditor's preparation of the preliminary audit program.

50. Which of the following is (are) valid reason why an auditor sends to his client an engagement letter?

	A	B	C	D
To ensure CPAs compliance to PSA	YES	NO	NO	YES
To document the objective and scope of the audit	YES	YES	YES	YES
To confirm the auditor's acceptance of the appointment	YES	YES	YES	NO
To avoid misunderstanding with respect to engagement	YES	YES	NO	YES

51. If an auditor believes that an understanding with the client has not been established, he should ordinarily
    a. Perform the audit with increased professional skepticism.
    b. Modify the scope of the audit to reflect an increased risk of material misstatement due to fraud.
    c. Decline to accept or perform the audit.
    d. Assess the control risk at the maximum level and perform a preliminary substantive audit.

52. In developing a preliminary audit strategy, an auditor should consider
    a. Findings from substantive tests performed at interim dates.
    b. Potential risks of material misstatement.
    c. Only when there is a material misstatements in the financial statements.
    d. Whether the inquiry of the client's attorney identifies any litigation, claims, or assessments not properly disclosed in the financial statements.

53. After client acceptance, the terms of the engagement are agreed by the auditor with the client. The objective and scope of the audit and the extent of the auditor's responsibilities to the client are best documented in:
    a. Independent auditor's report
    b. Engagement letter.
    c. Client's representation letter.
    d. Comfort letter.

54. Audit programs should be designed so that
    a. Most of the required procedures can be performed as interim work.

b. Inherent risk is assessed at a sufficiently low level.
c. The auditor can make constructive suggestions to managements.
d. The audit evidence gathered supports the auditor's conclusions.

55. An engagement letter is prepared with the interest(s) of _____ in mind.
a. The auditor.
b. The client.
c. The public.
d. Both the client and the auditor.

56. The engagement letter will do one, some, or all of the following:

	A	B	C	D
1. State whether the CPA will perform audit, review or compilation services.	Yes	Yes	Yes	Yes
2. State whether the CPA will perform tax or management advisory or other services.	Yes	Yes	No	Yes
3. State any restriction to be imposed on the CPA's work.	No	Yes	Yes	Yes
4. Identify deadlines for completing the work.	Yes	Yes	No	Yes
5. State the amount and type of work to be done by client's personnel in generating auditor's workpapers.	No	No	Yes	Yes

57. Preliminary arrangements agreed to by the auditor and the client should be related to writing by the auditor. The **best** place to set forth these arrangements is in.
a. A memorandum to be placed in the permanent section of the auditing working papers.
b. An engagement letter.
c. A client representation letter.
d. A confirmation letter attached to the constructive services letter.

58. In designing written audit programs, an auditor should establish specific audit objectives that relate primarily to the
a. Timing of audit procedures.
b. Cost-benefit of gathering evidence.
c. Selected and techniques.
d. Financial statement assertions.

59. The element of the audit planning process most likely to be agreed upon with the client before implementation of the audit strategy is the determination of the
a. Methods of statistical sampling to be used in confirming accounts receivable.
b. Pending legal matters to be included in the inquiry of the client's attorney.
c. Evidence to be gathered to provide a sufficient basis for the auditor's opinion.
d. Schedules and analyses to be prepared by the client's staff.

60. In obtaining an understanding of an entity's internal control policies and procedures that are relevant to audit planning, and auditor is required to obtain knowledge about the
a. Steadiness with which the policies and procedures are currently being applied.
b. Effectiveness of control procedures related to each principal transaction class and account balance.
c. Design of the policies and procedures pertaining to the internal control components.
d. Effectiveness of the policies and procedures that have been placed in operation.

COMPREHENSIVE CASES

CASE 1

RJA, CPA, is approached by a prospective audit client who wants to engage RJA to perform an audit for the current year. In prior years this prospective client was audited by another CPA. Identify the specific procedures that RJA J should follow in deciding whether to accept this client.

CASE 2

Rodolfo Andres has been asked to accept an engagement to audit a small financial institution. Andres has not been previously audited a financial institution.

Required:

a. Describe the types of knowledge about the prospective client and its industry that Andres must obtain to plan the engagement.
b. Explain how Andres may obtain this knowledge.
c. Discuss how this knowledge of the client's business and industry will help Andres in planning and performing an audit in accordance with auditing standards.

CASE 3

Juan dela Cruz, CPA, agreed to perform an audit of a new client engaged in the manufacture of power tools. After some preliminary discussion of the purposes of the audit and the basis for the determination of the audit fee, Dela Cruz asked to be taken on a comprehensive guided tour of the client's plant facilities. Explain specific ways that the knowledge gained by Dela Cruz during the plant tour may help in planning and conducting the audit.

CASE 4

Pedro is the in-charge auditor with administrative responsibilities for the upcoming annual audit of RNB Company, a continuing client. Pedro will supervise two assistants on the engagement and will visit the client before the field work begins.

Pedro started the planning process by preparing a list of procedures to be performed prior to the beginning of the field work. The list includes the following:

A. Review correspondence and permanent files.
B. Review prior year's audit working papers, financial statements, and auditor's reports.
C. Discuss with CPA firm personnel responsible for audit and non-audit services to the client matters that may affect the examination.
D. Discuss with management current business developments affecting the client.

Required:

a. Complete Pedro's list of procedures to be performed prior to the beginning of field work.



Chapter 6
RISK ASSESSMENT, MATERIALITY AND PRELIMINARY AUDIT STRATEGIES

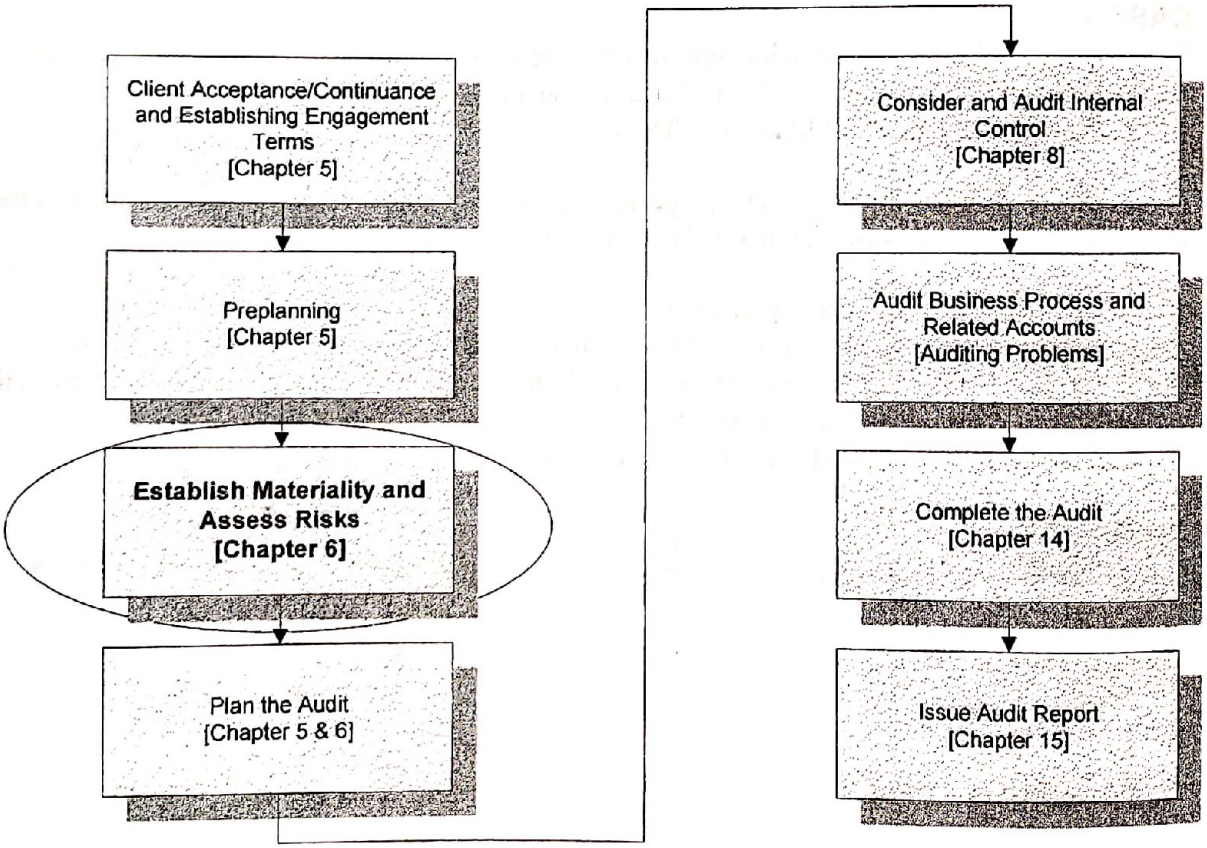
LEARNING OBJECTIVES

Upon completion of this chapter you will

1. **Understand the basic concept of audit risk.**
2. **Know the form and components of the audit risk model.**
3. **Learn how to use the audit risk model.**
4. **Understand the auditor's risk assessment process.**
5. **Understand the documentation requirements for risk assessment and responses.**
6. **Understand the basic concept of materiality.**
7. **Identify the steps to applying materiality to an audit**
8. **Understand the relationship between materiality and audit risk.**

This chapter covers the third phase of the audit process identified in Chapter 5 (Figure 5.1), ***the risk assessment and materiality.***

Major Phases of an Audit



AUDIT RISK

An auditor engaged to conduct a financial statement audit faces two types of risk: audit risk; and auditor's business risk.

- *Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.*
- *Auditor's business risk is the auditor's exposure to loss or injury to professional practice from litigation, adverse publicity, or other events arising in a connection with financial statements audited and reported on.*

Audit risk is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. The auditor should conduct the audit to reduce audit risk to a sufficiently low level, that is, in the auditor's professional judgment, appropriate for expressing an opinion on the financial statements. In doing so, the auditor needs to consider audit risk at the financial statement level and at the account balance or class of transactions level. The ***audit risk model*** serves as a framework for this process.

Financial statement level – the auditor considers risks of material misstatement that relate pervasively to the financial statements and potentially affect many assertions. Such risks often relate to the entity's control environment and may be relevant to the auditor's consideration of the risks of material misstatement arising from fraud. Chapter 7 provides a detailed discussion on control environment.

Account balance or class of transaction level – the auditor considers risk to directly aid them to plan the appropriate audit procedures for those accounts or transactions.

Auditor's business risk relates to an auditor's exposure to financial loss and damage to his professional reputation.

Audit risk can be directly controlled by the scope of the auditor's test procedures while auditor's business risk cannot be directly controlled by the auditor though some control can be exercised through the careful acceptance and in continuance of clients as discussed in previous chapter.

AUDIT RISK MODEL

The audit risk model helps the auditor in determining the scope of auditing procedures for a particular account balance or class of transactions. The use of this model and the determination of audit risk involve considerable judgment on the part of the auditor.

The formula for the audit risk model is:

Audit risk = Inherent risk x Control risk x Detection risk

Audit risk is a function of financial statement risk (the risk that the financial statements are materially misstated), and detection risk (the risk that the auditor will not detect such misstatements).

- **Financial statement risk**
  This has two components – inherent risk and control risk.

  ✓ ***Inherent risk*** is the susceptibility of an assertion to a misstatement which could be material (individually or when aggregated with other misstatements), assuming that there were no related internal controls.

  ✓ ***Control risk*** is the risk that a misstatement that could occur in an assertion and that could be material individually or when aggregated with other misstatements will not be prevented or detected and corrected on a timely basis by the internal control. Auditors consider the control environment of an entity together with detailed control activities and systems objectives in assessing the control risk for a specified area of the financial statements. Chapter 8 provides a detailed discussion on this matter.

  It is important to consider that the auditor has *no control* over the extent of either inherent or control risk; these are risks borne by the entity subject to audit. However, the auditor has to assess them in the process of determining the extent of the detailed substantive procedures to be carried out.

- **Detection risk**

  This is simply the risk that the auditor's procedures will not detect a misstatement that exists in an assertion that could be material (individually or when aggregated with other misstatements).

  Detection risk results from two uncertainties that are a function of the effectiveness of an audit procedure and of its application by the auditor.

  1. **Sampling risk**. Sampling risk means the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would have been reached if the entire population were subject to the same audit procedure.

     Auditors can minimize the sampling risk by adjusting the sample size and using the appropriate method of selecting sample items from the population.

  2. **Non-sampling risk.** Non-sampling risk is the risk of auditor error and arises from:

     - Inappropriate or ineffective audit procedures.
     - Failure to recognize errors in the sample tested.
     - Misinterpretation of evidence obtained.

Auditors can minimize the non-sampling risk by careful design of the audit procedures and proper instruction, adequate training, effective supervision, and review of the audit team.

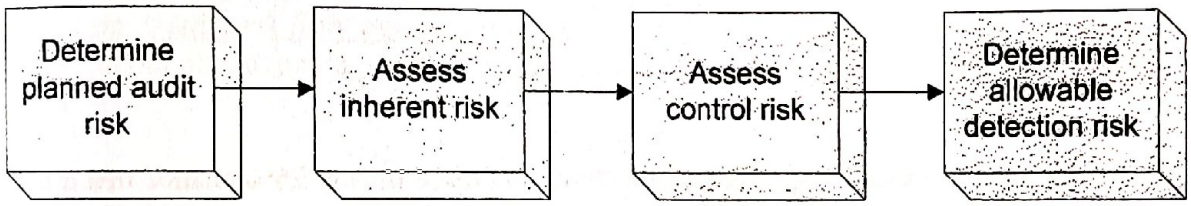
Detection risk can be *controlled* by the auditor through the scope of the audit procedures conducted.

USE OF THE AUDIT RISK MODEL

From the formula of audit risk model, it is apparent that if risk percentage values can be assessed for both inherent risk and control risk, then for a desired level of (acceptable) audit risk, a prescribed level of detection risk can be set and thus the extent of required substantive procedures can be determined. There are steps involved in the auditor's use of the audit risk model at the account balance or class of transaction level:

Figure 6.1 shows the steps followed using the audit risk model.

Figure 6.1 Steps Followed Using the Audit Risk Model



In applying the audit risk model, the auditor assesses each component of the model using either quantitative or qualitative terms.

Step 1. The auditor sets audit risk for each account balance or class of transactions in such a way that, at the completion of the engagement, an opinion can be issued on the financial statements at an acceptable level of audit risk.

Step 2. The auditor assesses inherent risk.

Step 3. The auditor assesses control risk.

Note: The auditor may assess inherent risk and control risk in combination (financial statement risk or auditee risk) or separately.

To assess these two components, the auditor assesses the entity's business risks and risk of material misstatement due to error or fraud. These assessments are described in detail in this chapter.

Step 4. The auditor determines the appropriate level of detection risk by solving the audit risk model as follows:

Audit risk (AR) = Inherent risk (IR) x Control risk (CR) x Detection risk (DR)

$$DR = \frac{AR}{IR \times CR}$$

The auditor uses this level of detection risk to design the audit procedures that will reduce audit risk to an acceptable level.

For quantitative example, if an audit firm works to a desired audit risk level of 5%, then for a given area of the financial statements where inherent risk and control risk factors have been assessed as 80% and 25% respectively, the required level of detection risk would need to be set at:

$$DR = \frac{AR}{IR \times CR}$$

$$DR = \frac{.05}{.80 \times .25}$$

$$DR = .25$$

Thus, the auditor establishes the scope of the audit that there is only 25% chance that a material misstatement, if present, is not detected.

For qualitative example, the audit risk might be classified into three categories: ***very low, low, and moderate***. It is not likely that an audit planned in accordance with auditing standards would consider a high level of audit risk. The remaining component of the audit risk model (inherent risk, control risk, and detection risk) may be classified into categories such as ***low, moderate, or high***. Following are the examples of the qualitative approach to the audit risk model.

AR	IR	CR	DR
Very low	High	High	Low
Low	Low	High	Moderate
Moderate	High	Low	Moderate

From the first example above, the auditor has determined that a ***very low*** level of audit risk is appropriate for this account because of its importance to the financial statement. Assume further that the auditor has assessed inherent risk and control risk as ***high***. A high assessment for these components indicates that there is high risk that a material misstatement occurred and was not prevented or detected by the internal control system. From these assessments, the auditor would set detection risk as ***low***. A low assessment for detection risk implies that the auditor will perform more detailed procedures of this account than if the assessment of detection risk were high.

NOTE

The higher the level of prescribed detection risk then the lower the level of substantive procedures and audit resources, and vice-versa.

Table 6.1 shows the relationship between the detection risk and the nature, timing, and extent of substantive tests.

TABLE 6.1 Relationship of Detection Risk to the Nature, Timing, and Extent of Substantive Tests

Effect of Detection Risk to	Acceptable Level of detection Risk	
	Lower	Higher
Nature of Substantive Test	Should use more persuasive tests	Could use less persuasive tests
Timing of Substantive Test	Perform tests at balance sheet date	Perform tests at interim dates
Extent of Substantive Test	Test more extensively	Test less extensively

Irrespective of the level at which audit risk is set, *detection risk has an inverse relationship to financial statement risk (inherent risk and control risk)* – the lower the financial statement risk then the higher the detection risk and consequently, the lower the level of detailed testing required.

It should be noted that once the prescribed level of detection risk has been set, audit firms may use manual tables as a guide to the size of samples to be tested, or – particularly for larger and more complex audits – will use dedicated computer software. Chapters 9 and 10 provide a detailed discussion of an audit sampling.

THE AUDITOR'S RISK ASSESSMENT PROCESS

The auditor should obtain an understanding of the management's objectives (e.g. growth in market share, first-rate reputation, etc.) and strategies (approaches used by management to achieve objectives) and the related business risks (threats to management's ability to achieve its objectives) that may result in material misstatement of the financial statements. A thorough understanding of business risks increases the likelihood of identifying material misstatements in the financial statements.

PSA 315 (revised), *Identifying and Assessing the Risks of Material Misstatements through Understanding the Entity and its Environment*, requires the auditor to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

The standard provides the following requirements:

- Risk Assessment Procedures and Related Activities
- The Required Understanding of the Entity and Its Environment, Including the Entity's Internal Control
- Identifying and Assessing the Risks of Material Misstatement
- Material Weakness in Internal Control
- Documentation

RISK ASSESSMENT PROCEDURES AND RELATED ACTIVITIES

Risk assessment procedures are the audit procedures designed and performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, *at the financial statement and assertion levels*.

Obtaining an understanding of the entity and its environment, including the entity's internal control is a continuous, dynamic process of gathering, updating and analyzing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit.

Information obtained by performing risk assessment procedures and related activities may be used by the auditor as audit evidence to support assessments of the risks of material misstatement. In addition, the auditor may obtain audit evidence about classes of transactions, account balances, or disclosures and related assertions and about the operating effectiveness of controls, even though such procedures were not specifically planned as substantive procedures or as tests of controls. The auditor also may choose to perform substantive procedures or tests of controls concurrently with risk assessment procedures because it is efficient to do so.

The risk assessment procedures should include the following:

I. Inquiries of management and of others within the entity.
II. Analytical procedures.
III. Observation and inspection.

I. INQUIRIES OF MANAGEMENT AND OF OTHERS WITHIN THE ENTITY

Much of the information obtained by the auditor's inquiries is obtained from management and those responsible for financial reporting. However, the auditor may also obtain information, or a different perspective in identifying risks of material misstatement, through inquiries of others within the entity and other employees with different levels of authority. For example:

- Inquiries directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared.
- Inquiries directed toward internal audit personnel may provide information about internal audit procedures performed during the year relating to the design and

effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.

- Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.
- Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements (such as joint ventures) with business partners and the meaning of contract terms.
- Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers.

In some instances, the auditor *might* also inquire others *outside* the entity. For example, the auditor may consider that it is appropriate to make inquiries of customers, suppliers, or specialists. Fraud is typically perpetrated by small number of people in top management and/or to the company's accounting department. Discussions with people outside those areas may provide information that will assist the auditor in discovering fraud. Customers, for example, may report that they received large number of unordered products from the audit client just before year-end. This would be an indicator of overstated revenues.

II. ANALYTICAL PROCEDURES

As introduced in the previous chapter, analytical procedures involve analysis and evaluation of significant financial information made by a study of relationships among both financial and non-financial data. Such preliminary analytical procedures assist the auditor in understanding the entity and its environment and in identifying areas that may represent specific risks relevant to the audit.

Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications. Unusual or unexpected relationships that are identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud.

However, when such analytical procedures use data aggregated at a high level (which may be the situation with analytical procedures performed as risk assessment procedures), the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist. Accordingly, in such cases, consideration of other information that has been gathered when identifying the risks of material misstatement together with the results of such analytical procedures may assist the auditor in understanding and evaluating the results of the analytical procedures. **PSA 520,** *Analytical Procedures*, provides further guidance on analytical procedures.

III. OBSERVATION AND INSPECTION

Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment. Examples of such audit procedures include the following:

- Observation of entity's operations.
- Review or inspection of documents (such as business plans and strategies), records, and internal control manuals.
- Reading/reviewing reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings).
- Visits to the entity's premises and plant facilities.
- Tracing transactions through the information system relevant to financial reporting (*walk-through*).

> *To perform a **walk-through**, the auditor traces a transaction from origination through the entity's information system until it is reflected in the entity's financial reports. It should encompass the entire process of initiating, authorizing, recording, processing, and reporting individual transactions and controls for each of the significant process identified. Walk-throughs help the auditor in confirming his understanding of control design and transaction process flow, as well as in determining whether all points at which misstatements could occur have been identified, evaluating the effectiveness of the design of controls and confirming whether controls have been placed in operation.*

The auditor must consider whether information obtained from the auditor's client acceptance or continuance process is relevant to identifying risks of material misstatement. Where the engagement partner has performed other engagements for the entity, the engagement partner must consider whether information obtained is relevant to identifying risks of material misstatement.

When the auditor intends to use information obtained from the auditor's previous experience with the entity and from audit procedures performed in previous audits, the auditor must determine whether changes have occurred since the previous audit that may affect its relevance to the current audit.

The engagement partner and other key engagement team members must discuss the susceptibility of the entity's financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner must determine which matters are to be communicated to engagement team members not involved in the discussion.

THE REQUIRED UNDERSTANDING OF THE ENTITY AND ITS ENVIRONMENT, INCLUDING THE ENTITY'S INTERNAL CONTROL

Obtaining an understanding of the entity and its environment is a continuous, dynamic process of gathering, updating, and analyzing information throughout the audit. The objective of this process is to assess the business risks faced by the entity.

The auditor's understanding of the entity and its environment includes the knowledge about the following categories:

- Industry, regulatory, and other external factors.
- The nature of the entity.
- Objectives and strategies, and those related business risks.
- Measurement and review of the entity's financial performance.
- Internal control.

Industry, Regulatory, and Other External Factors

The auditor should obtain an understanding of industry, regulatory and other external factors that are relevant to the audit client. Obtaining an understanding of these factors helps the auditor in identifying risks of material misstatement. Examples of these factors are shown in Exhibit 6.1.

EXHIBIT 6.1 Industry, Regulatory and Other External Factors

Industry Conditions

- The market and competition, including demand, capacity, and price competition.
- Cyclical or seasonal activity.
- Product technology relating to the entity's products.
- Energy supply and cost.

Regulatory Environment

- Accounting principles and industry specific practices.
- Regulatory framework for a regulated industry.
- Legislation and regulation that significantly affect the entity's operations, including direct supervisory activities.
- Taxation (corporate and other).
- Government policies currently affecting the conduct of the entity's business, such as monetary, including foreign exchange controls, fiscal, financial incentives (for example, government aid programs), and tariffs or trade restrictions policies.
- Environmental requirements affecting the industry and the entity's business.

Other External factors

- General economic conditions (e.g. recession, growth).
- Interest rates and availability of financing.
- Inflation or currency revaluation.

Nature of the Entity

The nature of an entity refers to the (1) entity's operations, (2) its ownership, (3) the types of investments it is making and plans to make, and (4) the way the entity is structured and how it is financed. An understanding of the nature of the entity provides the auditor a better idea of what to expect in the financial statement. It also enables the auditor to understand such matters as:

- Whether the entity has a complex structure, for example with subsidiaries or other components in multiple locations. Complex structures often introduce issues that may give rise to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or special-purpose entities are accounted for appropriately.
- The ownership, and relations between owners and other people or entities. This understanding assists in determining whether related party transactions have been identified and accounted for appropriately.

Examples of matters that the auditor may consider when obtaining an understanding of the nature of the entity are presented in Exhibit 6.2.

Objectives and Strategies and Related Business Risks

The entity conducts its business in the context of industry, regulatory and other internal and external factors. To respond to these factors, the entity's management or those charged with governance define objectives, which are the overall plans for the entity. Strategies are the approaches by which management intends to achieve its objectives. The entity's objectives and strategies may change over time.

Business risk is broader than the risk of material misstatement of the financial statements, though it includes the latter. Business risk may arise from change or complexity. A failure to recognize the need for change may also give rise to business risk. Business risk may arise, for example, from:

- The development of new products or services that may fail.
- A market which, even if successfully developed, is inadequate to support a product or service.
- Flaws in a product or service that may result in liabilities and reputational risk.

An understanding of the business risks facing the entity increases the likelihood of identifying risks of material misstatement, since most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, the auditor does not have a responsibility to identify or assess all business risks because not all business risks give rise to risks of material misstatement.

Examples of matters that the auditor may consider when obtaining an understanding of the entity's objectives, strategies and related business risks that may result in a risk of material misstatement of the financial statements are presented in Exhibit 6.3.

EXHIBIT 6.2 **Examples of Matters that the Auditor may Consider when Obtaining an Understanding of the Nature of the Entity**

Business operations

- Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as Internet sales and marketing activities.
- Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).
- Alliances, joint ventures, and outsourcing activities.
- Geographic dispersion and industry segmentation.
- Location of production facilities, warehouses, and offices, and location and quantities of inventories
- Key customers and important suppliers of goods and services, employment arrangements (including the existence of union contracts, pension and other post employment benefits, share option or incentive bonus arrangements, and government regulation related to employment matters).
- Research and development activities and expenditures.
- Transactions with related parties.

Investments/investment activities

- Planned or recently executed acquisitions or divestitures.
- Investments and dispositions of securities and loans.
- Capital investment activities.
- Investments in non-consolidated entities, including partnerships, joint ventures and special-purpose entities.

Financing/financing activities

- Major subsidiaries and associated entities, including consolidated and nonconsolidated structures.
- Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements.
- Beneficial owners (local, foreign, business reputation and experience) and related parties.
- Use of derivative financial instruments.

Financial reporting

- Accounting principles and industry specific practices, including industry-specific significant categories (for example, loans and investments for banks, or research and development for pharmaceuticals)
- Revenue recognition practices
- Accounting for fair values
- Foreign currency assets, liabilities and transactions
- Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for share-based compensation).

EXHIBIT 6.3 **Examples of Matters That the Auditor Considers When Developing an Understanding of the Entity's Objectives and Strategies**

- Existence of objectives relating to the following:
  - ✓ Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
  - ✓ New products and services (a potential related business risk might be, for example, that there is increased product liability).
  - ✓ Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
  - ✓ New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation, or increased costs).
  - ✓ Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure).
  - ✓ Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the entity's inability to meet requirements).
  - ✓ Use of IT (a potential related business risk might be, for example, that systems and processes are incompatible).
- The effects of implementing a strategy, particularly any effects that will lead to new accounting requirements.

A business risk may have an immediate consequence for the risk of material misstatement for classes of transactions, account balances, and disclosures at the assertion level or the financial statement level. For example, the business risk arising from a contracting customer base may increase the risk of material misstatement associated with the valuation of receivables. However, the same risk, particularly in combination with a contracting economy, may also have a longer-term consequence, which the auditor considers when assessing the appropriateness of the going concern assumption. Whether a business risk may result in a risk of material misstatement is, therefore, considered in light of the entity's circumstances. Usually, management identifies business risks and develops approaches to address them.

Measurement and Review of the Entity's Financial Performance

Management and others will measure and review those things they regard as important. Performance measures, whether external or internal, create pressures on the entity. These

pressures, in turn, may motivate management to take action to improve the business performance or to misstate the financial statements. Accordingly, an understanding of the entity's performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud. PSA 240 provides for requirements and guidance in relation to the risks of fraud.

The measurement and review of financial performance is not the same as the monitoring of controls (discussed as a component of internal control in Chapter 8), though their purposes may overlap:

- The measurement and review of performance is directed at whether business performance is meeting the objectives set by management (or third parties).
- Monitoring of controls is specifically concerned with the effective operation of internal control.

In some cases, however, performance indicators also provide information that enables management to identify deficiencies in internal control. Examples of information the auditor might consider to obtain an understanding of an entity's measurement and review system are presented in Exhibit 6.4.

EXHIBIT 6.4 **Examples of Matters That the Auditor Might Consider When Developing an Understanding of the Entity's Measurement and Review of Performance**

- Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics.
- Period-on-period financial performance analyses.
- Budgets, forecasts, variance analyses, segment information and divisional, departmental or other level performance reports.
- Employee performance measures and incentive compensation policies.
- Comparisons of an entity's performance with that of competitors.

External parties may also measure and review the entity's financial performance. For example, external information such as analysts' reports and credit rating agency reports may represent useful information for the auditor. Such reports can often be obtained from the entity being audited.

Internal measures may highlight unexpected results or trends requiring management to determine their cause and take corrective action (including, in some cases, the detection and correction of misstatements on a timely basis). Performance measures may also indicate to the auditor that risks of misstatement of related financial statement information do exist. For example, performance measures may indicate that the entity has unusual rapid growth or profitability when compared to that of other entities in the same industry. Such information, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate the potential risk of management bias in the preparation of the financial statements.

Smaller entities often do not have processes to measure and review financial performance. Inquiry of management may reveal that it relies on certain key indicators for evaluating financial performance and taking appropriate action. If such inquiry indicates an absence of performance measurement or review, there may be an increased risk of misstatements not being detected and corrected.

Internal Control

According to PSA 315 (revised), **internal control** is defined as the process designed and effected by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

An understanding of internal control assists the auditor in identifying types of potential misstatements and factors that affect the risks of material misstatement, and in designing the nature, timing, and extent of further audit procedures. Chapter 8 provides a detailed discussion on the auditor's consideration of internal control.

IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT DUE TO ERROR OR FRAUD

According to PSA 315 (revised), the auditor must identify and assess the risks of material misstatement to provide a basis for designing and performing further audit procedures at:

- The financial statement level; and
- The assertion level for classes of transactions, account balances, and disclosures.

For this purpose, the auditor must:

- Identify 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.
- Assess the identified risks, and evaluate whether they relate more pervasively to the financial statements as a whole and potentially affect many assertions.
- Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test.
- Consider the likelihood of misstatement, including the possibility of multiple misstatements, and whether the potential misstatement is of a magnitude that could result in a material misstatement.

Information gathered by performing risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, is used as audit evidence to support the risk assessment. The risk assessment determines the nature, timing, and extent of further audit procedures to be performed.

In making risk assessments, the auditor may identify the controls that are likely to prevent, or detect and correct, material misstatement in specific assertions. Generally, it is useful to obtain an understanding of controls and relate them to assertions in the context of processes and systems in which they exist because individual control activities often do not in themselves address a risk. Often, only multiple control activities, together with other components of internal control, will be sufficient to address a risk.

Conversely, some control activities may have a specific effect on an individual assertion embodied in a particular class of transactions or account balance. For example, the control activities that an entity established to ensure that its personnel are properly counting and recording the annual physical inventory relate directly to the existence and completeness assertions for the inventory account balance.

Controls can be either directly or indirectly related to an assertion. The more indirect the relationship, the less effective that control may be in preventing, or detecting and correcting, misstatements in that assertion. For example, a sales manager's review of a summary of sales activity for specific stores by region ordinarily is only indirectly related to the completeness assertion for sales revenue. Accordingly, it may be less effective in reducing risk for that assertion than controls more directly related to that assertion, such as matching shipping documents with billing documents.

According to PSA 240, in planning and performing the audit to reduce audit risk to an acceptably low level, the auditor should consider the risks of material misstatements in the financial statements due to fraud.

Types of Misstatements

Misstatements in the financial statements can result from error or fraud.

- **Errors** are unintentional misstatements or omissions of amounts or disclosures.
- **Fraud** involves intentional misstatements that can be classified into:
  - ✓ Misstatements arising from fraudulent financial reporting.
  - ✓ Misstatements arising from misappropriation of assets.

Exhibit 6.5 present examples of misstatements.

EXHIBIT 6.5 Examples of Misstatements

Errors

- Errors in gathering/processing data from which financial statements are prepared.
- Oversight/misinterpretation of facts that results in unreasonable accounting estimates.
- Errors in the application of accounting principles relating to amount, classification, manner of presentation, or disclosure.

Fraud

Fraudulent Financial Reporting

- Falsification/manipulation/alteration (including forgery) of accounting records or supporting documents from which financial statements are prepared.
- Intentional omission from or misrepresentation in, the financial statements of events, transactions, or other significant information.
- Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure.

Misappropriation of Assets (Defalcation)

- Embezzling cash received.
- Stealing assets.
- Causing the entity to pay for goods or services not received.

Fraudulent financial reporting involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.

Misappropriation of assets involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect. Misappropriation of assets can be accomplished in a variety of ways. **PSA 240**, *The Auditor's Responsibilities Relating Fraud in an Audit of Financial Statements*, provides a detailed guidance on the matter.

Risks that Require Special Audit Consideration

As part of the risk assessment as described above, the auditor must determine whether any of the risks identified are, in the auditor's judgment, a significant risk. In exercising this judgment, the auditor must exclude the effects of identified controls related to the risk.

In exercising judgment as to which risks are significant, the auditor must consider at least 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 transactions.
- 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 measurements 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.

Significant risks often relate to significant non-routine transactions or judgmental matters. Non-routine transactions are transactions that are unusual, due to either size or nature, and that therefore occur infrequently. Judgmental matters may include the development of accounting estimates for which there is significant measurement uncertainty. Routine, noncomplex transactions that are subject to systematic processing are less likely to give rise to significant risks.

Risks of material misstatement may be greater for significant non-routine transactions arising from matters such as the following:

- Greater management intervention to specify the accounting treatment.
- Greater manual intervention for data collection and processing.
- Complex calculations or accounting principles.
- The nature of non-routine transactions, which may make it difficult for the entity to implement effective controls over the risks.

Risks of material misstatement may be greater for significant judgmental matters that require the development of accounting estimates, arising from matters such as the following:

- Accounting principles for accounting estimates or revenue recognition may be subject to differing interpretation.
- Required judgment may be subjective or complex, or require assumptions about the effects of future events, for example, judgment about fair value.

Conditions and Events that may Indicate Risks of Material Misstatement

Exhibit 6.6 show examples of conditions and events that may indicate the existence of risks of material misstatement. The examples provided cover a broad range of conditions and events; however, not all conditions and events are relevant to every audit engagement and the list of examples is not necessarily complete.

EXHIBIT 6.6 Examples of Conditions and Events that may Indicate Risks of Material Misstatement

- Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies.
- Operations exposed to volatile markets, for example, futures trading.
- Operations that are subject to a high degree of complex regulation.
- Going concern and liquidity issues including loss of significant customers.
- Constraints on the availability of capital and credit.
- Changes in the industry in which the entity operates.
- Changes in the supply chain.
- Developing or offering new products or services, or moving into new lines of business.
- Expanding into new locations.
- Changes in the entity such as large acquisitions or reorganizations or other unusual events.
- Entities or business segments likely to be sold.
- The existence of complex alliances and joint ventures.
- Use of off-balance-sheet finance, special-purpose entities, and other complex financing arrangements.
- Significant transactions with related parties.
- Lack of personnel with appropriate accounting and financial reporting skills.
- Changes in key personnel including departure of key executives.
- Weaknesses in internal control, especially those not addressed by management.
- Inconsistencies between the entity's IT strategy and its business strategies.
- Changes in the IT environment.
- Installation of significant new IT systems related to financial reporting.
- Inquiries into the entity's operations or financial results by regulatory or government bodies.
- Past misstatements, history of errors or a significant amount of adjustments at period end.
- Significant amount of non-routine or non-systematic transactions including intercompany transactions and large revenue transactions at period end.
- Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities.
- Application of new accounting pronouncements.
- Accounting measurements that involve complex processes.
- Events or transactions that involve significant measurement uncertainty, including accounting estimates.
- Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.

Risks for Which Substantive Procedures Alone Do Not Provide Sufficient Appropriate Audit Evidence

In respect of some risks, the auditor may judge that it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures. Such risks may relate

to the inaccurate or incomplete recording of routine and significant classes of transactions or account balances, the characteristics of which often permit highly automated processing with little or no manual intervention. In such cases, the entity's controls over such risks are relevant to the audit and the auditor must obtain an understanding of them.

Risks of material misstatement may relate directly to the recording of routine classes of transactions or account balances, and the preparation of reliable financial statements. Such risks may include risks of inaccurate or incomplete processing for routine and significant classes of transactions such as an entity's revenue, purchases, and cash receipts or cash payments.

Where such routine business transactions are subject to highly automated processing with little or no manual intervention, it may not be possible to perform only substantive procedures in relation to the risk. For example, the auditor may consider this to be the case in circumstances where a significant amount of an entity's information is initiated, recorded, processed, or reported only in electronic form such as in an integrated system. In such cases:

- Audit evidence may be available only in electronic form, and its sufficiency and appropriateness usually depend on the effectiveness of controls over its accuracy and completeness.
- The potential for improper initiation or alteration of information to occur and not be detected may be greater if appropriate controls are not operating effectively.

Revision of Risk Assessment

The auditor's assessment of the risks of material misstatement at the assertion level may change during the course of the audit as additional audit evidence is obtained. In circumstances where the auditor obtains audit evidence from performing further audit procedures, or if new information is obtained, either of which is inconsistent with the audit evidence on which the auditor originally based the assessment, the auditor must revise the assessment and modify the further planned audit procedures accordingly.

During the audit, information may come to the auditor's attention that differs significantly from the information on which the risk assessment was based. For example, the risk assessment may be based on an expectation that certain controls are operating effectively. In performing tests of those controls, the auditor may obtain audit evidence that they were not operating effectively at relevant times during the audit. Similarly, in performing substantive procedures the auditor may detect misstatements in amounts or frequency greater than is consistent with the auditor's risk assessments. In such circumstances, the risk assessment may not appropriately reflect the true circumstances of the entity and the further planned audit procedures may not be effective in detecting material misstatements.

MATERIAL WEAKNESS IN INTERNAL CONTROL

The auditor must evaluate whether, on the basis of the audit work performed, the auditor has identified a material weakness in the design, implementation or maintenance of internal control.

The types of material weaknesses in internal control that the auditor may identify when obtaining an understanding of the entity and its internal controls may include:

- Risks of material misstatement that the auditor identifies and which the entity has not controlled, or for which the relevant control is inadequate.
- A weakness in the entity's risk assessment process that the auditor identifies as material or the absence of a risk assessment process in those cases where it would be appropriate for one to have been established.

Material weaknesses may also be identified in controls that prevent, or detect and correct error, or those that prevent and detect fraud.

The auditor must communicate material weaknesses in internal control identified during the audit on a timely basis to management at an appropriate level of responsibility.

DOCUMENTATION

The auditor must document:

- The discussion among the engagement team where required under the risk assessment procedures and related activities, and the significant decisions reached;
- Key elements of the understanding obtained regarding each of the aspects of the entity and its environment and of each of the internal control components; the sources of information from which the understanding was obtained; and the risk assessment procedures performed;
- The identified and assessed risks of material misstatement at the financial statement level and at the assertion level; and
- The risks identified, and related controls about which the auditor has obtained an understanding.

MATERIALITY

PAS 1, *Presentation of Financial Statements*, provides the definition of **materiality** as:

> Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. ***Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.***

Financial reporting frameworks often discuss the concept of materiality in the context of the preparation and presentation of financial statements. Although financial reporting frameworks may discuss materiality in different terms, they generally explain that:

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements;

- Judgments about materiality are made in the light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both; and
- Judgments about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

The auditor's determination of a materiality level or levels is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of the financial statements. In this context, it is reasonable for the auditor to assume that users:

- Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence;
- Understand that financial statements are prepared and audited to levels of materiality;
- Recognize the uncertainties inherent in the measurement of amounts based on the use of estimates, judgment and the consideration of future events; and
- Make reasonable economic decisions on the basis of the information in the financial statements.

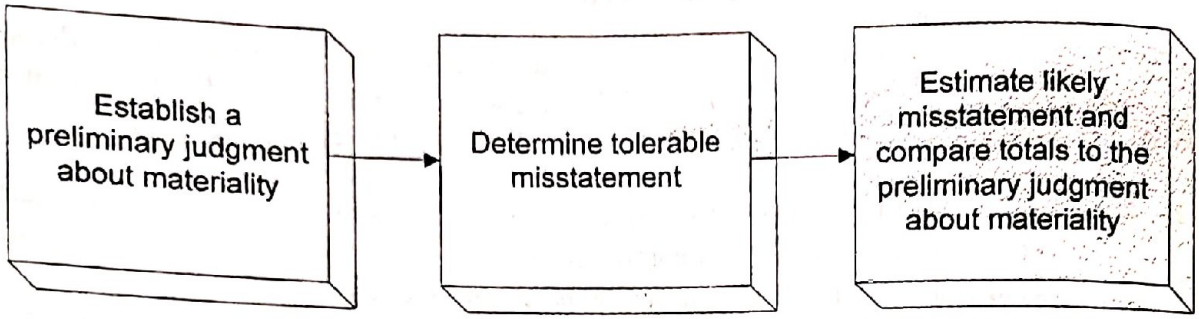
The concept of materiality is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the financial statements and the opinion in the auditor's report.

In planning the audit, the auditor makes judgments about the size of misstatements that will be considered material. These judgments affect the nature, timing and extent of audit procedures. The materiality level or levels determined when planning the audit do not necessarily establish a threshold below which misstatements identified during the audit will always be evaluated as immaterial. The circumstances related to some misstatements may cause the auditor to evaluate them as material even if they are below the materiality level or levels. It is not practicable to design audit procedures to detect misstatements that could be material solely because of their nature; however, the auditor considers not only the size but also the nature of any identified misstatements, and the particular circumstances of their occurrence, when evaluating their effect on the financial statements and the opinion in the auditor's report. **PSA 320** (Revised), *Materiality in Planning and Performing an Audit*, provides further guidance on materiality.

STEPS IN APPLYING MATERIALITY

Figure 6.2 presents the three major steps in the application of materiality to an audit. The first two steps are usually performed early in the engagement as part of planning the audit. The last step is performed in the completion phase of the audit to evaluate the effect of misstatements on the financial statements.

Figure 6.2 Steps in Applying Materilaity



Step 1. Establish a Preliminary Judgment about Materiality

The auditor sets up a materiality level for the financial statements as a whole when planning the audit to establish the nature and extent of risk assessment procedures, to identify and assess the risk of material misstatement, and to determine the nature, timing, and extent of further audit procedures. The preliminary judgment about materiality is the maximum amount by which the auditor believes the financial statements could be misstated and still not affect the decisions of reasonable users.

The auditor should set up a base that, when multiplied by a percentage factor, establishes the initial quantitative judgment about materiality. The auditor should document the level of materiality used in the audit, including the base it was established on. The resulting materiality amount can be adjusted for any qualitative factors that may be relevant to the engagement.

Step 2. Determine Tolerable Misstatement

After establishing the materiality level, the auditor determines the tolerable misstatement based on planning materiality. The auditor allocates the overall materiality to the financial statement account balance (an individual line item in the financial statements such as inventory or investment) or class of transactions (type of transaction processed by the entity's accounting system such as revenue or purchase transactions). The allocated materiality to an account balance or class of transactions is called **tolerable misstatement**. This allows the auditor to plan the scope of audit procedures for the individual account balance or class of transactions.

Because of the many factors (qualitative and quantitative) involved, standards do not provide specific guidelines as to how the allocation should be done. The process can be done judgmentally or using some formal quantitative approach.

Step 3. Estimate Likely Misstatements and Compare Totals to the Preliminary Judgment about Materiality

After conducting the audit procedures, the auditor aggregates misstatements from each account balance or class of transactions. The auditor compares the aggregated uncorrected misstatements to the preliminary judgment about materiality (or revised

materiality level). In making such comparison, the standard also stipulates the auditor to consider the qualitative aspects of the entity's accounting practice. The auditor should be alert and consider the cumulative effect of a lack of neutrality in management's judgments.

The allocated amounts of materiality (tolerable misstatement) in step 2 are also used for determining the fair presentation of the individual accounts after completion of the audit work. Standards require that the auditor document the nature and effect of aggregated amounts of misstatements.

When the uncorrected amounts of misstatements are less than the preliminary judgment about materiality, the auditor can conclude that the financial statements are fairly presented. When the uncorrected misstatements are greater than the preliminary judgment about materiality, the auditor should request that the client adjust the financial statements. If the client refuses to adjust the financial statements, the auditor should issue a qualified or adverse opinion. Chapter 14 provides a detailed discussion on audit reporting.

RELATIONSHIP BETWEEN MATERIALITY AND AUDIT RISK

PSA 200, *Objective and General Principles Governing an Audit of Financial Statements*, requires the auditor to plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit. Audit risk is a function of the risk of material misstatement of the financial statements and the risk that the auditor will not detect such misstatement. Materiality and audit risk are considered throughout the audit, in particular, when:

- Identifying and assessing the risks of material misstatement [**PSA 315** (Revised), *Identifying and Assessing the Risk of Material Misstatements Through Understanding the Entity and Its Environment*];
- Determining the nature, timing and extent of further audit procedures [**PSA 330**, *The Auditor's Responses to Assessed Risks*]; and
- Evaluating the effect of uncorrected misstatements on the financial statements and the opinion in the auditor's report (PSA 450).

NOTE

The auditor must recognize that there is an inverse relationship between audit risk and materiality, and between the desired level of audit risk and the amount of audit evidence the auditor must gather.

There is a close relationship between materiality and risk. Risk is a measure of uncertainty, whereas materiality is a measure of magnitude or size. Combined together, they measure the uncertainty of amounts of a given magnitude. For example, the auditor plans to accumulate evidence such that there is only 5% risk (acceptable audit risk) of failing to uncover misstatements exceeding tolerable misstatements of P100,000 (materiality) is a precise statement. If the statement eliminates either the risk or materiality portion, it would be useless. A 5% risk without specific materiality measure could mean that a P10 or P1,000,000 misstatement is acceptable. A P100,000 misstatement without specific risk could mean that a 10% or 80% risk is acceptable.

REVIEW QUESTIONS

1. Define and differentiate audit risk and auditor's business risk.
2. How do inherent risk and control risk differ from detection risk?
3. Distinguish between sampling and non-sampling risk.
4. In understanding the entity and its environment, the auditor gathers knowledge about what categories of information?
5. Give examples of conditions and events that may indicate the existence of business risks.
6. Distinguish between errors and fraud. Give examples of each.
7. Why is it important for audit firms to develop policies and procedures for establishing materiality?
8. List and describe the three major steps in applying materiality to an audit.
9. Explain briefly the relationship between materiality and audit risk.
10. Describe the relationship between detection risk and evidence accumulation.

MULTIPLE CHOICE QUESTIONS

1. Adequate planning of the audit work helps ensure that

	Appropriate attention is devoted to important areas	All misstatements will be detected	Potential problems are identified	The work is completed expeditiously
a.	YES	NO	YES	NO
b.	YES	NO	YES	YES
c.	NO	YES	NO	YES
d.	YES	YES	YES	YES

2. Which of the following procedures would a CPA ordinarily perform during audit planning?
   a. Review the client's bank reconciliation.
   b. Review and evaluate client's internal control.
   c. Obtain understanding of the client's business and industry.
   d. Obtain client's representation letter.

3. In developing the overall audit plan for a new client, factor not to be considered is
   a. Materiality levels.
   b. The amount of estimated audit fee.
   c. The audit risks and procedures to be performed to achieve audit objectives.

d. The client's business, including the structure of the organization and accounting system used.

4. In planning the audit engagement, the auditor should consider each of the following except
   a. The kind of opinion that is likely to be expressed.
   b. The entity's accounting policies and procedures.
   c. Matters relating to the entity's business and the industries in which it operates.
   d. Anticipated levels of control risk and materiality.

5. Analytical procedures are used for the following purposes except
   a. To evaluate the effectiveness of the client's internal control.
   b. To assist the auditor in planning the nature, timing and extent of the other auditing procedures.
   c. As an overall review of financial information in the final review stage of the audit.
   d. As a substantive test to obtain evidential matter about a particular assertion related to account balances or classes of transactions.

6. For all audits of financial statements made in accordance with PSAs, the use of analytical procedures is required to some extent

	In the planning stage	As a substantive test	In the review stage
a.	YES	NO	YES
b.	NO	YES	NO
c.	YES	YES	YES
d.	YES	NO	NO

7. Analytical procedures used in planning an audit should focus on identifying
   a. Areas that may represent specific risk relevant to the audit.
   b. Material weaknesses in the internal control structure.
   c. The predictability of financial data from individual transactions.
   d. The various assertions that are embodied in the financial statements.

8. To help plan the nature, timing and extent of substantive auditing procedures, preliminary analytical procedures should focus on
   a. Applying ratio analysis to externally generated data such as published industry statistics or price indices.
   b. Comparing recorded financial information to the results of other tests of transactions and balances.
   c. Developing plausible relationship that corroborate anticipated results with a measurable amount of precision.
   d. Enhancing the auditor's understanding of the client's business and events that have occurred since the last audit date.

9. Analytical procedures enable the auditor to predict the balance or quantity of an item under audit. Information to develop this estimate can be obtained from all of the following except
   a. Comparison of financial data with data for comparable prior periods, anticipated results (e.g. budgets and forecasts), and similar data for the industry in which the entity operates.
   b. Study of the relationships of elements of financial data that would be expected to conform to a predictable pattern based upon the entity's experience.
   c. Study of the relationships of financial data with relevant non-financial data.

d. Tracing transactions through the system to determine whether procedures are being applied as prescribed. → THIS IS A TEST OF CONTROL

10. An example of an analytical procedures is the comparison of
    a. CIS-generated data with similar data generated by a manual accounting system.
    b. Financial information with similar information regarding the industry in which the entity operates.
    c. Recorded amounts of major disbursements with appropriate invoices.
    d. Results of statistical sample with the expected characteristics of the actual population.

11. For initial engagements, PSA 510 does not require the auditor to obtain evidence
    a. That appropriate accounting policies are consistently applied or changes in accounting policies have been properly accounted for and adequately disclosed.
    b. That the opening balances do not contain material misstatements that materially affect the current period's financial statements.
    c. That the prior period financial statements were audited by an independent CPA.
    d. That the prior period's ending balances have been correctly brought forward to the current period or, when appropriate, have been restated.

12. According to PSA 320, materiality should be considered by the auditor when:

	Determining the nature, timing and extent of the audit procedures	Evaluating the effects of misstatements
a.	NO	NO
b.	NO	YES
c.	YES	YES
d.	YES	NO

13. Which of the following statements is not correct about materiality? → MATERIALITY IS DETERMINED FOR THE FS AS A WHOLE, NOT SEPARATELY FOR EACH FS.
    a. An auditor considers materiality for planning purposes in terms of the largest aggregate level of misstatements that could be material to any one of the financial statements.
    b. An auditor's consideration of materiality is influenced by the auditor's perception of the needs of a reasonable person who will rely on the financial statements.
    c. Materiality judgments are made in light of surrounding circumstances and necessarily involve both quantitative and qualitative judgments.
    d. The concept of materiality recognizes that some matters are important for fair presentation of financial statements in conformity with acceptable financial reporting framework, while other matters are not important.

14. In developing the preliminary level of materiality in an audit, the auditor will
    a. Use the same materiality level as that used for different clients in the same industry.
    b. Rely primarily on professional judgment to determine the materiality level.
    c. Look to audit standards for specific materiality guidelines.
    d. Increase the level of materiality if fraud is suspected.

15. In considering materiality for planning purposes, an auditor believes that misstatements aggregating P1,000,000 would have a material effect on an entity's income statement, but those misstatement would have to aggregate P1,200,000 to materially affect the balance sheet. Ordinarily, it would be appropriate to design auditing procedures that would be expected to detect misstatements that aggregate

a. P1,000,000
b. P2,200,000
c. P200,000
d. P600,000

16. Which of the following would an auditor most likely use in determining the auditor's preliminary judgment about materiality?
a. The results of internal control questionnaire.
b. The entity's annualized interim financial statements.
c. The contents of the management representation letter.
d. The anticipated sample size of the planned substantive tests.

17. The concept of materiality with respect to the attest function
a. Requires the auditor to make judgments as to whether misstatements affect the fairness of the financial statements.
b. Requires that relatively more effort be directed to those assertions that are more susceptible to misstatement.
c. Has greater application to the standards of reporting than the other generally accepted auditing standards.
d. Applies only to publicly held firms

18. The relationship between materiality and risk is ordinarily
a. Direct
b. None
c. Inverse
d. Parallel

19. When comparing level of materiality used for planning purposes and the level of materiality used for evaluating evidence, one would most likely expect
a. The level of materiality for planning purposes to be based on total assets while the level of materiality for evaluating purposes to be based on net income.
b. The level of materiality for planning purposes to be smaller.
c. The level of materiality for planning purposes to higher.
d. The level of materiality to be always similar.

20. When assessing materiality levels for audit purposes, the auditor should consider the

	Amount involve	Nature of misstatements
a.	YES	YES
b.	YES	NO
c.	NO	NO
d.	NO	YES

21. Relationship between control risk and detection risk is ordinarily
a. Parallel
b. Inverse
c. Equal
d. Direct

22. An auditor uses the assessed level of control risk to
a. Determine the acceptable level of detection risk for financial statements.
b. Evaluate the effectiveness of the entity's internal control policies and procedures.
c. Identify transactions and account balances where inherent risk is at a high level.
d. Indicate whether materiality thresholds for planning and evaluation purposes are sufficiently high.

23. What is the magnitude of audit risk if the inherent risk is .60, control risk .40 and detection risk .20?
0.6 x 0.4 x 0.2 = 0.048
a. .048 b. .02 c. 1.20 d. .20

24. According to auditing standards, the auditor uses the assess level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk for the financial statement assertions. As the acceptable level of detection risk decreases, the auditor may do one or more of the following except change the
a. Assurance provided by substantive tests to a lower level.
b. Extent of substantive tests, such as using larger sample size.
c. Nature of substantive tests to more effective procedures.
d. Timing of substantive tests, such as performing them at year-end rather than at interim date.

25. As the acceptable level of detection risk decreases, an auditor may change the
a. Timing of tests of controls by performing them at several dates rather than at one time.
b. Timing of substantive tests by performing them at an interim date rather than at year-end.
c. Nature of substantive tests from a less effective to a more effective procedure.
d. Assesses level of inherent risk to a higher level.

26. As the acceptable level of detection risk decreases, an auditor may
a. Eliminate the assessed level of inherent risk from consideration as a planning factor.
b. Lower the assessed level of control risk
c. Postpone the planned timing of substantive tests from interim dates to the year-end.
d. Reduce substantive testing by relying on the assessments of inherent risk and control risk.

27. On the basis of the audit evidence gathered and evaluated, an auditor decides to increase the assessed level of control risk from that originally planned. To achieve an overall audit risk level that is substantially the same as the planned audit risk level, the auditor would
a. Decrease detection risk.
b. Decrease substantive testing.
c. Increase inherent risk.
d. Increase materiality levels.

28. Which of the following statements is not true about the auditor's assessment of inherent risk when planning a financial statement audit?
a. The auditor's assessment of inherent risk is influenced by the condition of the client's accounting and internal control system.
b. The auditor can make a separate or combined assessment of inherent and control risk.
c. In developing the overall audit plan, the auditor should assess inherent risk at the financial statement level.
d. In developing an audit program, the auditor should assess inherent risk at the account balance or transaction class level.

29. The auditor should obtain sufficient understanding of the entity and its environment, including internal control in order to

	Identify and assess the risk of material misstatement	Design appropriate audit procedures
a.	NO	YES
b.	YES	NO

c.	NO	NO
d.	YES	YES

30. According to PSA 315, **Risk assessment procedures** means
   a. Discussing with the members of the audit team the susceptibility of the entity's financial statements to material misstatements.
   b. Identifying business risks relevant to financial reporting objectives and deciding about actions to address those risks.
   c. Obtaining understanding of entity and its environment, including its internal control.
   d. Performing substantive tests and testing the operating effectiveness of the entity's internal control.

31. Risk assessment procedures would include all of the following except
   a. Reperformance of client's procedures.
   b. Observation and inspection.
   c. Inquiries of management and others within the entity.
   d. Analytical procedures.

32. Which of the following statements about analytical procedures is incorrect?
   a. Analytical procedures may be performed in the planning, testing and completion phases of the audit.
   b. Analytical procedures are required to be performed in the planning phase of the audit.
   c. Analytical procedures are required to be done during the testing phase of the audit.
   d. Analytical procedures are required to be done during the completion phase of the audit.

33. An auditor should design the written audit program so that
   a. The audit procedures selected will achieve specific audit objectives.
   b. Substantive tests prior to the balance sheet date will be minimized.
   c. Each account balance will be tested under either tests of controls or tests of transactions.
   d. All material transactions will be selected for substantive testing.

34. An audit program should be designed for each individual audit and should include audit steps and procedures to
   a. Provide assurance that the objectives of the audit are met.
   b. Insure that only material items are audited.
   c. Increase the amount of management information available.
   d. Detect and eliminate fraud.

35. Which of the following statements is incorrect about audit planning documentation?
   a. The audit program should set out the nature, timing and extent of the planned audit procedures required to implement the overall audit plan.
   b. The audit plan and related program should no longer be changed once the audit is started.
   c. In preparing an audit program, the auditor should consider the specific assessments of inherent and control risks and the required level of assurance to be provided by substantive tests.
   d. Although the precise form and content of the audit plan may vary, it should be sufficiently detailed to guide the development of an audit program.

36. Which of the following matters would least likely appear in the audit program?
    a. Documentation of the accounting and internal control systems being reviewed.
    b. Estimated time that will be spent in performing certain procedures.
    c. Specific audit objectives.
    d. Specific audit procedures that will be performed.

37. Set the following steps in proper order:
    I. Re-assess control risk.
    II. Obtain an understanding of the entity and its environment.
    III. Make a preliminary control risk assessment.
    IV. Determine the nature, extent and timing of substantive tests.
    V. Determine the appropriate response to assessed risks.
    a. V,I,II, IV & II
    b. II,III,V,I and IV
    c. V,IV,I,II & III
    d. II,V,I,III and IV

38. After obtaining a sufficient understanding of internal control, the auditor:
    a. Determines the preliminary assessment of control risk.
    b. Determines the assessed levels of detection risk and inherent risk.
    c. Assesses the need to apply Philippine Auditing Standards.
    d. Assesses detection risk to determine the acceptable level of inherent risk.

39. The audit risk model consists of: AR = IR x CR x DR. The detection risk is the dependent variable. What is the acceptable level of **detection risk** if the assessed level of inherent risk is HIGH and the control risk is HIGH?
    a. Medium
    b. Lowest
    c. Moderate
    d. Low

40. The ultimate purpose of assessing control risk is to contribute to the auditor's evaluation of the risk that:
    a. Entity policies may be circumvented by senior management.
    b. Material misstatements may exist in the financial statements.
    c. Specified controls requiring segregation of duties may be circumvented by collusion.
    d. Tests of controls may fail to identify controls relevant to assertions.

41. An auditor's preliminary control risk assessment is at HIGH level. Which of the following are the possible reasons for this assessment?
    I. Evaluating the effectiveness of the entity's internal control system would not be efficient.
    II. The entity's internal control system is not effective.
    a. Both I and II.
    b. I only.
    c. II only.
    d. Neither I nor II.

42. When the control risk is assessed at less than high for all financial statements assertions, an auditor should document the auditor's

	A	B	C	D
▪ Basis for the conclusion that control risk is less than high	Yes	Yes	No	No
▪ Conclusion that control risk is less than high	No	Yes	Yes	Yes
▪ Understanding of the entity's internal control structure	Yes	Yes	No	Yes

43. Overall responses to address the risks of material misstatement at the financial statement level include:
a. Assigning more experienced staff or those with special skills or using experts.
b. Emphasizing to the audit team the need to maintain professional skepticism in gathering and evaluating audit evidence.
c. Incorporating additional elements of unpredictability in the selection of further audit procedures.
d. All of the above.

44. Tests of controls are used to test whether controls are:
a. Properly incorporated in the financial statements.
b. Properly documented by the client.
c. Placed in operation or implemented.
d. Operating effectively.

45. The risk that the auditor may express an incorrect opinion on the financial statements is called
a. Audit risk
b. Control risk
c. Detection risk
d. Inherent risk

46. The susceptibility of an account to misstatement assuming no internal control is referred to as the
a. Audit risk
b. Control risk
c. Detection risk
d. Inherent risk

47. Audit risk consists of all but the following components
a. Inherent risk
b. Substantive risk
c. Detection risk
d. Control risk

48. For a particular assertion, control risk is the risk that
a. A material misstatement will occur in the accounting process.
b. Audit procedures will fail to detect a weak control system.
c. Controls will not detect a material misstatement that occurs.
d. The prescribed control procedures will not be applied uniformly.

49. The audit risk against which the auditor and those who rely on his opinion require reasonable protection is a combination of three separate risks at the account balance or class of transaction level. The first is inherent risk. The second risk is that material misstatements will not be prevented or detected by internal control. The third risk is that
a. Material misstatement that occur will not be detected by the audit.
b. The auditor will apply an inappropriate audit procedure.
c. The auditor will apply an inappropriate measure of audit materiality.
d. The auditor will reject a correct account balance as incorrect.

50. When planning a financial statement audit, the auditor should assess inherent risk at the

	Financial statement level	Account balance or transaction class level
a.	NO	YES
b.	NO	NO
c.	YES	NO
d. ✓	YES	YES

COMPREHENSIVE CASES

CASE 1

Louisito & Louise Co. was approached on November 15 by one of its clients, KM Corporation, about performing a special audit of one of its smaller subsidiaries, MP Company. MP is to be sold to Lance Corporation. The agreement between KM and Lance provides that KM's auditor is to perform an audit of MP to establish the value of certain assets in order to determine the final price for the sale. The agreement also provides that Lance has the right to allow its auditor to evaluate any disputed amount. In addition, although MP had P40 million in sales and P6 million in income during the last year, the agreement provides that KM and Lance each have the right to request an adjustment for any amount over P100,000.

Required:

Determine the significant factors that will affect Louisito & Louise's audit risk and business risk.

CASE 2

Below are the auditor's planned audit risk and assessment of inherent risk and control risk for five situations.

Situation	Planned Audit Risk (%)	Assessed Inherent Risk (%)	Assessed Control Risk (%)
1	10	30	40
2	10	10	80
3	40	40	30
4	50	60	100
5	50	70	100

Required:

a. Determine the detection risk that can be allowed for each situation.
b. Rank the five situations, based on the amount of audit evidence that will be needed. You may assume that all other factors that may affect audit evidence accumulation are the same.

Chapter 7
AUDIT EVIDENCE, PROCEDURES AND DOCUMENTATION

LEARNING OBJECTIVES

Upon completion of this chapter you will

1. **Know the relationship between audit evidence and the auditor's report.**
2. **Understand the basic concepts of audit evidence.**
3. **Understand the use of assertions in obtaining audit evidence.**
4. **Define audit procedures and understand their relationship to assertions.**
5. **Identify and define the audit procedures used for obtaining audit evidence.**
6. **Learn the objectives of audit documentation.**
7. **Develop an understanding of the content, types, organization and ownership of audit documentation.**

Most of the auditor's work involves obtaining and evaluating evidences using procedures such as inspection of records and confirmations to test the fair presentation of the financial statements. To perform this task effectively and efficiently, an auditor must understand thoroughly the important aspects of audit evidence. This includes understanding how audit evidence relates to financial statement assertions and the auditor's report, the sufficiency and appropriateness of evidence, types of audit procedures and the documentation of evidence in the working papers.

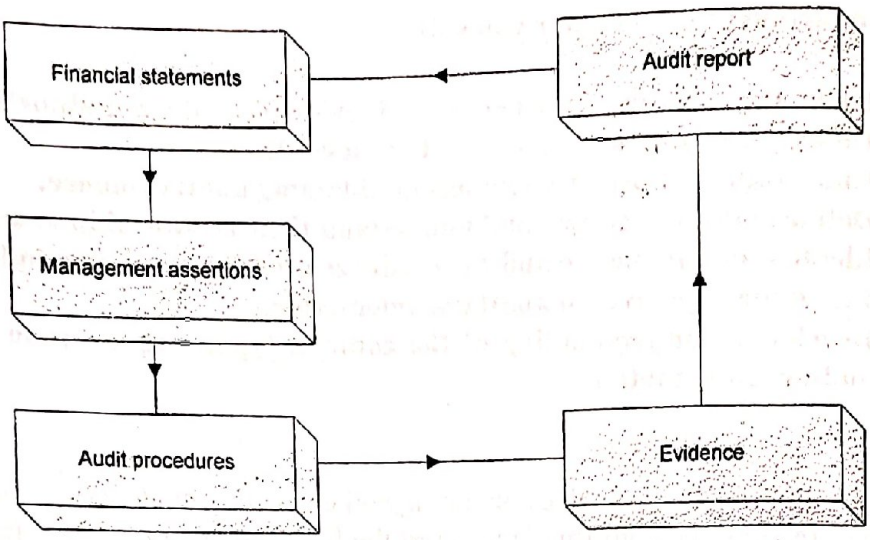
AUDIT EVIDENCE

PSA 500 as revised provides the basic framework for the auditor's understanding of evidence and its use to support the auditor's opinion on the financial statements. The auditor gathers evidence by conducting audit procedures to test management assertions in expressing an opinion on the financial statements. The evidence gathered from the audit procedures is used to determine the fairness of the financial statements and the type of audit report to be issued. Figure 7.1 presents an overview of the relationships among the financial statements, management assertions about components of the financial statements, audit procedures and the audit report. The financial statements reflect management's assertions about the various financial statement components. The auditor conducts audit procedures to gather evidence regarding whether each relevant management assertion is being supported. The application of audit procedures provides the evidence that supports the auditor's report.

CONCEPT OF AUDIT EVIDENCE

Audit evidence is all information used by the auditor in arriving at the conclusions on which the audit opinion is based, and includes the information contained in the accounting records underlying the financial statements and other information. Auditors are not expected to examine all information that may exist. Audit evidence, which is cumulative in nature, includes audit evidences obtained from audit procedures performed during the course of the audit and may include audit evidence obtained from other sources such as previous audits and a firm's quality control procedures for client acceptance and continuance.

Figure 7.1 An Overview of the Relationships among the Financial Statements, Management Assertions, Audit Procedures, and the Audit Report



The Nature of Audit Evidence

Accounting records generally include the records of initial entries and supporting records, such as checks and records of electronic fund transfers; invoices; contracts; the general and subsidiary ledgers, journal entries, and other adjustments to the financial statements that are not reflected in formal journal entries; and records such as worksheets and spreadsheets supporting cost allocations, computations, reconciliations, and disclosures. The entries in the accounting records are often initiated, authorized, recorded, processed, and reported in electronic form. In addition, the accounting records may be part of integrated systems that share data and support all aspects of the entity's financial reporting, operations, and compliance objectives.

Management is responsible for the preparation of the financial statements based on the accounting records of the entity. The auditor should obtain audit evidence by testing the accounting records, for example, through analysis and review, reperforming procedures followed in the financial reporting process, and reconciling related types and applications of the same information. Through the performance of such audit procedures, the auditor may determine that the accounting records are internally consistent and agree to the financial statements. However, because accounting records alone do not provide sufficient appropriate audit evidence on which to base an audit opinion on the financial statements, the auditor should obtain other audit evidence. Table 7.1 shows other information that the auditor may use as audit evidence.

TABLE 7.1 Other Information that the Auditor may Use as Audit Evidence

- minutes of meetings
- confirmations from third parties
- industry analysts' reports
- comparable data about competitors (benchmarking)
- controls manuals
- information obtained by the auditor from such audit procedures as inquiry, observation, and inspection
- other information developed by or available to the auditor that permits the auditor to reach conclusions through valid reasoning.

The Appropriateness of Audit Evidence

Appropriateness is the measure of the quality of audit evidence, that is, its relevance and its reliability in providing support for, or detecting misstatements in, the classes of transactions, account balances, and disclosures and related assertions.

Relevance ~ DOES THE AUDIT EVIDENCE RELATE TO THE AUDIT OBJECTIVE?

The definition of relevance emphasizes the need for engagement work to be restricted to achieving the engagement objectives. However, evidence also should be gathered on "all matters" within the engagement scope. Relevant information has a logical relationship to what it purports to prove.

A given set of audit procedures may provide audit evidence that is relevant to certain assertions but not to others. For example, inspection of records and documents related to the collection of receivables after the period end may provide audit evidence regarding both existence and valuation, although not necessarily the appropriateness of period-end cutoffs. On the other hand, the auditor often obtains audit evidence from different sources or of a different nature that is relevant to the same assertion. For example, the auditor may analyze the aging of accounts receivable and the subsequent collection of receivables to obtain audit evidence relating to the valuation of the allowance for doubtful accounts. Furthermore, obtaining audit evidence relating to a particular assertion, for example, the physical existence of inventory, is not a substitute for obtaining audit evidence regarding another assertion, for example, rights and obligations.

Reliability ~ HOW TRUSTWORTHY IS THE EVIDENCE?

The reliability of audit evidence is influenced by its source and by its nature which is dependent on the individual circumstances under which it is obtained. Generalizations about the reliability of various kinds of audit evidence can be made; however, such generalizations are subject to important exceptions. Even when audit evidence is obtained from sources external to the entity, circumstances may exist that could affect the reliability of the information obtained. For example, audit evidence obtained from an independent external source may not be reliable if the source is not knowledgeable. While recognizing that exceptions may exist, the following generalizations about the reliability of audit evidence are useful:

- Audit evidence is more reliable when it is obtained from knowledgeable independent sources outside the entity.
- Audit evidence that is generated internally is more reliable when the related controls imposed by the entity are effective.
- Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
- Audit evidence is more reliable when it exists in documentary form, whether paper, electronic, or other medium (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.

The auditor should consider the reliability of the information to be used as audit evidence, for example, photocopies; facsimiles; or filmed, digitized, or other electronic documents, including consideration of controls over their preparation and maintenance where relevant. However, an

audit rarely involves the authentication of documentation, nor is the auditor trained as or expected to be an expert in such authentication.

When information produced by the entity is used by the auditor to perform further audit procedures, the auditor should obtain audit evidence about the accuracy and completeness of the information. In order for the auditor to obtain reliable audit evidence, the information upon which the audit procedures are based needs to be sufficiently complete and accurate. For example, in auditing revenue by applying standard prices to the records of sales volume, the auditor should consider the accuracy of the price information and the completeness and accuracy of the sales volume data. Obtaining audit evidence about the completeness and accuracy of the information produced by the entity's information system may be performed concurrently with the actual audit procedure applied to the information when obtaining such audit evidence. In other situations, the auditor may have obtained audit evidence of the accuracy and completeness of such information by testing controls over the production and maintenance of the information. However, in some situations the auditor may determine that additional audit procedures are needed. For example, these additional procedures may include the use of computer-assisted audit techniques (CAATs) to recalculate the information.

The auditor ordinarily obtains more assurance from consistent audit evidence obtained from different sources or of a different nature than from items of audit evidence considered individually. In addition, obtaining audit evidence from different sources or of a different nature may indicate that an individual item of audit evidence is not reliable. For example, corroborating information obtained from a source independent of the entity may increase the assurance the auditor obtains from a management representation. Conversely, when audit evidence obtained from one source is inconsistent with that obtained from another, the auditor should determine what additional audit procedures are necessary to resolve the inconsistency.

The Sufficiency of Audit Evidence

Sufficiency is the measure of the quantity of audit evidence. The auditor should consider the sufficiency and appropriateness of audit evidence to be obtained when assessing risks and designing further audit procedures. The quantity of audit evidence needed is affected by the risk of misstatement (the greater the risk, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less the audit evidence that may be required). Accordingly, there is an inverse relationship between the sufficiency and appropriateness of audit evidence.

The auditor may consider the relationship between the cost of obtaining audit evidence and the usefulness of the information obtained. However, the matter of difficulty or expense involved is not in itself a valid basis for omitting an audit procedure for which there is no appropriate alternative.

In forming the audit opinion, the auditor does not examine all the information available (evidence) because conclusions ordinarily can be reached by using sampling approaches and other means of selecting items for testing. Also, the auditor may find it necessary to rely on audit evidence that is persuasive rather than conclusive; however, to obtain reasonable assurance, the auditor must not be satisfied with audit evidence that is less than persuasive. The auditor should use professional judgment and should exercise professional skepticism in evaluating the quantity and quality of audit evidence, and thus its sufficiency and appropriateness, to support the audit

opinion. Determining the sufficiency of evidence is one of the more critical decisions the auditor faces on an engagement.

The Evaluation of Audit Evidence

The auditor should be thorough in searching for evidence and unbiased in its evaluation. The auditor must be capable of assessing when a sufficient amount of appropriate evidence has been obtained in order to determine whether the fairness of management's assertions can be supported.

THE USE OF ASSERTIONS IN OBTAINING AUDIT EVIDENCE

It is stated in **PSA 500** 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 potential misstatements that may occur, and thereby designing audit procedures that are responsive to the particular risks.

Assertions used by the auditor fall into the following categories:

A. Assertions about classes of transactions and events for the period under audit
B. Assertions about account balances at the period end
C. Assertions about presentation and disclosure

Table 7.2 shows these categories in details.

TABLE 7.2 Assertions Used by Auditor in Obtaining Evidence

Assertions about classes of transactions and events for the period under audit
a) *Occurrence.* Transactions and events that have been recorded have occurred and pertain to the entity.
b) *Completeness.* All transactions and events that should have been recorded have been recorded.
c) *Accuracy.* Amounts and other data relating to recorded transactions and events have been recorded appropriately.
d) *Cutoff.* Transactions and events have been recorded in the correct accounting period.
e) *Classification.* Transactions and events have been recorded in the proper accounts.
Assertions about account balances at the period end
a) *Existence.* Assets, liabilities, and equity interests exist.
b) *Rights and obligations.* The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
c) *Completeness.* All assets, liabilities, and equity interests that should have been recorded have been recorded.
d) *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.
Assertions about presentation and disclosure
a) *Occurrence and rights and obligations.* Disclosed events and transactions have occurred and pertain to the entity.
b) *Completeness.* All disclosures that should have been included in the financial statements have been included.
c) *Classification and understandability.* Financial information is appropriately presented and described and disclosures are clearly expressed.
d) *Accuracy and valuation.* Financial and other information are disclosed fairly and at appropriate amounts.

Relevant assertions are assertions that have a meaningful bearing on whether the account is fairly stated. For example, valuation may not be relevant to the cash account unless currency translation is involved; however, existence and completeness are always relevant. Similarly, valuation may not be relevant to the gross amount of the accounts receivable balance but is relevant to the related allowance accounts. Additionally, the auditor might, in some circumstances, focus on the presentation and disclosure assertion separately in connection with the period-end financial reporting process.

The assertions are not individually assessed but quite often at the same time. For example, to ensure completeness of electricity expense, the auditor ensures that the 12 months of payments were booked. Since the client may record the bills paid on a cash basis, electricity expense of a month of previous basis period might be entered in the current year. Electricity expense of last month of current year might be recorded next year. If the monthly fluctuation is immaterial, the auditor always ignores the cut-off issue. In case where electricity is a material expense, the auditor considers preparing adjustments for year ended cut-off purpose so that the profit or loss would not be materially misstated.

AUDIT PROCEDURES

Audit procedures are specific acts or methods performed by the auditor to gather evidence to determine if specific assertions are being met. The auditor should obtain audit evidence to draw reasonable conclusions on which to base the audit opinion by performing audit procedures to:

a) Obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels (audit procedures performed for this purpose are referred to as *risk assessment procedures*)

b) When necessary, or when the auditor has determined the need to do so, test the operating effectiveness of controls in preventing or detecting material misstatements at the relevant assertion level (audit procedures performed for this purpose are referred to as *tests of controls*)

c) Detect material misstatements at the relevant assertion level (audit procedures performed for this purpose are referred to as *substantive procedures* and include tests of details of classes of transactions, account balances, and disclosures, and substantive analytical procedures).

The auditor must perform risk assessment procedures to provide a satisfactory basis for the assessment of risks at the financial statement and relevant assertion levels. Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion and must be supplemented by further audit procedures in the form of tests of controls, when relevant and substantive procedures.

The auditor obtains audit evidence by one or more of the following procedures:

a) Inspection of records or documents
b) Inspection of tangible assets
c) Observation
d) Inquiry

e) Confirmation
f) Recalculation
g) Reperformance
h) Analytical procedures

Inspection of Records or Documents

Inspection consists of examining records or documents, whether internal or external, in paper form, electronic form, or other media. Inspection of records and documents provides audit evidence of varying degrees of reliability, depending on their nature and source and, in the case of internal records and documents, on the effectiveness of the controls over their production. An example of inspection used as a test of controls is inspection of records or documents for evidence of authorization.

An **internal document** is one that has been prepared and used within the client's organization and is retained without going to an outside party such as a customer or a vendor. Examples include duplicate sales invoice, employees' time reports, and inventory receiving report. An **external document** is one that has been in the hands of someone outside the client's organization and is a party to the transaction being documented.

Some documents represent direct audit evidence of the existence of an asset, for example, a document constituting a financial instrument such as a stock or bond. Inspection of such documents may not necessarily provide audit evidence about ownership or value. In addition, inspecting an executed contract may provide audit evidence relevant to the entity's application of accounting principles, such as revenue recognition.

Some records or documents relate directly to the occurrence (existence) and completeness assertions and to the direction of testing when documentary evidence is examined. Figure 7.2 presents an overview of the documentary evidence related to assertions.

Vouching refers to first selecting an item for testing from the underlying accounting data and then examining the source document (corroborating information). This procedure is used to establish the existence or occurrence of the selected item. For example, to verify the occurrence of sales transactions, recorded sales transactions in the sales journal maybe compared to supporting documents such as invoices and shipping documents.

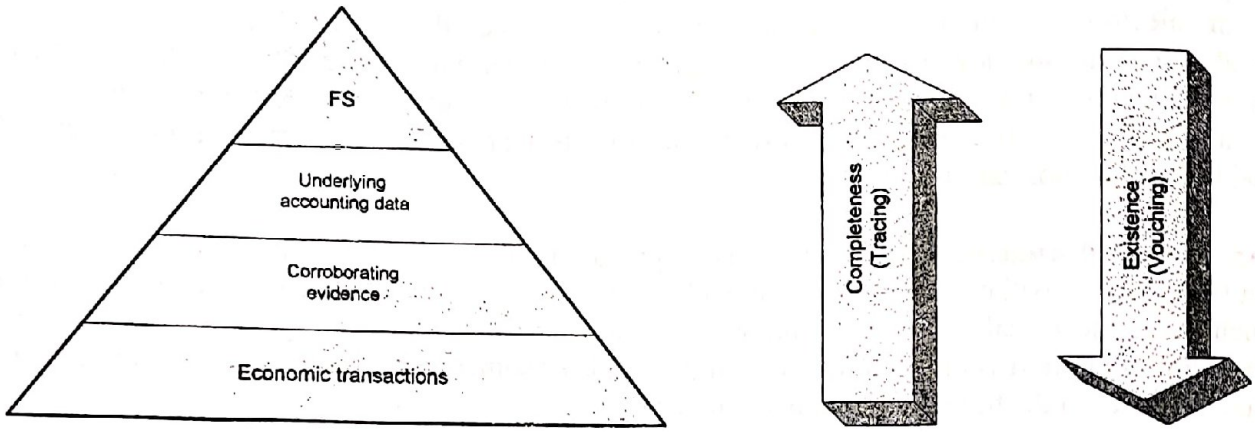
Tracing refers to selecting an accounting transaction (corroborating information) and tracing it into the journal or ledger (underlying accounting data). This procedure establishes the completeness of transactions. For example, to ensure that the selected shipping documents occurred are recorded, the auditor compares/traces shipping documents to sales invoice then to sales journal.

Inspection of Tangible Assets

Inspection of tangible assets consists of physical examination of the assets. Inspection of tangible assets may provide appropriate audit evidence with respect to their existence, but not necessarily about the entity's rights and obligations or the valuation of the assets. Inspection of individual inventory items ordinarily accompanies the observation of inventory counting. For example, when observing an inventory count, the auditor may inspect individual inventory items (such as

opening containers included in the inventory count to ensure that they are not empty) to verify their existence.

Figure 7.2 Documentary Evidence Related to Assertions



- Underlying accounting data consist of the book of original entry (e.g., journals and registers), the general and subsidiary ledgers, related accounting manuals, and records such as worksheets supporting cost allocations, computations and reconciliations.

- Corroborating evidence includes both written and electronic information (e.g., checks, invoices, contracts, and minutes of meetings); confirmations and other written representations by knowledgeable people; information obtained by the auditor from inquiry, observation, inspection, and physical examination; and other information developed by, or available to, the auditor that permits conclusions through valid reasoning.

Observation

Observation consists of looking at a process or procedure being performed by others. Examples include observation of the counting of inventories by the entity's personnel and observation of the performance of control activities. Observation provides audit evidence about the performance of a process or procedure but is limited to the point in time at which the observation takes place and by the fact that the act of being observed may affect how the process or procedure is performed.

Inquiry

Inquiry consists of seeking information of knowledgeable persons, both financial and nonfinancial, inside or outside the entity. Inquiry is an audit procedure that is used extensively throughout the audit and often is complementary to performing other audit procedures. Inquiries may range from formal written inquiries to informal oral inquiries. Evaluating responses to inquiries is an integral part of the inquiry process.

Inquiry normally involves:

- Considering the knowledge, objectivity, experience, responsibility, and qualifications of the individual to be questioned.
- Asking clear, concise, and relevant questions.
- Using open or closed questions appropriately.
- Listening actively and effectively.
- Considering the reactions and responses and asking follow-up questions.
- Evaluating the response.

In some cases, the auditor should obtain replies to inquiries in the form of written representations from management. For example, when obtaining oral responses to inquiries, the nature of the response may be so significant that it warrants obtaining written representation from the source.

Responses to inquiries may provide the auditor with information not previously possessed or with corroborative audit evidence. Alternatively, responses might provide information that differs significantly from other information that the auditor has obtained, for example, information regarding the possibility of management override of controls. In some cases, responses to inquiries provide a basis for the auditor to modify or perform additional audit procedures. The auditor should resolve any significant inconsistencies in the information obtained.

The auditor should perform audit procedures in addition to the use of inquiry to obtain sufficient appropriate audit evidence. Inquiry alone ordinarily does not provide sufficient appropriate audit evidence to detect a material misstatement at the relevant assertion level. Moreover, inquiry alone is not sufficient to test the operating effectiveness of controls.

Confirmation

Confirmation, which is a specific type of inquiry, is the process of obtaining a representation of information or of an existing condition directly from a third party. For example, the auditor may seek direct confirmation of receivables by communication with debtors. Confirmations are frequently used in relation to account balances and their components but need not be restricted to these items. A confirmation request can be designed to ask if any modifications have been made to the agreement, and if so, what the relevant details are. For example, the auditor may request confirmation of the terms of agreements or transactions an entity has with third parties. Confirmations also are used to obtain audit evidence about the absence of certain conditions, for example, the absence of a 'side agreement' that may influence revenue recognition.

PSA 505, *External Confirmations*, requires that the auditor should determine whether the use of external confirmation is necessary to obtain sufficient appropriate audit evidence to support specific assertions.

The major types of information that are normally confirmed, along with the source of the confirmation, are indicated in Exhibit 7.1.

There are two common types of confirmation requests:

1. Positive confirmations
2. Negative confirmations

A positive confirmation asks the recipient to respond in all circumstances. It may request the recipient to provide the information (called a blank form), or the confirmation may include the information and request the respondent to indicate whether he agrees with the information. The latter type of positive confirmation is often used because the response rate is higher than the blank form. However, because recipients may sign the request without verifying the information, there is a risk that the information is incorrect and tends to be less reliable.

In negative confirmation, the recipient is asked to respond only when the information is incorrect. Because confirmations are considered significant evidence only when returned, this type of confirmation is less competent than positive confirmation.

EXHIBIT 7.1 Information Normally Confirmed by the Auditors

Information Confirmed	Source of Confirmation
Assets	
Cash in bank	Bank
Accounts receivable	Customer
Notes receivable	Maker
Inventory out on consignment	Consignee
Inventory held in public warehouse	Public warehouse
Cash surrender value of life insurance	Insurance company
Liabilities	
Accounts payable	Creditor
Notes payable	Lender
Advances from customers	Customer
Mortgage payable	Mortgagor
Bonds payable	Bondholder
Shareholders' Equity	
Shares outstanding	Registrar and transfer agent
Other Information	
Insurance coverage	Insurance company
Contingent liabilities	Bank, lender, and client's legal counsel
Bond indenture agreements	Bondholder
Collateral held by creditors	Creditor

To be considered reliable, confirmations must be controlled by the auditor from the time they are prepared until they are returned.

→ THE AUDITOR PREPARES, SENDS, AND RECEIVES THE CONFIRMATION.

Recalculation

Recalculation consists of checking the mathematical accuracy of documents or records. Recalculation can be performed through the use of information technology, for example, by obtaining an electronic file from the entity and using CAATs to check the accuracy of the summarization of the file.

Reperformance

Reperformance is the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control, either manually or through the use of CAATs, for example, reperforming the aging of accounts receivable.

Analytical Procedures

Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts. **PSA 520,** *Analytical Procedures*, provides further guidance on analytical procedures.

AUDIT DOCUMENTATION

Audit documentation is the principal record of auditing procedures applied, relevant audit evidence obtained, and conclusions reached by the auditor in the engagement. **PSA 230** (revised) *Audit Documentation*, requires the auditor to document matters that are important to support an opinion and evidence that the audit was conducted in accordance with Philippine Standards on Auditing and applicable legal and regulatory requirements..

Audit documentation is also referred to as working papers or the audit file. Some working papers are prepared in hard-copy format, but, nowadays, audit software is normally used to prepare and store them.

PURPOSES OF WORKING PAPERS

Working papers are prepared mainly to

a. Assist the auditor in planning, performance, review and supervision of the engagement.
b. Support the auditor' representation as to compliance with Philippine Standards on Auditing.
c. Support the auditor's opinion on financial statements.

Working papers also assist the auditor in

a. Planning future audits.
b. Providing information useful in rendering other services.
c. Providing adequate defense in case of litigation.

FORM AND CONTENT OF WORKING PAPERS

The auditor should prepare the audit documentation so as to enable an experienced auditor, having no previous connection with the audit, to understand:

a. The nature, timing, and extent of audit procedures performed to comply with PSAs and applicable legal and regulatory requirements;
b. The results of the audit procedures and the audit evidence obtained;
c. Significant matters arising during the audit and the conclusions reached thereon.

The auditor must document significant findings or issues, actions taken to address them (including additional evidence obtained), and the basis for the conclusions reached in connection with each engagement. Judging the significance of a matter requires an objective analysis of the facts and circumstances. *Significant findings or issues* are substantive matters that are important to the procedures performed, evidence obtained, or conclusions reached, and include, but are not limited to, the following:

a. Significant matters involving the selection, application, and consistency of accounting principles, including related disclosures. Significant matters include, but are not limited to, accounting for complex or unusual transactions, accounting estimates, and uncertainties as well as related management assumptions.
b. Results of auditing procedures that indicate a need for significant modification of planned auditing procedures, the existence of material misstatements, omissions in the financial statements, the existence of significant deficiencies, or material weaknesses in internal control over financial reporting.
c. Audit adjustments. An *audit adjustment* is a correction of a misstatement of the financial statements that was or should have been proposed by the auditor, whether or not recorded by management that could, either individually or when aggregated with other misstatements, have a material effect on the company's financial statements.
d. Disagreements among members of the engagement team or with others consulted on the engagement about final conclusions reached on significant accounting or auditing matters.
e. Circumstances that cause significant difficulty in applying auditing procedures.
f. Significant changes in the assessed level of audit risk for particular audit areas and the auditor's response to those changes.
g. Any matters that could result in modification of the auditor's report.

It is not practical to document every matter the auditor considers. In deciding the extent of working papers is a matter of professional judgment by the auditor.

The form and content of working papers depend on factors such as:

- Nature of the engagement.
- Form of the auditor's report.
- Nature and complexity of the business.
- Nature and condition of the entity's accounting and internal control systems.
- Needs in the particular circumstances for direction, supervision, and review of work performed by assistants.
- Specific audit methodology and technology used in the course of the audit.

TYPES OF FILES

- Permanent files
- Current files

Permanent files contain information about the client that are of continuing relevance to the audit. These files provide a convenient source of information about the audit that is of continuing significance from year to year. Current files include all the information applicable to the year under audit. Exhibit 7.2 contains examples of the types of information included in each type of file.

AUDIT PROGRAM

An audit program contains the detailed audit procedures that will be conducted by the auditor. It is normally maintained in a separate file to improve the coordination and integration of all parts of the audit. As the audit progresses, each auditor initials the program for the audit procedures conducted and indicates the date of completion.

EXHIBIT 7.2 Examples of Information Included in Permanent and Current Files

Permanent File
▪ Copies of the corporate charter/ bylaws ▪ Copies of contracts ▪ Chart of accounts ▪ Organizational chart ▪ Accounting manuals ▪ Information relating to the understanding the internal control ▪ Terms of stock and bond issues ▪ The results of analytical procedures from prior year's audit.
Current File
▪ Audit program ▪ Working trial balance ▪ Copies of minutes of meetings ▪ Copy of financial statement ▪ Copy of auditor's report ▪ Working papers supporting financial statement accounts (lead and detailed schedules)

WORKING TRIAL BALANCE

The working trial balance is a listing of the general accounts with its year-end balances as unadjusted amount directly obtained from client, proposed audit adjustment, and the audited balance amount. Each line item on the trial balance is supported by a lead schedule. Lead (Top) schedule contains the detailed accounts from the general ledger making up the line item total. Each detailed account on the lead schedule is supported by appropriate schedules supporting the audit work performed and the conclusion reached. For example, the trial balance would contain only one line for cash and the lead schedule would list all general ledger cash accounts (e.g., Petty Cash, Cash in Bank A, Cash in Bank B) and each detailed account on the lead schedule for cash is supported by appropriate schedules (Cash count for Petty Cash, Bank Reconciliation for Cash in Bank). Figure 7.3 shows the relationships of working papers to financial statements.

SUPPORTING SCHEDULES

These are the largest portion of audit documentation prepared by auditors in support of specific amounts on the financial statements.

ADJUSTING AND RECLASSIFICATION ENTRIES

Adjusting entries are made to correct the discovered misstatement in the client's records. Reclassification entries are made in the financial statements to present the accounting information properly. It should be noted that only those adjusting and reclassification entries that significantly affect the fair presentation of financial statements must be made. The determination of when misstatement should be adjusted is based on materiality.

FORMAT OF WORKING PAPERS

Working papers may be prepared in both manually and electronically. Whether these were prepared manually or electronically, the manner in which it is formatted usually contains the following characteristics:

Heading

All working papers should have a proper heading such as the name of the client, the title of the working paper and the date covered by the examination.

Indexing and Cross-Referencing

Indexing is the use of lettering or numbering system in the working paper. For example cash may be labeled as A for its lead schedule. When auditor conducts audit work on one working paper and the supporting information is obtained from another working paper, the auditor cross-references the information on each working paper. This is important to provide a trail useful in reviewing the working papers.

Tick Marks

The auditors use tick marks to document work performed. These are the symbols that describe the audit procedures performed by the auditor.

OWNERSHIP OF WORKING PAPERS

According to PAS 230, working papers are the property of the auditor. Portions of working papers may be made available to the client at the discretion of the auditor, but they should not be considered as part or as substitute for the client's records. The Philippine Accountancy Act of 2004, Section 29 specifies the legal provision on ownership of audit working papers.

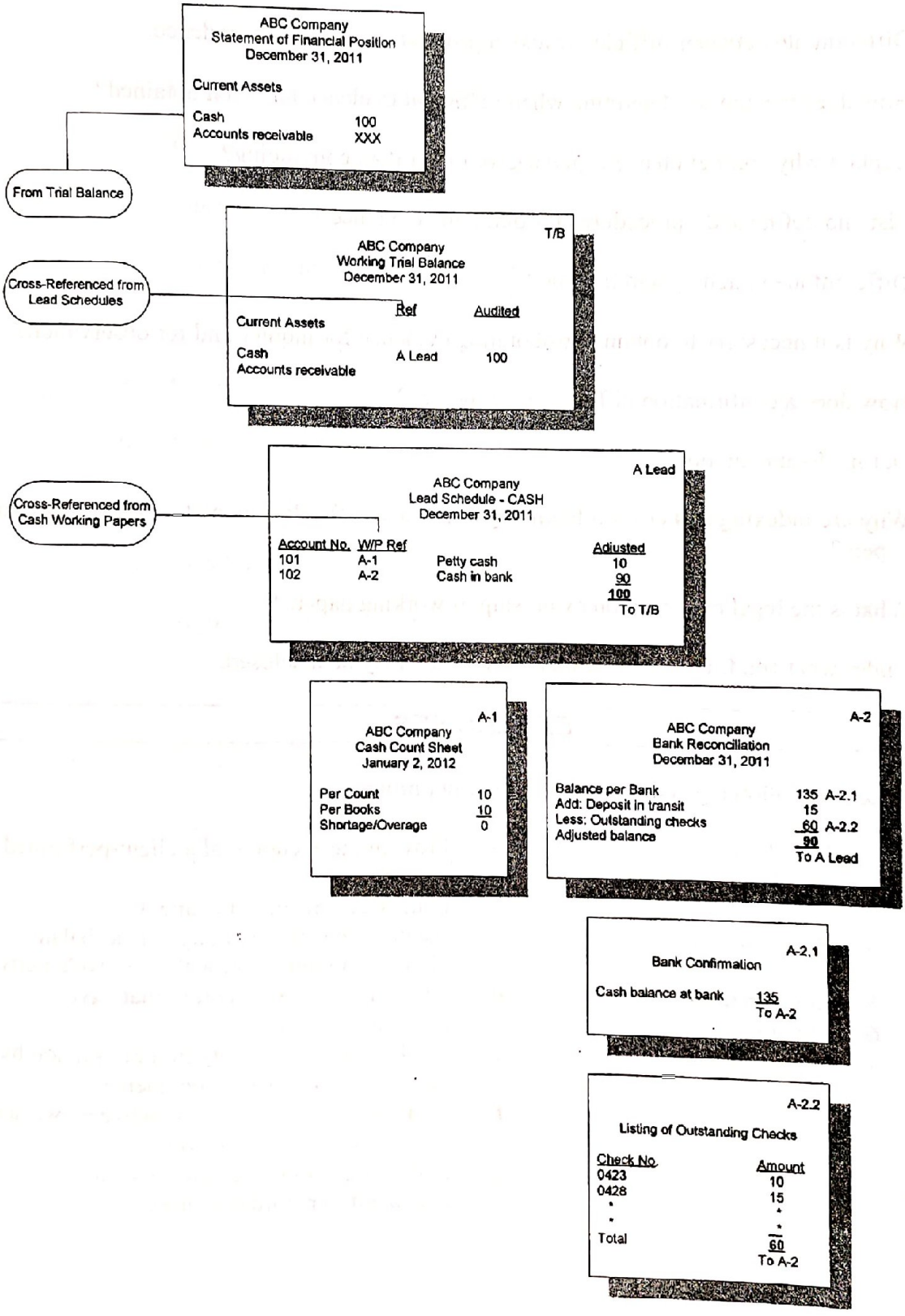
CONFIDENTIALITY OF WORKING PAPERS

Although the auditor owns the working papers, they cannot be shown, except under certain circumstances, to anyone without the client's consent. Section 4 of the Code of Ethics for Professional Accountants in the Philippines provides guidance for the confidentiality of information obtained during the course of audit. One of the guidance is that the auditor can disclose confidential information even without the client's consent when:

1. Disclosure is required by law.
   a. To produce documents or to give evidence in the course of legal proceedings.
   b. To disclose to the appropriate public authorities infringements of law which come to light

2. There is a professional duty or right to disclose.
   a. To comply with technical standards and ethics requirements
   b. To protect professional interest of a professional accountant in legal proceedings
   c. To comply with the quality review of a member body or professional body
   d. To respond to an inquiry or investigation by a member body or regulatory body

Figure 7.3 Relationship of Working Papers to Financial Statements



REVIEW QUESTIONS

1. Define audit evidence?
2. What purpose does an auditor have in obtaining evidence?
3. How do management assertions relate to financial statements?
4. Differentiate between sufficiency and appropriateness of audit evidence.
5. How does the auditor determine when sufficient evidence has been obtained?
6. Explain why audit evidence is persuasive rather than convincing?
7. List and define audit procedures for obtaining evidence.
8. Differentiate vouching and tracing.
9. Why is it necessary to obtain corroborating evidence for inquiry and for observation?
10. How does a confirmation differ from an inquiry?
11. Define documentation?
12. Why are indexing and cross-referencing important to the documentation of audit working papers?
13. What is the legal provision on ownership of working papers?
14. Under what conditions confidential information may be disclosed.

EXCERCISES

1. Match the following audit terms with their definitions.

E	1. Vouching	a.	Proving the accuracy of a client-performed activity. (4)
D	2. Physical examination	b.	Critical review of a document. (3)
B	3. Inspection	c.	Establishing the validity of a balance by direct communication with an outside party. (5)
A	4. Reperformance	d.	Observing assets/inventory that have physical existence. (2)
C	5. Confirmation	e.	Establishing the validity of a transaction by examining supporting documents. (1)
G	6. Tracing	f.	Establishing the agreement between two sets of related accounting record. (3)
F	7. Reconciliation	g.	Following a transaction from a source document to recorded entries. (6)

2. The auditors have two types of working paper files, the current file (**CF**) and the permanent file (**PF**). Using the initials and the spaces provided, indicate which file each of the following documents would most likely be filed.

PF 1. A loan agreement.
CF 2. A confirmation of financial institution deposits.
PF 3. Articles of incorporation.
PF 4. An analysis of long-term debt.
CF 5. General Ledger.
PF 6. Copies of the corporate by-laws.
CF 7. A positive confirmation letter of customer's balance.
PF 8. A bond indenture.
PF 9. An analysis of owners' equity accounts.
PF 10. A chart of accounts.
PF 11. A pension agreement.
CF 12. An adjusted trial balance.
CF 13. Adjusting journal entries.
CF 14. An analysis of miscellaneous expenses.
CF 15. Copy of financial statements.

3. Listed below are the management assertions that are contained in financial statements, and several financial statement misstatements. For each misstatement, indicate with the appropriate letter the assertion by management that is being violated.

Assertion

A Existence and occurrence
B Completeness
C Rights and obligation
D Valuation or allocation
E Presentation and disclosure
F Accuracy and valuation
G Classification and understandability

Misstatements

B 1. The client failed to include in their financial statements inventory that was consigned to others.
D 2. The client had a significant amount of damaged goods that were presented at cost.
E 3. The client failed to describe in the financial statements significant debt restrictions.
A 4. The client recorded receivables that were fictitious.
C 5. The client failed to pay its obligations to suppliers or failed to control their rights to assets.

4. Listed below are the audit objectives for the audit of assets and audit procedures design to achieve certain of those objectives. Match the procedure with the primary objective or objectives that it is intended to achieve.

Audit Objectives

A Establish the existence of the assets
B Establish the rights to the assets
C Establish the completeness of recorded assets
D Determine the appropriate valuation of the assets
E Determine the appropriate financial statement presentation

Audit Procedures

ABD 1. Confirm a sample of accounts receivable by direct communication with the client.
E 2. Trace selected purchase transactions to entries in accounts.
ABD 3. Vouch purchases of property, plant and equipment made during the year.
E 4. Obtain a lawyer's letter from the client's attorney.
ACD 5. Observe the client's physical inventory.

MULTIPLE CHOICE QUESTIONS

1. The best definition of information identified to achieve an auditing engagement's objectives is information that
   a. Provides an absolute basis for engagement conclusions.
   b. Provides a sound basis for engagement conclusions.
   c. Is useful and reliable.
   d. Is useful and convincing.

2. Engagement information is usually considered relevant when it is
   a. Consistent with the engagement objectives.

b. Derived through valid statistical sampling.
c. Factual, adequate, and convincing.
d. Objective and unbiased.

3. To determine the sufficiency of information regarding interpretation of a contract, an auditor uses
   a. Logical relationships between information and issues.
   b. Objective evaluations.
   c. Subjective judgments.
   d. The best obtainable information.

4. Reliable information is
   a. Competent and the best attainable through the use of appropriate engagement techniques.
   b. Factual, adequate, and convincing so that a prudent person would reach the same conclusion as the auditor.
   c. Helpful in assisting the organization in meeting prescribed goals.
   d. Supportive of the engagement observations and consistent with the engagement objectives.

5. When sampling methods are used, the concept of sufficiency of information means that the samples selected provide
   a. Absolute assurance that a sample is representative of the population.
   b. Reasonable assurance that the information has a logical relationship to the engagement objective.
   c. Reasonable assurance that they are representative of the sampled population.
   d. The best information that is reasonably obtainable.

6. Which of the following is an essential factor in evaluating the sufficiency of information? The information must
   a. Be based on references that are considered competent.
   b. Be convincing enough for a prudent person to reach the same decision.
   c. Be well documented and cross-referenced in the working papers.
   d. Bear a direct relationship to the observation and include all of the elements of an observation.

7. An auditor is evaluating the advertising function. The organization has engaged a medium-sized local advertising agency to place advertising in magazine publications. As part of the review of the engagement working papers, the auditing supervisor is evaluating the information collected. The auditor reviewed the language in the advertising for its legality and compliance with fair trade regulations by interviewing the organization's advertising manager, the product marketing director (who may not have been objective), and five of the organization's largest customers (who may not have been knowledgeable). The supervisor can justifiably conclude that the information is
   a. Conclusive.
   b. Insufficient.
   c. Irrelevant.
   d. Reliable.

8. An auditor has set an engagement objective of determining whether all cash receipts are deposited intact daily. To satisfy this objective, the auditor interviewed the controller who gave assurances that all cash receipts are deposited as soon as is reasonably possible. As information that can be used to satisfy the stated engagement objective, the controller's assurances are
   a. Sufficient, reliable, and relevant.
   b. Sufficient but not reliable or relevant.
   c. Relevant but not sufficient or reliable.
   d. Not sufficient, reliable, or relevant.

9. While performing an engagement relating to an organization's cash controls, the auditor observed that cash receipts are not deposited intact daily. A comparison of a sample of cash receipts lists revealed that each cash receipt list equaled cash journal entry amounts but not daily bank deposits amounts, and cash receipts list totals equaled bank deposit totals in the long run. This information as support for the auditor's observations is
   a. Sufficient, reliable, and relevant.
   b. Sufficient but not reliable or relevant.
   c. Relevant but not sufficient or reliable.
   d. Not sufficient, reliable, or relevant.

10. During an engagement, the auditor should consider the following factor(s) in determining the extent to which analytical procedures should be used during the engagement:
   a. Significance of the area being examined.
   b. Precision with which the results of analytical audit procedures can be predicted.
   c. Adequacy of the system of internal control.
   d. All of the answers are correct.

11. An inexperienced auditor notified the senior auditor of a significant variance from the engagement client's budget. The senior told the new auditor not to worry because the senior had heard that there had been an unauthorized work stoppage that probably accounted for the difference. Which of the following statements is most appropriate?
   a. The senior used proper judgment in curtailing what could have been a wasteful investigation.
   b. The senior should have halted the engagement until the variance was fully explained.
   c. The senior should have aided the new auditor in formulating a plan for accumulating appropriate information.
   d. The new auditor should have investigated the matter fully and not bothered the senior.

12. Analytical procedures enable the auditor to predict the balance or quantity of an item. Information to develop this estimate can be obtained by all of the following except
   a. Comparing financial data with data for comparable prior periods, anticipated results (e.g., budgets and forecasts), and similar data for the industry in which the entity operates.
   b. Studying the relationships of elements of financial data that would be expected to conform to a predictable pattern based upon the entity's experience.
   c. Studying the relationships of financial data with relevant nonfinancial data.
   d. Tracing transactions through the system to determine whether procedures are being applied as prescribed.

13. A production manager for a moderate-sized manufacturing organization began ordering excessive raw materials and had them delivered to a wholesaler that the manager was running as a side business. The manager falsified receiving documents and approved the invoices for payment. Which of the following engagement procedures is most likely to detect this fraud?
    a. Observe the receiving dock and count materials received; compare the counts with receiving reports completed by receiving personnel.
    b. Perform analytical tests, comparing production, materials purchased, and raw materials inventory levels; investigate differences.
    c. Take a sample of cash disbursements and confirm the amount purchased, purchase price, and date of shipment with the vendors.
    d. Take a sample of cash disbursements; compare purchase orders, receiving reports, invoices, and check copies.

14. Analytical procedures can best be categorized as
    a. Budget comparisons.
    b. Qualitative tests.
    c. Substantive tests.
    d. Tests of controls.

15. Analytical procedures in which current financial statements are compared with budgets or previous statements are primarily intended to determine the
    a. Use of an erroneous cutoff date.
    b. Overall reasonableness of statement contents.
    c. Existence of specific errors or omissions.
    d. Adequacy of financial statement disclosure.

16. An adequately documented working paper should
    a. Not contain copies of engagement client records.
    b. Follow a unique form and arrangement.
    c. Contain examples of all forms and procedures used by the engagement client.
    d. Be concise but complete.

17. Which of the substantive fieldwork procedures presented below provides the best information about completeness of recorded revenues?
    a. Reconciling shipping records to recorded sales.
    b. Reconciling the sales journal to the general ledger control account.
    c. Vouching charges made to the accounts receivable subsidiary ledger to supporting shipping records.
    d. Vouching shipping records to the customer order file.

18. Observation is considered a reliable engagement procedure, but one that is limited in usefulness. However, it is used in a number of different engagement situations. Which of the following statements is true regarding observation as an engagement technique?
    a. It is the most persuasive technique for determining if fraud has occurred.
    b. It is the most persuasive methodology to learn how transactions are really processed during the period under review.
    c. It is the most effective engagement methodology to use in filling out internal control questionnaires.
    d. It is rarely sufficient to satisfy any assertion other than existence.

19. Which of the following types of tests is the most persuasive if an auditor wants assurance of the existence of inventory stored in a warehouse?
    a. Examining the shipping documents that support recorded transfers to and from the warehouse.
    b. Examining warehouse receipts contained in the engagement client's records.
    c. Obtaining written confirmation from management.
    d. Physically observing the inventory in the warehouse.

20. Documents provide information with differing degrees of persuasiveness. If the engagement objective is to obtain information that payment has actually been made for a specific invoice from a vendor, which of the following documents ordinarily is the most persuasive?
    a. A canceled check, made out to the vendor and referenced to the invoice, included in a cutoff bank statement that the auditor received directly from the bank.
    b. A vendor's original invoice stamped "PAID" and referenced to a check number.
    c. An accounts payable subsidiary ledger that shows payment of the invoice.
    d. An entry in the engagement client's cash disbursements journal supported by a voucher package containing the vendor's invoice.

21. An auditor at a savings and loan concludes that a secured real estate loan is collectible. Which of the following engagement procedures provides the most persuasive information about the loan's collectibility?
    a. Reviewing the loan file for proper authorization by the credit committee.
    b. Examining the loan application for appropriate borrowers' signatures.
    c. Examining documentation of a recent, independent appraisal of the real estate.
    d. Confirming the loan balance with the borrower.

22. The most persuasive information about the existence of newly acquired computers for the sales department is
    a. Physical examination.
    b. Observation of engagement client's procedures.
    c. Inquiry of management.
    d. Documentation prepared externally.

23. The most persuasive information regarding the asset value of newly acquired computers is
    a. Physical examination.
    b. Documentation prepared externally.
    c. Observation of engagement client's procedures.
    d. Inquiry of management.

24. Which of the following does not describe one of the functions of engagement working papers?
    a. Provides the principal support for engagement communications.
    b. Facilitates third-party reviews.
    c. Aids in the professional development of the operating staff.
    d. Aids in the planning, performance, and review of engagements.

25. Which of the following represents the general order of persuasiveness, from most to least, for the types of information listed below:
    I. Inquiry of management
    II. Observation of engagement client's procedures
    III. Physical examination
    IV. Documentation prepared externally

    a. IV, III, I, II.
    b. IV, I, II, III.
    c. III, IV, II, I.
    d. II, IV, I, III.

26. The primary purpose of an auditor's working papers is to
    a. Serve as a means with which to prepare the financial statements.
    b. Provide documentation of the planning and execution of engagement procedures performed.
    c. Document weaknesses in internal control with recommendations to management for improvement.
    d. Comply with the Standards.

27. Which of the following is the most important if working papers are to have the characteristics that will ensure that they achieve their primary purposes?
    a. Working papers must provide sufficient, reliable, and useful information to support the final engagement communication.
    b. Working papers must be properly indexed and cross-referenced to the draft final engagement communication.
    c. Working papers must be of standard format and standard content.
    d. Working papers must be arranged in logical order following the engagement work program sequence.

28. The primary purpose of an engagement working paper prepared in connection with payroll expense is to
    a. Verify the work done by the auditor.
    b. Record the names of all employees.
    c. Record payroll data and analyses to support reported recommendations.
    d. Provide documentation to support payroll taxes due.

29. Engagement working papers should include
    a. All working papers prepared during a previous engagement performed in the same area.
    b. Documentation of the examination and evaluation of the adequacy and effectiveness of the system of internal control.
    c. Copies of all procedures that were reviewed during the engagement.
    d. Copies of all source documents examined in the course of the engagement.

30. Which of the following is an unnecessary feature of a working paper prepared in connection with maintenance costs?
    a. The auditor has initialed and dated the working paper as of the date completed even though the working paper was prepared over the preceding 4 working days.

b. Total acquisition cost of property, plant, and equipment for the preceding month is shown.
c. Total repair expense for the month preceding the engagement is shown.
d. The supervisor has initialed the working paper as reviewer although the working paper was prepared by another person.

31. Each individual working paper should, at a minimum, contain
a. An expression of the auditor's overall opinion.
b. A descriptive heading.
c. A tick mark legend.
d. A complete flowchart of the system of internal controls for the area being reviewed.

32. Engagement working papers are indexed by means of reference numbers. The primary purpose of indexing is to
a. Support the final engagement communication.
b. Permit cross-referencing and simplify supervisory review.
c. Determine that working papers adequately support observations, conclusions, and recommendations.
d. Eliminate the need for follow-up reviews.

33. When engagement conclusions are challenged, the auditor's factual rebuttal is best facilitated by
a. Cross-referencing of the working papers.
b. Explicit procedures in the engagement work program.
c. Pro forma working papers.
d. Summaries in the engagement work program.

34. Which of the following conditions constitutes inappropriate working-paper preparation?
a. All forms and directives used by the engagement client are included in the working papers.
b. Engagement observations are cross-referenced to supporting documentation.
c. Flowcharts are included in the working papers.
d. Tick marks are explained in notes.

35. Which of the following engagement procedures provides the best information about the collectibility of notes receivable?
a. Confirmation of note receivable balances with the debtors.
b. Examination of cash receipts records to determine promptness of interest and principal payments.
c. Examination of notes for appropriate debtors' signatures.
d. Reconciliation of the detail of notes receivable and the provision for uncollectible amounts to the general ledger control.

36. Ordinarily, what source of information should most affect the auditor's conclusions?
a. Oral.
b. Inquiry.
c. Informal.
d. External.

37. An auditor's objective is to determine the cause of inventory shortages shown by the physical inventories taken by an independent service organization that used some engagement client personnel. The auditor addresses this objective by reviewing the count sheets, inventory printouts, and memos from the last inventory. The source of information and the sufficiency of this information are
   a. Both external and internal and not sufficient.
   b. Both external and internal and sufficient.
   c. External and sufficient.
   d. Internal and not sufficient.

38. The most conclusive information to support supplier account balances is obtained by
   a. Reviewing the vendor statements obtained from the accounts payable clerk.
   b. Performing analytical account analysis.
   c. Obtaining confirmations of balances from the suppliers.
   d. Interviewing the accounts payable manager to determine the internal controls maintained over accounts payable processing.

39. The supervisor is reviewing the working papers produced by a staff auditor during a fraud investigation. Among the items contained in the working papers is a description of an item of physical information. Which of the following is the most probable source of this item of information?
   a. Computing variances.
   b. Examining records.
   c. Interviewing people.
   d. Observing conditions.

40. An auditor takes a photograph of the engagement client's workplace. The photograph is a form of what kind of information?
   a. Testimonial.
   b. Physical.
   c. Documentary.
   d. Analytical.

41. Which of the following is an example of documentary information?
   a. A photograph of an engagement client's workplace.
   b. A page of the general ledger containing irregularities placed there by the perpetrator of a fraud.
   c. A page of the auditor's working papers containing the computations that demonstrate the existence of an error or irregularity.
   d. A letter from a former employee alleging a fraud.

42. In an engagement to review travel expenses, the auditor calculates average expenses per day traveled for all sales personnel and then examines detailed receipts for those with high averages. These procedures represent the identification of which types of information?
   a. Analytical and physical.
   b. Documentary and analytical.
   c. Documentary and physical.
   d. Physical and testimonial.

43. Of the following which is the least persuasive type of audit evidence?
    a. Documents mailed by outsiders to the auditor.
    b. Correspondence between auditor and vendors.
    c. Copies of invoices inspected by the auditor.
    d. Copies of bank-statement.

44. Which of the following presumptions does not relate to the competence of audit evidence?
    a. The more effective the internal control structure, the more assurance it provides about the accounting data and financial statements.
    b. An auditor's opinion, to be economically useful, is formed within reasonable time and based on evidence obtained at a reasonable cost.
    c. Evidence obtained from independent sources outside the entity is more reliable than evidence secured solely within the entity.
    d. The independent auditor's direct personal knowledge, obtained through observation and inspection, is more persuasive than information obtained indirectly.

45. Which of the following types of audit evidence is the least persuasive?
    a. Prenumbered purchase order forms.
    b. Bank statements obtained from the client.
    c. Test counts of inventory performed by the auditor.
    d. Correspondence from the client's attorney about litigation.

46. Which of the following types of audit evidence is the most persuasive?
    a. Prenumbered client purchase order forms.
    b. Client work sheets supporting cost allocations.
    c. Bank statements obtained from the client.
    d. Client represented letter.

47. During the initial planning phase of audit, a CPA most likely would
    a. Identify specific internal control activities that are likely to prevent fraud.
    b. Evaluate the reasonableness of the client's accounting estimates.
    c. Discuss the timing of the audit procedures with the client's management.
    d. Inquire of the client's attorney as to whether any unrecorded claims are probable of assertion.

48. An auditor should design the written audit program so that
    a. All material transactions will be selected for substantive testing.
    b. Substantive test prior to the balances sheet date will be minimized.
    c. The audit procedures selected will achieve specific audit objectives.
    d. Each account balance will be tested under either tests of control or tests of transactions.

49. Which of the following circumstances most likely would cause an auditor to consider whether material misstatements exist in an entity's financial statements?
    a. Management places little emphasis on meeting earnings projections.
    b. The board of directors makes all major financing decisions.
    c. Reportable conditions previously communicated to management are not corrected.

(d) Transactions selected for testing are not supported by proper documentation.

50. The in-charge auditor most likely would have a supervisory responsibility to explain to the staff assistants
    a. That immaterial irregularity is not to be reported to the client's audit committee.
    (b.) How the results of various auditing procedures performed by the assistants should be evaluated.
    c. What benefits may be attained by the assistants' adherence to established time budgets.
    d. Why certain documents are being transferred from, the current file to the permanent file.

COMPREHENSIVE CASES

CASE 1

RER, CPA, is engaged to audit the financial statements of BBB Company for the year ended December 31, 2021. RER obtained and documented an understanding of internal control relating to the accounts receivable and assessed control risk relating to accounts receivable at the maximum level. RER requested and obtained from BBB an aged accounts receivable schedule listing the total amount owed by each customer as of December 31, 2021, and sent positive confirmation requests to a sample of customers.

Required:

What additional substantive procedures should RER consider applying in auditing accounts receivable?

CASE 2

Ed, CPA, was engaged to audit the financial statements of Mhil Company, a continuing audit client. Ed is about to audit Mhil's payroll transactions. Mhil uses an in-house payroll department to compute payroll data and prepare and distribute checks.

During the planning process, Ed determined that the inherent risk of overstatement of payroll expense is high. In addition, Ed obtained an understanding of internal control and assessed control risk at the maximum level for payroll related assertions.

Required:

Describe the audit procedures Ed should consider performing in an audit of Mhil's payroll transactions to address the risk of overstatement.

CASE 3

Most of an auditor's work in forming an opinion on financial statements consists of obtaining and evaluating evidential matter concerning the financial statement assertions.

Required:

1. What is the definition of financial statement assertions?
2. What is the relationship between audit objectives and financial statement assertion?
3. What should and auditor consider in developing the audit objectives of a particular engagement?
4. What is the relationship between audit objectives and audit procedures?
5. What are the auditor's primary considerations when selecting particular substantive tests to achieve audit objectives?

Chapter 8

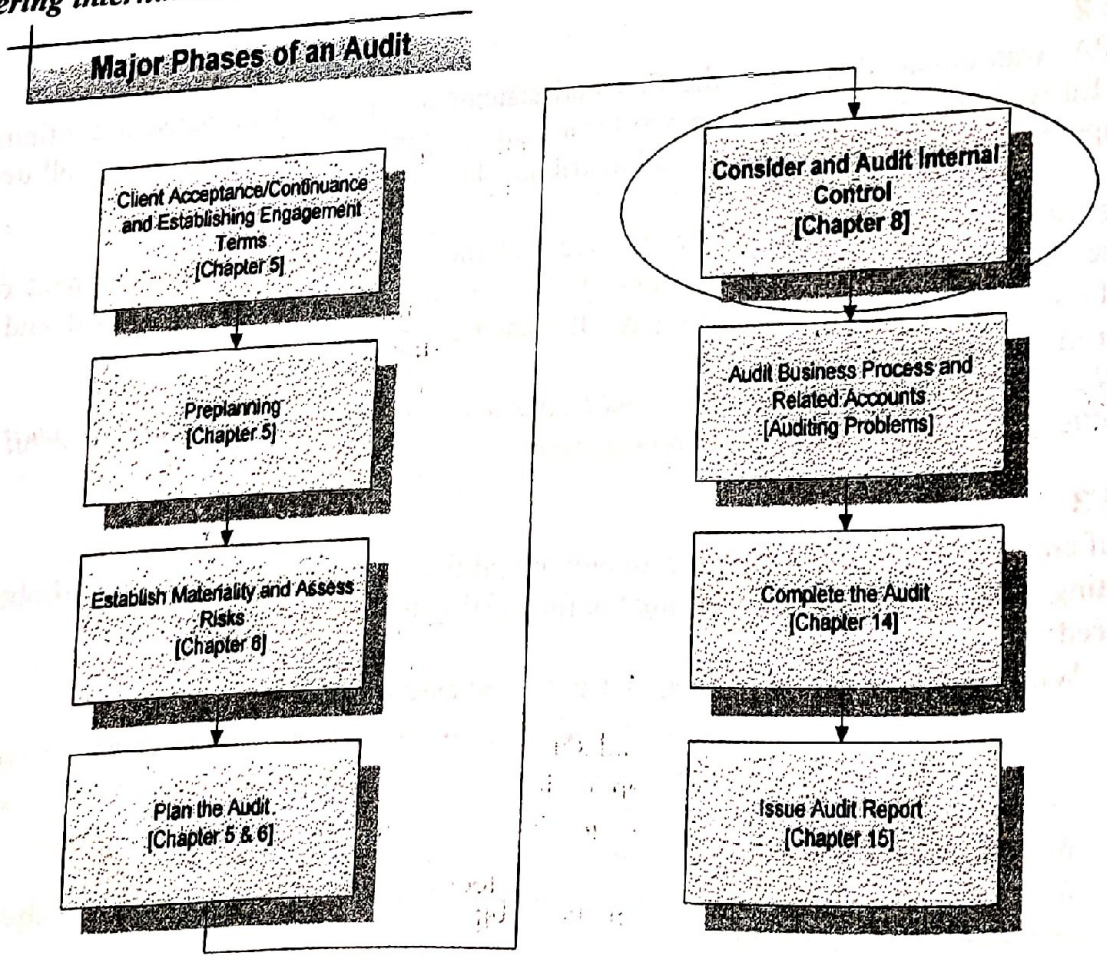
INTERNAL CONTROL IN A FINANCIAL STATEMENT AUDIT

LEARNING OBJECTIVES

Upon completion of this chapter you will

1. **Learn the basic concepts of internal control.**
2. **Define what is meant by internal control.**
3. **Identify the different elements/components of internal control.**
4. **Understand the limitations of internal control.**
5. **Describe the auditor's consideration of internal control.**
6. **Know how to develop an understanding of an entity's internal control.**
7. **Identify the tools available for documenting the understanding of internal control.**
8. **Know how to assess the level of control risk.**
9. **Know the types of test of controls.**
10. **Understand audit strategies for the nature, timing, and extent of substantive procedures based on different levels of detection risk.**
11. **Understand about the auditors' responsibility for communicating internal control related matters.**

This chapter covers the fifth phase of the audit process identified in Chapter 5 (Figure 5.1), ***considering internal control in a financial statement audit.***

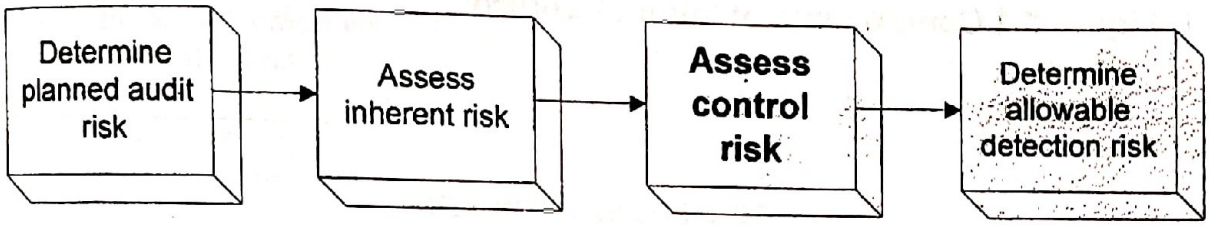


BASIC CONCEPTS AND ELEMENTS OF INTERNAL CONTROL

Using the Audit Risk Model as identified in Chapter 6 (Figure 6.1), after planning the audit risk and assessing the inherent risk, the auditor assesses the level of control risk. This chapter provides detailed coverage of auditor's assessment of control risk. It addresses the importance of internal control and its components, as well as how evaluating internal control relates to substantive testing.

PSA 315, *Understanding the Entity and Its Environment and Assessing the Risk of Material Misstatement*, provides guidance in obtaining an understanding of the accounting and internal control system and on audit risk and its component: inherent risk, control risk, and detection risk.

Steps Followed Using the Audit Risk Model



NATURE AND PURPOSE OF INTERNAL CONTROL

Internal control, as defined in PSA 315, is the process designed and effected by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations.

Entity typically has three broad objectives in designing an effective internal control system:

- Effectiveness and efficiency of operations
- Reliability of financial reporting
- Compliance with laws and regulations

The management designs internal control system to accomplish all three objectives. The auditor's focus is on those controls related to the reliability of financial reporting plus those controls related to operation and to compliance with laws and regulations.

COMPONENTS/ELEMENTS OF INTERNAL CONTROL

The five components of entity's internal control are:

1. The control environment.
2. The entity's risk assessment process.
3. The information system, including the related business process relevant to financial reporting, and communication.

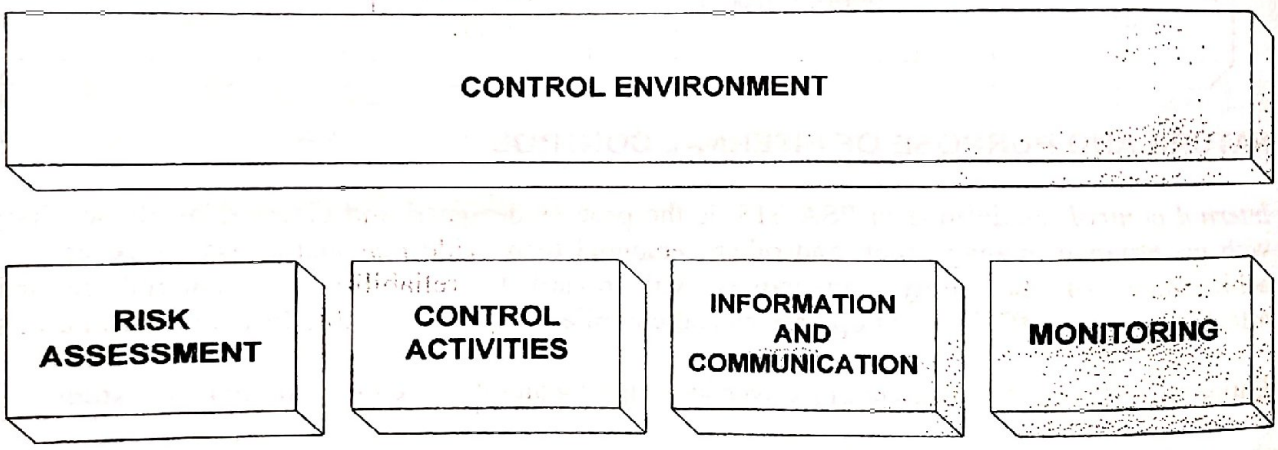
4. Control activities
5. Monitoring controls

1. CONTROL ENVIRONMENT

Sometimes referred to as the tone at the top of the organization, meaning the integrity, ethical values, and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility and organizes and develops its people; and the attention and direction provided by the board of directors. It is the foundation for all other components of internal control, providing discipline and structure. It is the overall attitude, awareness, policies and actions of management and those charged with governance concerning the entity's internal control and its importance in the entity.

In Figure 8.1, the control environment serves as the umbrella for the other four components. It covers the entire entity and establishes the framework for implementing the entity's accounting systems and internal controls.

Figure 8.1 Components of Internal Control



Factors affecting the control environment are:

- Communication and enforcement of integrity and ethical values.
- Management's philosophy and operating style
- Participation of those charged with governance.
- A commitment to competence.
- Human resource policies and procedures.
- Assignment of authority and responsibility.
- Organizational structure.

Communication and Enforcement of Integrity and Ethical Values

An entity should establish ethical and behavioral standards that are communicated to employees and are reinforced by day-to-day practice. The entity can best communicate integrity and ethical behavior within an entity by example and through the use of policy statements and code of conduct.

Management's Philosophy and Operating Style

Factors that may signal important information to the auditor about management's philosophy and operating style include the following:

- Management's approach to taking and monitoring business risks.
- Management's attitudes and actions towards financial reporting.
- Management's attitudes towards information processing and accounting functions and personnel.

Participation by Those Charged with Governance

The entity must have an audit committee who will take fiduciary responsibilities to oversee the entity's accounting and reporting policies and procedures. Factors that affect the effectiveness of those charged with governance include the following:

- Its independence from management.
- The experience and stature of its members.
- Its interaction with internal and external auditors.

A Commitment to Competence

Competence is the knowledge and skills necessary to accomplish the tasks that define an employee's job. The management must specify the competence level for a particular job and translate it into the required level of knowledge and skills. Management then must hire an individual who have the appropriate competence for the job.

Human Resource Policies and Procedures

The entity should have appropriate policies for hiring, orienting, training, evaluating, counseling, promoting, compensating and taking remedial action of its personnel. The effectiveness of internal control is a direct function of the quality of the personnel operating the system.

Assignment of Authority and Responsibility

Assignment of authority and responsibility includes how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established. It also includes policies regarding acceptable business practices, knowledge and experience of key employees, and sources provided for carrying out duties. The entity must implement appropriate methods of assigning authority and responsibility to avoid incompatible functions and minimize the possibility of errors because of too much work load assigned to an employee.

Organizational Structure

Organizational structure provides the overall framework within which an entity's activities for achieving objectives are planned, executed, controlled and reviewed. It defines how authority and responsibility are delegated and monitored. Understanding this gives the auditor the knowledge about the management and functional elements of the business and perceives how controls are implemented.

2. ENTITY'S RISK ASSESSMENT PROCESS

Risk assessment for financial reporting is an entity's identification, analysis and management of risks relevant to the preparation of financial statements.

Every organization, regardless of size, structure, nature, or industry, face a variety of risks from external and internal sources that must be managed. Because of the constant change in economic, industry, regulatory and operating conditions, the management is challenged with developing mechanisms to identify and deal with risks associated with change. Internal control under one set of conditions will not necessarily be effective under another.

An entity's risk assessment process is its process for identifying and responding to business risk. This includes how management identifies risks relevant to the preparation of financial statement, estimates their significance, assesses the likelihood of their occurrence and decides upon actions to manage them.

Circumstances or factors that may increase risk are as follows:

- **Changes in operating environment**. Changes in the operating or regulatory environment can result in changes in competitive pressures and create significantly different risks.
- **New personnel**. New personnel may have a different focus on or understanding of internal control.
- **New or revamped information systems**. Significant and rapid changes in information systems can change the risk relating to internal control.
- **Rapid growth**. Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown of controls.
- **New technology**. Incorporating new technologies onto production processes or information systems may change the risk associated with internal control.
- **New business models, products, or activities**. Entering business areas or transactions with which an entity has little experience may introduce new risk associated with internal control.
- **Corporate restructuring**. Restructuring may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- **Expanded international operations**. The expansion or acquisition of international operation carries new and often unique risks that may affect internal control.
- **New accounting pronouncements**. Adopting new accounting principles or changing accounting principles may impact the risk involved in preparing financial statements.

3. CONTROL ACTIVITIES

Control activities are the policies and procedures that help ensure that management directives are carried out. The control procedures that are relevant to financial statement audit include:

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

Performance Review

These control activities include independent reviews and analyses of actual performance versus budgets, forecast and prior period performance; investigation of unexpected differences, and corrective actions.

Information Processing Controls

A variety of controls are used to check accuracy, completeness and authorization in the processing of transactions. The two broad categories of information systems control activities are:

1. General controls
2. Application controls

General controls apply to all computer activities. They normally include controls over the development, modification, and maintenance of computer programs and controls over the use of and changes to data maintained in computer files. General controls encompass:

a. The plan of organization and operation of the computer activity.
b. The procedures for documenting, reviewing, testing, and approving systems or programs and changes in them.
c. Controls built into the equipment by the manufacturer (hardware controls)
d. Control over access to equipment and data files.
e. Other data and procedural controls affecting computer operations.

Application controls relate to specific tasks performed by the system. They should provide reasonable assurance that the recording, processing, and reporting of data are properly performed. Application controls relate to individual computerized accounting applications, for example, programmed edit controls for verifying customer's account numbers and credit limits. Types of application controls include input controls, processing controls, and output controls.

Controls should ensure the efficiency and effectiveness of information technology operations. They include proper segregation of the duties within the information technology environment.

Physical Controls

These control activities include the physical security of the assets, including adequate safeguards such as secured facilities, authorizations for access to computer programs and data files, and periodic counting of assets and comparison to control records.

Segregation of Duties

Segregating authorization of transactions, recording of transactions and custody of the assets is very important for every entity because it reduces the opportunity for any one person to be in position to both perpetrate and conceal errors or fraud in the normal course of his duties. For example, the same person should not be responsible for recording the cash received on account and for posting the receipts to the accounting records. It is possible for that person to misappropriate the cash and cover the shortage in the accounting records.

4. INFORMATION AND COMMUNICATION SYSTEM

An information system consists of infrastructure (physical and hardware components), software, people, procedures and data. The information system relevant to financial reporting objective includes the accounting system, and consists of procedures, and records established to initiate, record, process and report an entity's transactions and to maintain accountability for the related assets and liabilities.

An information system encompasses method and records that:

- Identify and record valid transactions.
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- Measure the value of transactions in manner that permits recording their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Properly present the transactions and related disclosures in the financial statements.

Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes the extent to which personnel understand how their activities in the financial reporting information system relate to work of others and the means of reporting exceptions. Policy manuals, accounting and financial reporting manuals, and memoranda communicate policies and procedures to the entity's personnel. Communication can also be made electronically, orally, and through the actions of management.

5. MONITORING OF CONTROLS

Monitoring is a process that assesses the quality of internal control performance over time. It deals with ongoing or periodic assessment of the quality of the internal control performance by management to determine that controls are operating as intended and that they are modified as appropriate for changes in conditions.

Monitoring can be accomplished through:

- ongoing activities
- separate evaluations

Ongoing monitoring procedures are built into the normal, recurring activities of the entity and include regular management and supervisory activities. Separate evaluations are monitoring activities that are performed on a non-routine basis. For example, management uses internal auditors to monitor the operating effectiveness of internal control.

LIMITATIONS OF INTERNAL CONTROL

The effectiveness of internal control system is subject to certain inherent limitation including:

- Management override of internal control
- Personnel errors or mistakes
- Collusion

Management Override of Internal Control

The management may override internal controls over financial reporting to perpetrate a fraud. Examples of techniques used by management in overriding internal controls over the financial reporting function include:

a. Back dating or forward dating documents to a different period.
b. Making adjusting entries during the financial reporting closing process.
c. Reclassifying items improperly between the statement of activity and the statement of financial condition.

Auditors are particularly concerned when senior management is involved in the override because it raises serious questions about management's integrity.

Personnel Errors or Mistakes

The effectiveness of internal control system depends upon the quality of the work performed by the personnel involved. Breakdowns in internal control can occur because of human failures such as simple errors or mistakes. The causes of personnel errors or mistakes include:

- Mistake in judgment.
- Do not completely understand the instructions.
- Careless.

Collusion

The effectiveness of segregation of duties lies in individuals performing only their assigned jobs or in the performance of one person being checked by another. These controls can be circumvented by collusion. For example, the cashier who receives cash collections from customers can collude with the bookkeeper who records those cash collections in the customers' records to steal cash from the entity.

CONCEPT OF REASONABLE ASSURANCE

The concept of reasonable assurance recognizes that the cost of internal control system should not exceed the benefits. A considerable estimation and judgment on the part of management is required to balance the cost of controls with the related benefits. Reasonable assurance allows for only remote likelihood that material misstatements will not be prevented or detected on a timely basis by internal control.

ILLUSTRATION OF A TYPICAL INTERNAL CONTROL SYSTEM

- Processing sales and collection cycle (Figure 8.2 and Figure 8.3)
- Acquisition and payment cycle (Figure 8.4 and Figure 8.5)
- Payroll (Figure 8.6)
- Production (Figure 8.7)

CONSIDERATION OF INTERNAL CONTROL IN A FINANCIAL STATEMENTS AUDIT

OBJECTIVE

Management has the responsibility to maintain controls that provide reasonable assurance that adequate controls exists over the entity's assets and records. Management needs a control system that generates reliable information for decision making. The auditor should give adequate considerations to these controls because the quality of the entity's internal control systems can have an impact on the overall audit strategy.

Figure 8.8 presents a summary of how an auditor considers internal control in a financial statements audit.

STAGES OF STUDY AND EVALUATION OF INTERNAL CONTROL

The steps involved in studying and evaluating internal control are:

1. Obtain an understanding of internal control.
2. Assessing the preliminary level of control risk.
3. Obtaining evidential matter to support the assessed level of control risk
4. Evaluating the results of evidential matter
5. Determining the necessary level of detection risk.

I. OBTAINING AN UNDERSTANDING OF INTERNAL CONTROL

The auditor must obtain an understanding of internal control (the five components) sufficient to plan the audit. This understanding should include knowledge about the design of relevant controls and whether they have been placed in operation by the entity. This knowledge is used to:

- Identify types of potential misstatements.
- Consider factors that affect the risk of material misstatement.
- Design substantive tests.

An initial understanding of the design of the entity's internal control is normally obtained by:

- Inquiry of appropriate entity personnel
- Inspection of documents and reports
- Observation of the application of controls

In all engagements, the auditors' understanding of internal control must encompass the five components of internal control.

Understanding the Control Environment
The auditor must obtain sufficient knowledge about the control environment to understand management's and those charged with governance's attitude, awareness, and actions concerning the control environment. The auditor should concentrate on the substance of controls, rather than their form.

Understanding the Entity's Risk Assessment Process
The auditor must obtain sufficient knowledge about the entity's risk assessment process to understand how management considers relevant to financial reporting objectives and decides on actions to address those risks.

Understanding Control Activities
While obtaining an understanding of the other internal control components, auditors generally obtain some knowledge about the entity's control activities. For example, while obtaining an understanding of the documents and other records relating to cash transactions, it is likely the auditor will discover whether bank accounts are reconciled. Whether it is necessary for the auditor to devote additional attention to obtain an understanding of the other control activities depends on the circumstance of the audit.

Understanding the Information System and Communication

The auditor must obtain sufficient knowledge of the information system relevant to the financial reporting to understand the following:

- The major types of transactions of the entity.
- The treatment of those transactions and how they are initiated.
- The related accounting records, supporting information and specific accounts in the financial statements that exist.
- How the information system captures other events and conditions that are significant to the financial statements.
- The financial reporting process used to prepare the entity's financial statements.

This is accomplished by performing ***transaction walk-through*** ***(walk-through test)***. This task involves tracing one or few transactions through the system. This test confirms the auditor's understanding of how the accounting information systems and control procedures function.

The auditor must also obtain sufficient knowledge of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting.

Understanding Monitoring of Controls

The auditor must obtain a sufficient understanding of the entity's monitoring methods relating to financial reporting to understand how those activities are used to initiate actions to address inadequate performance.

DOCUMENTING THE UNDERSTANDING OF INTERNAL CONTROL

The auditor must document the understanding of the internal control components in their working papers to plan the audit. The form and extent of this documentation is affected by the size and complexity of the entity, as well as the nature of the entity's internal control. The documentation usually takes the form of:

- Internal control questionnaire
- Narrative description
- Flowcharts

The more complex the internal control and the more extensive the procedures performed by the auditor, the more extensive should be the documentation.

Internal Control Questionnaires

Internal control questionnaires provide a systematic means for the auditor to investigate areas such as internal control structure. It contains questions about factors of internal control components. Most internal control questionnaires are designed to yield "yes", "no", or "not applicable" answers to the question.

Narrative Description

The understanding of entity's internal control may be documented in a memorandum. It describes the flow of transaction cycles, identifying the employees performing various tasks, documents prepared, records maintained, and the division of duties. This is more appropriate when the entity has a simple internal control system.

Flowcharts

Flowchart is a diagram, a symbolic representation of an entity's internal control system or a series of procedures shown in sequence. It illustrates the interaction of the system in terms of functions, documents, processes, and reports.

The advantages and disadvantages of methods of documentation are shown in Table 8.1

TABLE 8.1 Advantages and Disadvantages of Methods of Documentation

Method	Advantages	Disadvantages
Questionnaire	▪ Easy to complete ▪ Comprehensive list of questions make it unlikely that important portions of the Internal Control will be overlooked. ▪ Weakness become obvious (unable to provide reasonable response)	▪ May be answered without adequate consideration ▪ Standardized questionnaires may not fit client adequately
Memorandum	▪ Tailor-made to fit specific engagement ▪ Requires a detailed analysis of the operations and thus, enable the auditor to understand the function	▪ May become very long and time-consuming ▪ Weaknesses in the structure are not always obvious ▪ Auditor may overlook important portions of the Internal Control
Flowchart	▪ Graphic presentations of the structure ▪ Important portions of the Internal Control will not be overlooked ▪ Goof for electronic systems	▪ Preparation is time-consuming ▪ Weaknesses in the structure not obvious (especially to inexperienced auditor)

II. ASSESSING THE PRELIMINARY LEVEL OF CONTROL RISK

After obtaining an understanding of the entity's internal control necessary to plan an audit, an assessed level of control risk is established. This level of control risk is established either at the maximum level or below the maximum level. The term *maximum level* means the greatest probability that a material misstatement that could occur in a financial statement assertion will not be prevented or detected on a timely basis by entity's internal control structure. If the auditor believes the assessed level should be at the maximum level, no test of controls will be performed. It will be more cost effective to perform extensive substantive testing than performing test of controls. However, whenever controls appear to be effective, the planned level of control risk may be established below the maximum level and test of controls are performed in order to decrease the substantive testing.

There are three instances when test of controls will not be performed:

- Controls are believed to be ineffective and control risk is assessed at maximum
- Controls are believed to be effective, but testing them is not cost efficient and therefore control risk is assessed at maximum level
- Controls are believed to be effective and evidence already obtained is adequate to support planned level of control risk.

To assess control risk below the maximum level, the auditor must:

- Identify relevant controls that will be relied upon.
- Perform test of control
- Conclude on the achieved level of control risk.

Identifying Controls that will be Relied Upon

An auditor's understanding of entity's internal control is used to identify controls that are likely to prevent or detect material misstatement in specific assertions. In identifying controls to be relied upon, the auditor should consider that the controls could have a pervasive effect on many assertions. For example, the conclusion that the control environment is effective may influence the auditor's decision on auditing procedures to be performed.

III. OBTAINING EVIDENTIAL MATTER TO SUPPORT THE ASSESSED LEVEL OF CONTROL RISK

Nature and Purpose of Tests of Control

The auditor obtains evidential matter to support the assessed level of control risk. Tests of controls are tests performed to obtain audit evidence about the effectiveness of controls in preventing, or detecting and correcting, material misstatement at the assertion level. This includes obtaining audit evidence about how the controls were applied at relevant times during the period under audit, the consistency with which they are applied and by whom or by what means they were applied.

The auditor is likely to use four types of procedures to support the operating effectiveness of internal controls. These include:

- Inquiry of appropriate entity personnel
- Inspection of documents and reports
- Observation of the application of controls
- Reperformance of the application of controls

A combination of these procedures may be necessary to evaluate the effectiveness of the operation of control.

There is a significant overlap between tests of controls and procedures performed to obtain an understanding the entity's' internal control. Both include inquiry, inspection, and observation. These three procedures of tests of controls are essentially an extension of procedures to obtain an understanding of internal control. Obtaining an understanding and assessing control risks are often done simultaneously.

Timing of Tests of Controls

The auditor normally performs tests of controls during an interim visit in advance of period end. However, auditor cannot rely on the results of such tests without considering the need to obtain further evidence remainder to the remaining period.

Factors to be considered include:

- The results of interim tests
- The length of the remaining period
- Whether changes have occurred in the accounting and internal control systems during the remaining period.

Extent of Tests of Controls

The extent to which tests of controls are applied depends on the preliminary assessed control risk. If the assessed level of control risk is below the maximum level, more extensive tests of controls are applied, both in terms of the number of controls tested and the extent of the tests for each control.

IV. EVALUATING THE RESULTS OF EVIDENTIAL MATTER

After the auditor has completed the tests of controls, he will evaluate or reassess the control risk based on the results of the tests. The conclusion reached as a result of this evaluation is called assessed level of control risk. If the tests of controls are consistent with the auditor's planned assessment of control risk, no revision in the nature, timing, and extent of substantive test. On the other hand, if the tests of controls revealed that the level of control risk is higher than planned, the achieved/assessed level of control risk will have to be increased and the nature, timing, and extent of the substantive tests will have to be modified. For example, the auditor may perform substantive tests at year-end rather than at interim.

DOCUMENTING THE ASSESSED LEVEL OF CONTROL RISK

The auditor's assessed level of control risk must be documented. If the assessed control risk is at maximum level, the auditor should document his conclusion that control risk is at maximum level. If the assessed control risk is below the maximum level, the auditor should document his conclusion that the control risk is below the maximum level and the basis for that assessment.

V. DETERMINING THE NECESSARY LEVEL OF DETECTION RISK

The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk. The auditor uses the acceptable level of detection risk to determine the nature, timing, and extent of the substantive tests to be used to detect material misstatements in the financial statement assertions.

The control risk and detection risk are inversely related. As the assessed level of control risk increases, the acceptable level of detection risk decreases. The effect of this to substantive tests would perform more persuasive tests, perform tests at the balance sheet date rather than interim, and would test more extensively. In contrast, as the assessed level of control risk decreases, the acceptable level of detection risk increases. Correspondingly, in planning the substantive tests an auditor would perform less persuasive, perform tests at interim dates rather than balance sheet date, and would test less extensively. Table 8.2 shows the relationship between the detection risk and the nature, timing, and extent of substantive tests.

TABLE 8.2 Relationship of Detection Risk to the Nature, Timing, and Extent of Substantive Tests		
Effect of Detection Risk to	Acceptable Level of detection Risk	
	Lower	Higher
Nature of Substantive Test	Should use more persuasive tests	Could use less persuasive tests
Timing of Substantive Test	Perform tests at balance sheet date	Perform tests at interim dates
Extent of Substantive Test	Test more extensively	Test less extensively

HOW ADEQUACY OR INADEQUACY OF INTERNAL CONTROL AFFECTS AUDIT PROCEDURES

The effectiveness of internal control and the extent of detailed audit procedures are inversely related. The more effective the internal control system, the less detailed testing is required. The strengths and weaknesses identified during the study and evaluation of internal control and tests of control will affect the nature, timing, and extent of audit procedures.

COMMUNICATION OF MATERIAL WEAKNESSES IN INTERNAL CONTROL

Management is responsible for establishing and maintaining effective internal control. However, the auditor may provide assistance by communicating the material weaknesses in the internal control identified by the audit procedures. PSAs define a material weakness in internal control as one that could have a material effect on the financial statements. PSA 315 requires that the auditor reports to those charged with governance of material weaknesses in the design or implementation of internal control. It can be communicated orally, but they normally set forth in a letter.

While auditors are not required to identify those internal control weaknesses, they must communicate it to the client when it comes to their attention during the course of the audit.

Figure 8.2 Internal Control Flowchart for Processing Sales

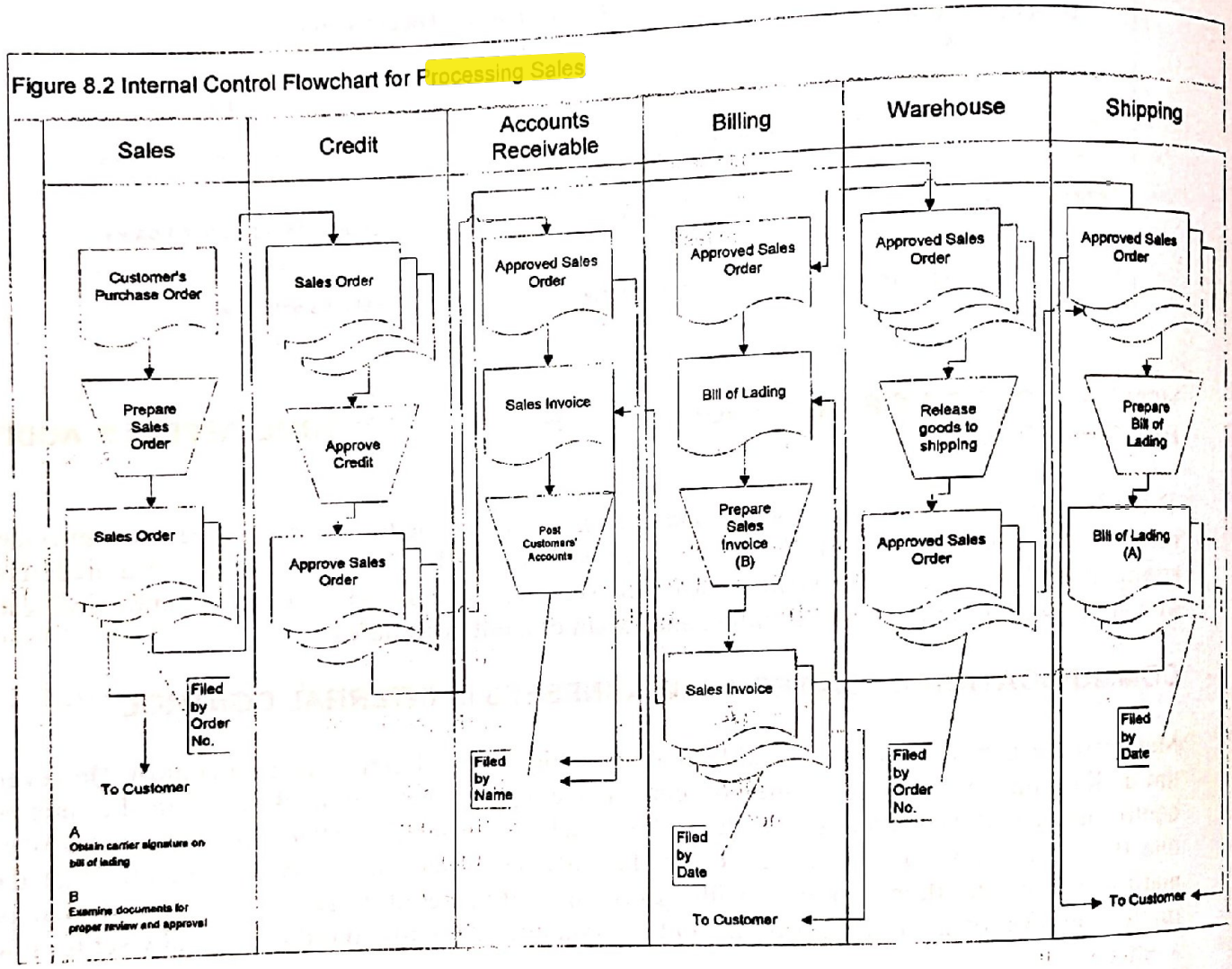


Figure 8.3 Internal Control Flowchart for Cash Receipts from Customers

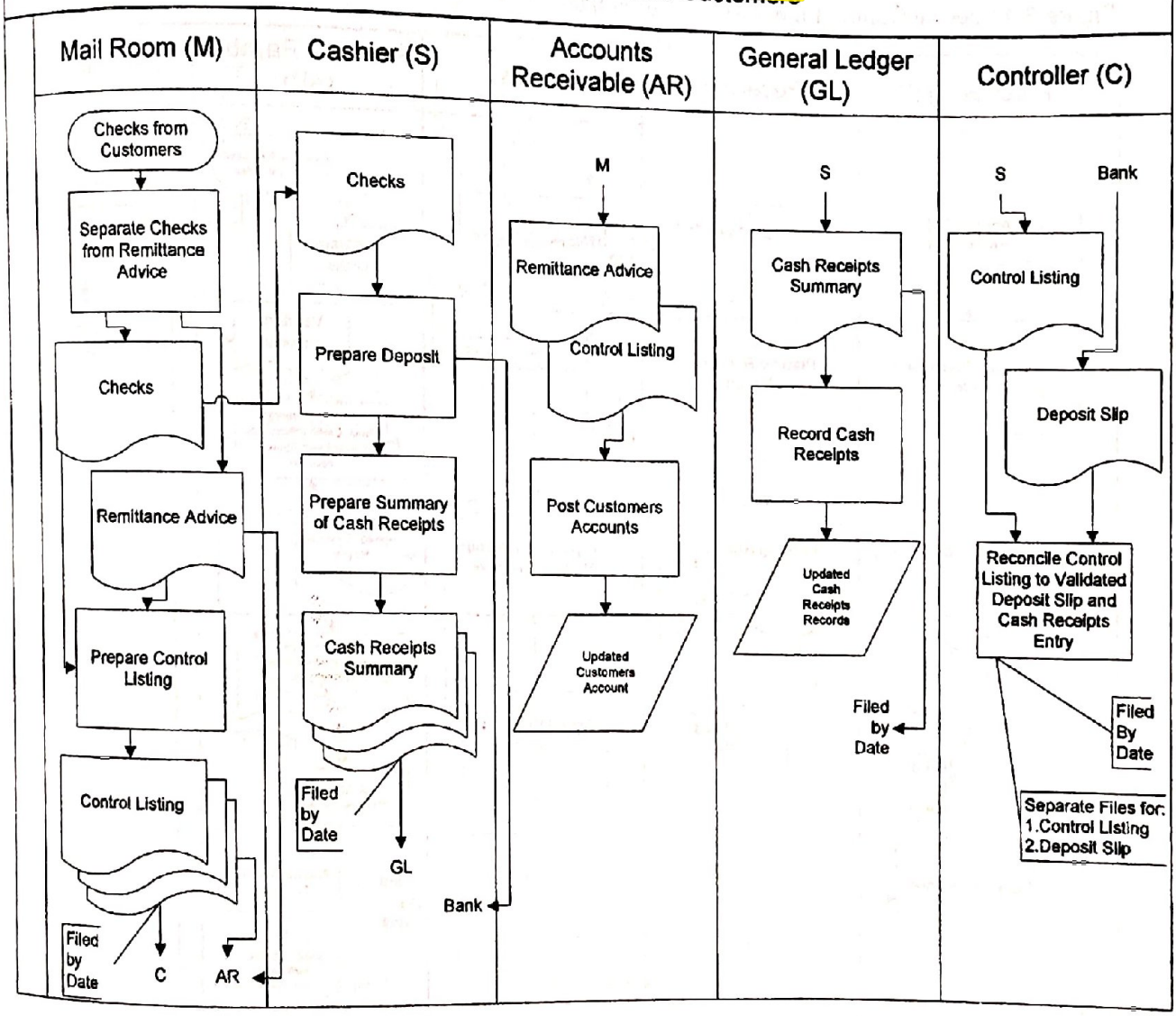


Figure 8.4 Internal Control Flowchart for Purchases

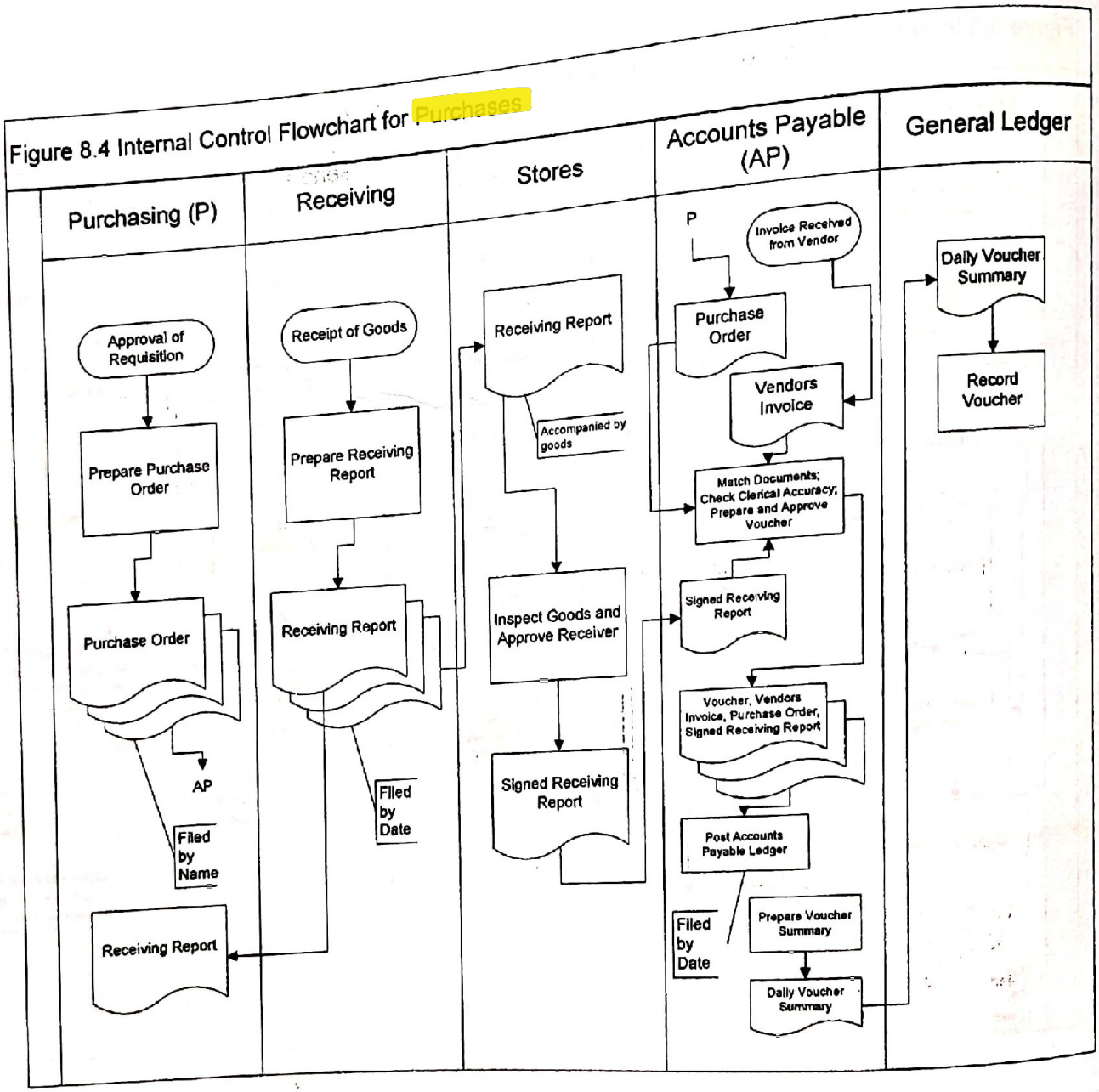


Figure 8.5 Internal Control Flowchart for Cash Disbursement

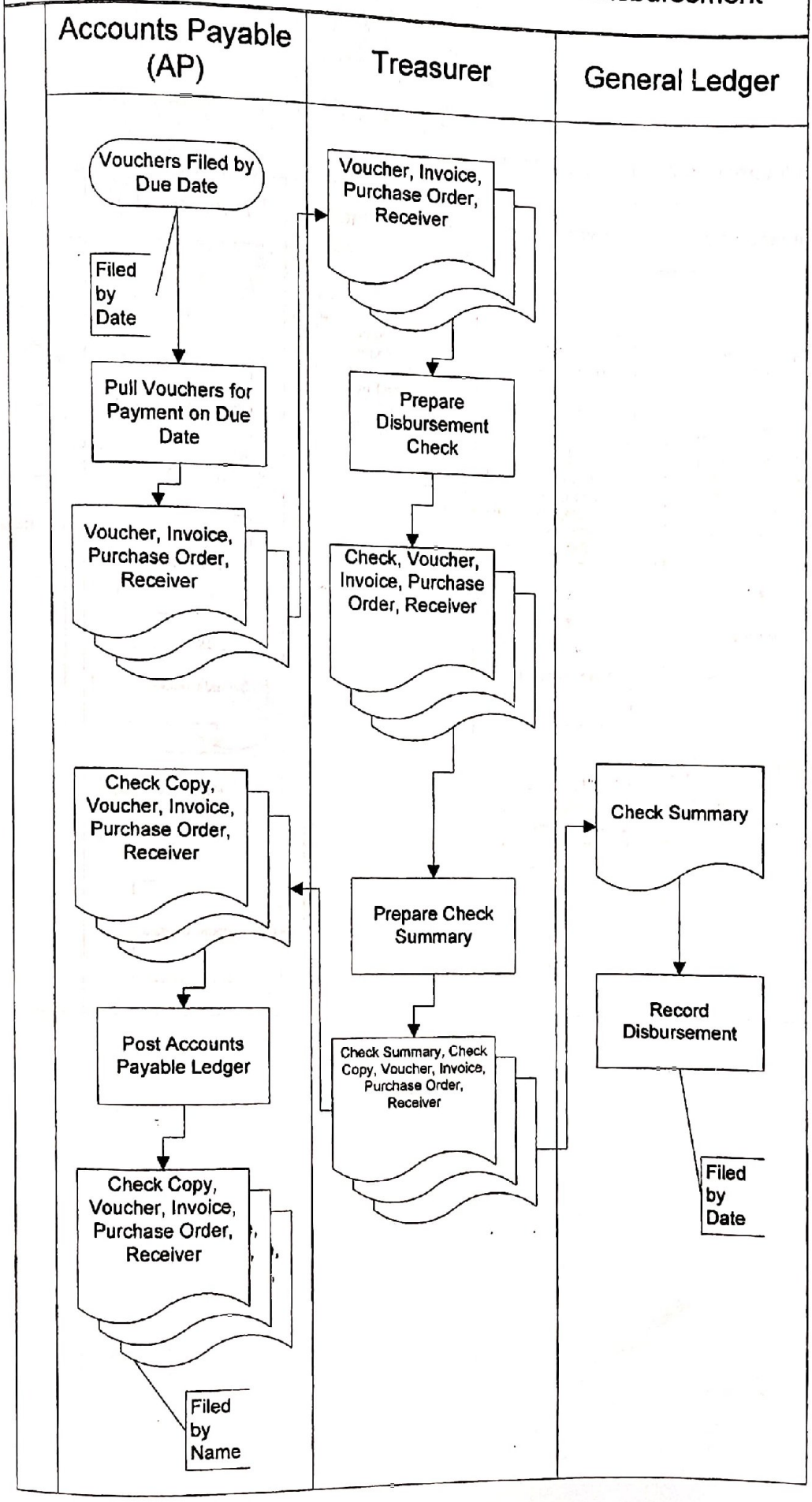


Figure 8.6 Internal Control Flowchart for Payroll

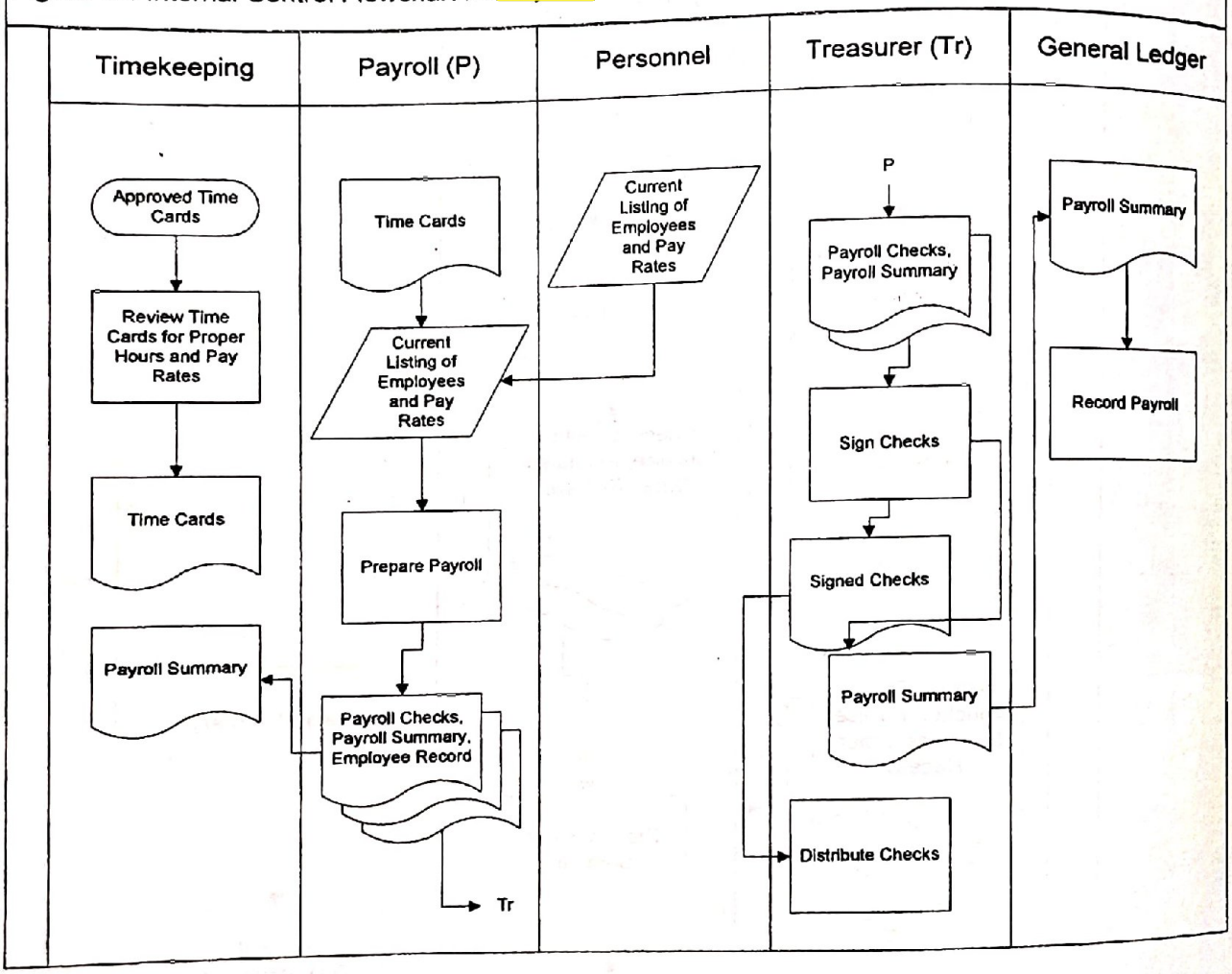


Figure 8.7 Internal Control Flowchart for Production

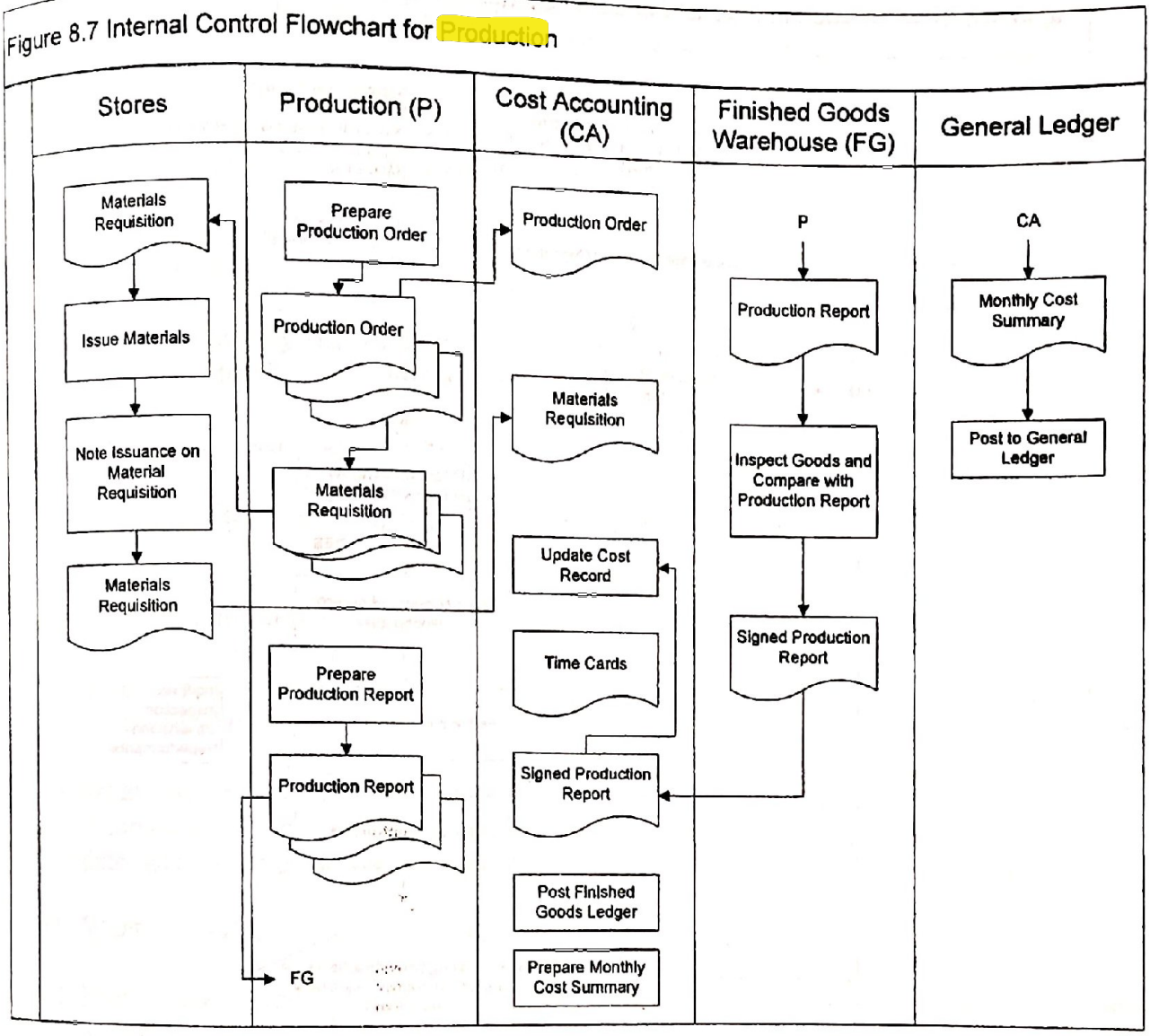
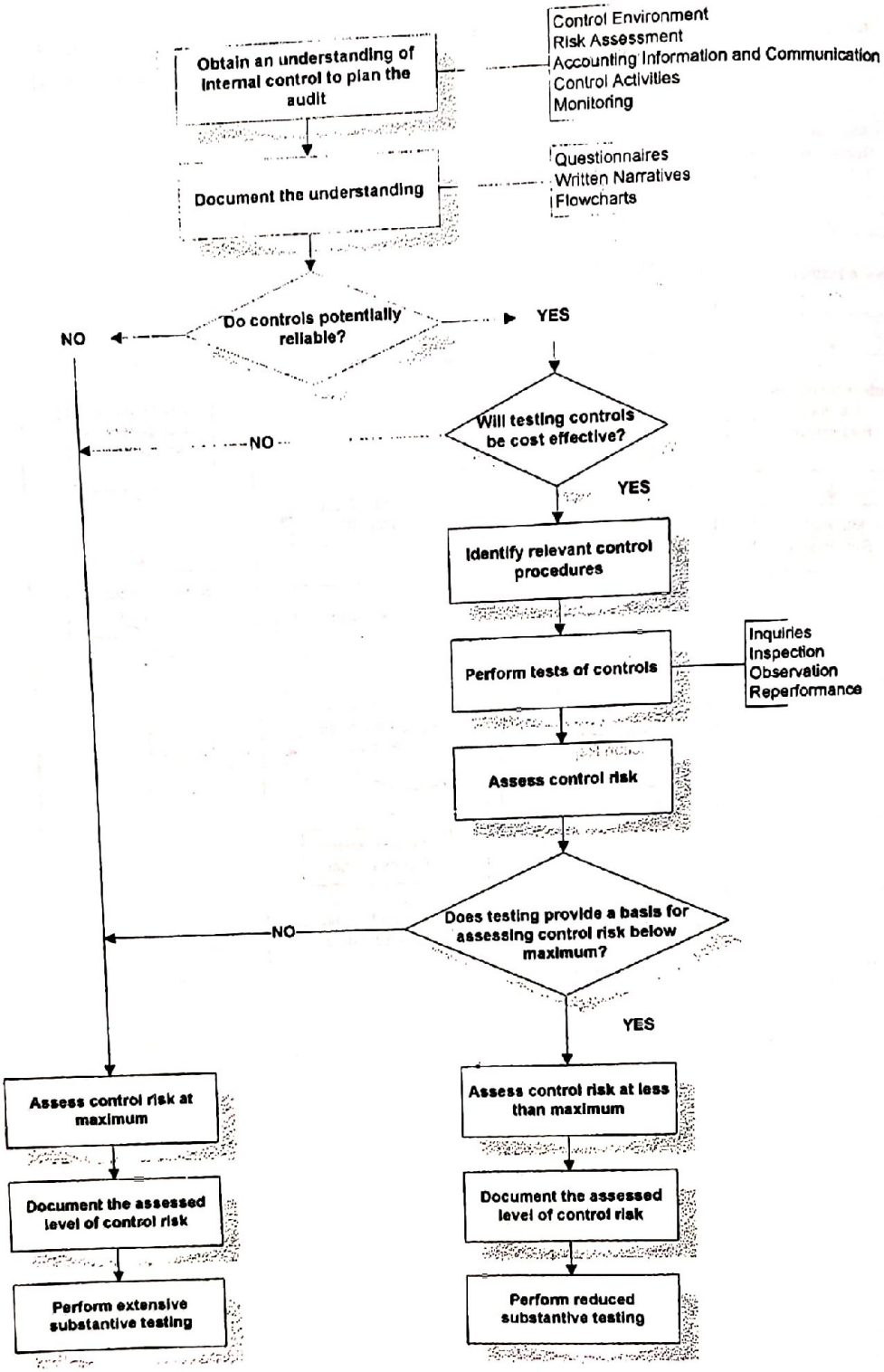


Figure 8.8 Consideration of Internal Control in a Financial Statements Audit



REVIEW QUESTIONS

1. What is internal control?
2. Identify the five components of an entity's internal control.
3. List the factors affecting the control environment.
4. How does separation of the recordkeeping function from custody of assets contribute to internal control?
5. What is meant by risk assessment component of internal control? How it contributes to internal control?
6. What are the two types of monitoring?
7. What are the types of control activities? How each type contributes to the internal control?
8. Why must the auditor obtain an understanding of internal control?
9. What is meant by the concept of reasonable assurance in terms of internal control? What are the inherent limitations of internal control?
10. What factors should the auditor consider when substantive procedures are to be completed at an interim date? If the auditor conducts substantive procedures at an interim date, what audit procedures would normally be completed for the remaining period?
11. What is a walkthrough of internal control?
12. How is the auditor's understanding of the entity's internal control documented in the audit working papers?
13. What are the advantages and disadvantages of documenting internal control by using: (a) internal control questionnaire, (b) memorandum, and (c) flowchart?
14. How does testing of internal control help in the design of substantive audit procedures?
15. What is the auditor's responsibility for communicating material weaknesses in internal control?

MULTIPLE CHOICE QUESTIONS

1. COSO treats internal control as a process designed to provide reasonable assurance regarding the achievement of objectives related to
   a. Compliance with applicable laws and regulations.
   b. Effectiveness and efficiency of operations.
   c. Reliability of financial reporting.
   d. All of the answers are correct.

2. Which of the following is a factor affecting risk?
   a. New or revamped information systems.
   b. New personnel.
   c. Rapid growth.
   d. All of the answers are correct.

3. Which of the following describes a control weakness?
   a. Normal operational purchases fall in the range from P5,000 to P10,000 with two signatures required for purchases over P10,000.
   b. Prenumbered blank purchase orders are secured within the purchasing department.
   c. Purchasing procedures are well designed and are followed unless otherwise directed by the purchasing supervisor. ~> OVERRIDE OF CONTROL
   d. The purchasing agent invests in a publicly traded mutual fund that lists the stock of one of the organization's suppliers in its portfolio.

4. To minimize the risk that agents in the purchasing department will use their positions for personal gain, the organization should
   a. Direct the purchasing department to maintain records on purchase prices paid, with review of such being required each 6 months. ~> DO IN PREVIOUS
   b. Request auditors to confirm selected purchases and accounts payable. ~> MORE DETECTIVE THAN PREVENTIVE
   c. Rotate purchasing agent assignments periodically.
   d. Specify that all items purchased must pass value-per-unit-of-cost reviews. ~> ONLY MANAGING PRICING NOT EMPLOYEE BEHAVIORS.

5. Which of the following controls could be used to detect bank deposits that are recorded but never made?
   a. Consolidating cash receiving points.
   b. Establishing accountability for receipts at the earliest possible time.
   c. Having bank reconciliations performed by a third party.
   d. Linking receipts to other internal accountabilities, for example, collections to either accounts receivable or sales.

6. Which of the following factors is most relevant when an auditor considers the client's organizational structure in the context of control risk? ~> HOW AUTHORITY AND RESPONSIBILITY ARE ASSIGNED AND REPORTED
   a. The suitability of the client's lines of reporting.
   b. The organization's recruiting and hiring practices.
   c. Physical proximity of the accounting functions to upper management.
   d. Management's attitude toward information processing and accounting departments.

7. Which of the following describes a weakness in accounts payable procedures?
   a. The accounts payable system compares the receiving report to the vendor invoice.

b. The accounts payable manager issues purchase orders.
c. The accounts payable clerk manually verifies arithmetic on the vendor invoice.
d. The accounts payable clerk files invoices and supporting documentation after payment.

8. Which of the following situations most likely could lead to an embezzlement scheme?
a. Vouchers and supporting documentation are examined and then canceled by the treasurer who personally mails the checks to vendors.
b. The accounts receivable bookkeeper receives a list of payments prepared by the cashier and personally makes entries in the customers' accounts receivable subsidiary ledger.
c. Access to blank checks and signature plates is restricted to the cash disbursements bookkeeper who personally reconciles the monthly bank statement.
d. Each vendor invoice is matched with the related purchase order and receiving report by the vouchers payable bookkeeper who personally approves the voucher for payment.

9. There is an inverse relationship that exists between the acceptable level of detection risk and the
a. Risk of misapplying audit procedures.
b. Risk of failing to discover material statements.
c. Preliminary judgment about materiality levels.
d. Assurance provided by substantive tests.

10. Control activities constitute one of the five components of internal control. Which of the following is not included in this internal control component?
a. Segregation of duties
b. Performance reviews
c. Information processing control
d. An internal audit function

11. When considering an entity's system of internal control, one of the auditor's major concerns is to ascertain whether internal control is designed to provide reasonable assurance that
a. The accounting manager reviews all accounting transactions.
b. Profit margins are maximized, and operational efficiency is optimized
c. Financial statements are fairly presented.
d. Corporate morale problems are addressed immediately and effectively.

12. Tests of controls are least likely to be omitted with regard to
a. Subsequent events
b. Accounts representing many transactions
c. Accounts representing few transactions
d. Accounts believed to be subject to ineffective controls.

13. In obtaining an understanding of internal control relevant to the audit, an auditor is required to obtain knowledge about the
a. Effectiveness of controls that have been implemented.
b. Design of the controls pertaining to internal control components.
c. Controls related to each class of transactions and account balance

d. Consistency with which controls are currently being applied.

14. Information about segregation of duties ordinarily is best obtained by
    a. Performing tests of transactions that corroborate management's financial statement assertions.
    b. Obtaining a flowchart of activities performed by entity personnel.
    c. Observing employees as they apply specific controls.
    d. Developing audit objectives that reduce control risk.

15. In a financial statement audit, the auditor is required to perform tests of controls when
    I. The auditor's risk assessment includes an expectation of operating effectiveness controls.
    II. Substantive procedures alone do not provide sufficient appropriate audit evidence at the assertion level.
    a. I only
    b. Either I or II
    c. II only
    d. Neither I nor II

16. Control risk should be assessed in terms of
    a. Control environment factors
    b. Financial statement assertions.
    c. Specific control procedures.
    d. Types of potential fraud.

17. An auditor may decide to assess control risk at the maximum level for certain assertions because the auditor believes
    a. The entity's control components are interrelated.
    b. Sufficient appropriate audit evidence to support assertions is likely to be available.
    c. More emphasis on tests of controls than substantive tests is warranted.
    d. Controls are unlikely to pertain to the assertions.

18. When an auditor increases the planned assessed level of control risk because certain controls were determined to be ineffective, the auditor would most likely increase the
    a. Level of inherent risk.
    b. Level of detection risk.
    c. Extent of tests of details.
    d. Extent of tests of controls.

19. In performing tests of the operating effectiveness of an entity's controls, an auditor selects from a variety of techniques, including
    a. Comparison and confirmation.
    b. Inquiry and analytical procedures.
    c. Inspection and verification.
    d. Reperformance and observation.

20. An auditor is least likely to test controls that provide for
    a. Segregation of the functions of recording disbursements and reconciling the bank account.
    b. Comparison of receiving reports and vendor's invoices with purchase orders.

c. Classification of revenue and expense transactions by product line.
d. Approval of the purchase and sale of trading securities.

21. When there are numerous property and equipment transactions during the year, an auditor who plans to assess control risk at a low level usually performs
a. Tests of controls and limited tests of current year property and equipment transactions.
b. Tests of controls and extensive tests of property and equipment balances at the end of the year.
c. Analytical procedures for property and equipment balances at the end of the year.
d. Analytical procedures for current year property and equipment transactions.

22. Directors, management, external auditors, and internal auditors all play important roles in creating proper control processes. Senior management is primarily responsible for
a. Reviewing the reliability and integrity of financial and operational information.
b. Implementing and monitoring controls designed by the board of directors.
c. Establishing and maintaining an organizational culture.
d. Ensuring that external and internal auditors oversee the administration of the system of risk management and control processes.

23. The most effective internal control guidance available today is the COSO's Internal Control – Integrated Framework. Which of the following is one of its conclusions?
a. The control framework is tied to the business objectives, so it is not flexible enough to be adapted without a major undertaking.
b. Operational efficiency and effectiveness are important aspects of the business.
c. Only management's participation is needed for control to be effective.
d. Internal control is limited to accounting controls.

24. Which of the following statements regarding effective control systems is false?
a. Controls should be simple.
b. Controls should measure the performance of all areas.
c. Excessive controls are costly in time and money.
d. Outdated information is inappropriate.

25. Internal control can provide only reasonable assurance that the organization's objectives and goals will be met efficiently and effectively. One factor limiting the likelihood of achieving those objectives is that
a. Management monitors performance.
b. The audit committee is active and independent.
c. The auditor's primary responsibility is the detection of fraud.
d. The cost of internal control should not exceed its benefits.

26. Which of the following are elements of the control environment?
a. Assignment of authority and responsibility.
b. Integrity and ethical value.
c. Organizational structure.
d. All of the answers are correct.

27. The policies and procedures helping to ensure that management directives are executed and actions are taken to address risks to the achievement of objectives describes

a. Control activities.
b. Control environments.
c. Monitoring.
d. Risk assessments.

28. Which of the following activities represents both an appropriate personnel department function and a deterrent to payroll fraud?
a. Authorization of additions and deletions from the payroll.
b. Authorization of overtime.
c. Collection and retention of unclaimed paychecks.
d. Distribution of paychecks.

29. The most appropriate method to prevent fraud or theft during the frequent movement of trailers loaded with valuable metal scrap from the manufacturing plant to the organization's scrap yard about 10 miles away would be to
a. Contract with an independent hauler for the removal of scrap.
b. Perform complete physical inventory of the scrap trailers before leaving the plant and upon arrival at the scrap yard.
c. Require existing security guards to log the time of plant departure and scrap yard arrival. The elapsed time should be reviewed by a supervisor for fraud.
d. Use armed guards to escort the movement of the trailers from the plant to the scrap yard.

30. A system of internal control includes physical controls over access to and use of assets and records. A departure from the purpose of such procedures is that
a. Access to the safe-deposit box requires two officers.
b. Only salespersons and sales supervisors use sales department vehicles.
c. Only storeroom personnel and line supervisors have access to the raw materials storeroom.
d. The mailroom compiles a list of the checks received in the incoming mail.

31. Management can best strengthen internal control over the custody of inventory stored in an off-site warehouse by implementing
a. Increases in insurance coverage.
b. Reconciliations of transfer slips to/from the warehouse with inventory records.
c. Regular confirmation of the amount on hand with the custodian of the warehouse.
d. Regular reconciliation of physical inventories to accounting records.

32. Which term best reflects the attitude and actions of the board and management regarding the significance of control within the organization?
a. Control activities.
b. Control environment.
c. Monitoring.
d. Risk assessment.

33. The auditor recognizes that certain limitations are inherent in any system of internal controls. Which one of the following scenarios is the result of an inherent limitation of internal control?
a. The organization sells to customers on account, without credit approval.
b. The comptroller both makes and records cash deposits.

c. An employee, who is unable to read, is assigned custody of the organization's computer tape library and run manuals that are used during the third shift.
d. A security guard allows one of the warehouse employees to remove assets from the premises without authorization.

34. Which of the following could be difficult to determine because electronic evidence may not be retrievable after a specific period?
a. The acceptance level of detection risk.
b. The assessed level of inherent risk.
c. The timing of control and substantive tests.
d. Whether to adopt substantive or reliance test strategies.

35. It is the process designed and effected by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity's objectives?
a. Accounting process
b. Business strategy
c. Internal auditing
d. Internal control

36. This internal control component is the foundation for all other components. It sets the tone of the organization, provides discipline and structure, and influences the control consciousness of employees.
a. Control activities
b. Control environment
c. Monitoring of control
d. The entity's risk assessment process

37. The internal control system that is working effectively
a. Cannot be circumvented by management
b. Eliminates risk and potential loss to the entity.
c. Is unaffected by changing circumstances and conditions encountered by the entity.
d. Reduces the need for management to review exception reports on a day-to-day basis

38. When obtaining knowledge about an entity's internal control, it is important for the auditor to consider the competence of its employees, because their competence bears directly and importantly upon the
a. Achievement of the objectives of internal control
b. Comparison of recorded accountability with assets
c. Cost-benefit relationship of internal control.
d. Timing of substantive tests to be performed.

39. The primary objective of procedures performed to obtain an understanding of internal control is to provide an auditor with
a. A basis for modifying tests of controls
b. Evidence to use in reducing detection risk.
c. Information necessary to prepare flowchart
d. Knowledge necessary to plan the audit

40. The auditor uses the understanding of internal control to

I. Identify types of potential misstatements
II. Consider factors that affect the risk of material misstatement.
III. Design the nature, timing, and extent of further audit procedures.

a. I, II, and III
b. I and III only
c. II and III only
d. I and II only

41. As a result of obtaining an understanding of an entity's internal control system, the auditor may become aware of material weaknesses in the design or implementation of internal control. The auditor is required to communicate this matter to
a. Board of Accountancy
b. Chief Executive Officers
c. Securities and Exchange Commission
d. Those charged with governance or management.

42. The auditor's primary objective in obtaining an understanding of the entity's control over purchasing function is to
a. Observe the annual physical count
b. Investigate the recording of unusual transactions regarding raw materials.
c. Determine the reliability of financial reporting by the purchasing function.
d. Ascertain that raw materials paid for are on hand

43. Tests of controls are concerned primarily with each of the following, except
a. By whom were the controls applied?
b. How were the controls applied?
c. Were the necessary controls consistently applied?
d. Why were the controls applied?

44. Regardless of the assessed level of control risk, the auditor would perform some
a. Tests of controls to determine the effectiveness of internal control policies.
b. Substantive tests to restrict detection risk for significant transaction classes.
c. Dual-purpose tests to evaluate both the risk of monetary misstatement and preliminary control risk.
d. Analytical procedures to verify the design of internal control procedures.

45. Which of the following best defines control?
a. Control accomplishes objectives and goals in an accurate, timely, and economical fashion.
b. Control is provided when cost-effective measures are taken to restrict deviations to a tolerable level.
c. Control is the result of proper planning, organizing, and directing by management.
d. Controls are statements of what the organization chooses to accomplish.

46. Which of the following presumption is correct about the reliability of evidential matter?
a. Information obtained indirectly from outside sources is the most reliable evidential matter.
b. To be reliable, evidential matter should be convincing rather than persuasive.
c. Reliability of evidential matter refers to the amount of corroborative evidence obtained.

d. An effective internal control structure provides more assurance about the reliability of evidential matter.

47. Which of the following statements regarding auditor documentation of the client's internal control is correct?
a. Documentation must include flow charts.
b. Documentation must include procedural write-ups.
c. No documentation is necessary although it is desirable.
d. No one particular form of documentation is necessary, and the extent of documentation may vary.

48. It is important for the CPA to consider the competence of the audit clients employees because their competence bears directly and importantly upon the
a. Cost/benefit relationship of the system of internal control.
b. Achievement of the objectives of the system of internal control.
c. Comparison of recorded accountability with assets.
d. Timing of the tests to be performed.

49. An auditors uses the knowledge provided by the understanding of internal control and the final assessed level of control risk primarily to determine the nature, timing , and extent of the
a. Attribute tests.
b. Compliance tests.
c. Tests of controls.
d. Substantive tests.

50. A flowchart is most frequently used by an auditor in connection with the
a. Preparation of generalized computer audit programs.
b. Documentation of the client's internal control procedures.
c. Use of statistical sampling in performing an audit.
d. Performance of analytical review procedures of account balances.

51. Which of the following are elements included in the control environment?
a. Risk assessment, assignment of responsibility, and human resource practices.
b. Organizational structure, management philosophy, and planning.
c. Integrity and ethical values, assignment of authority, and human resource policies.
d. Competence of personnel, backup facilities, laws, and regulations.

52. Which group is charged with overseeing the establishment, administration, and evaluation of the processes of risk management and control?
a. External auditors.
b. Internal auditors.
c. Operating managers.
d. Senior management.

COMPREHENSIVE CASES

CASE 1

An auditor is required to obtain a sufficient understanding of each of the components of an entity's internal control. This is necessary to plan the audit of the entity's financial statements and to assess control risk.

Required:

1. For what purpose should an auditor's understanding of internal control components be used in planning an audit?
2. What is required for an auditor to assess control risk at below the maximum level?
3. What should an auditor consider when seeking a further reduction in the planned assessed level of control risk?
4. What are the auditor's documentation requirements concerning an entity's internal control and the assessed level of control risk?

CASE 2

In all audits, the auditor should obtain an understanding of internal control sufficient to plan the audit. Internal control is defined as

A process effected by an entity's board of director's, management, and other personnel designed to provide reasonable assurance regarding the achievement of objectives in the following categories: (1) reliability of financial reporting, (2) effectiveness and efficiency of operations, and (3) compliance with applicable laws and regulations.

Required:

1. Describe the relevance of the three categories of internal control objectives relating to an audit.
2. Internal control is composed of five interrelated components. Present and briefly describe each component.
3. While each of the internal control components is related to safeguarding of assets, an auditor's consideration of safeguarding controls is generally more limited. Discuss an auditor's overall responsibility with respect to client's controls over the safeguarding of assets.

Chapter 9
AUDIT SAMPLING FOR TESTS OF CONTROLS

LEARNING OBJECTIVES

Upon completion of this chapter you will

1. **Define audit sampling.**
2. **Explain the difference between sampling and nonsampling risk.**
3. **Distinguish between statistical and nonstatistical sampling.**
4. **Describe how the basic concepts apply to audit sampling.**
5. **Distinguish between attributes and classical variables sampling plans.**
6. **Discuss the effects of changes in various population characteristics and sample requirements on required sample size.**
7. **Describe how the auditors plan, perform, and evaluate samples for test of controls.**
8. **Explain how the auditors use attributes sampling to perform test of controls.**

BASIC AUDIT SAMPLING CONCEPTS

NATURE AND PURPOSE

In the last chapter, we learned about designing tests of controls and substantive tests of transactions needed to perform an audit. Before these tests can be performed, the auditor needs to decide for each audit procedure the sample size and items to select from the population. When the auditor decides to select less than 100 percent of the population for testing for the purpose of making conclusions about the population, it is called **audit sampling.**

PSA 530, *Audit Sampling and Other Testing Procedures*, provides guidance on the use of sampling in an audit of financial statements.

Audit sampling, whether statistical or nonstatistical, is the application of an audit procedure to less than 100% of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of all the items within the balance or class of transactions.

WHY AUDITORS SAMPLE

No matter how competent the auditor or how sophisticated the software used, reviewing each account is a physical impossibility. Even if 100 percent of the information could be tested, the cost of testing would likely exceed the expected benefits to be derived. What is required is a sampling of the accounts. Also, auditor uses sampling when the nature and materiality of the balance or class does not demand a 100 percent audit.

TESTING PROCEDURES WHICH DO NOT INVOLVE SAMPLING

There are many audit procedures which do not involve sampling.

- Inquiry and observation
- Analytical review procedure
- One-hundred percent examination

- Inquiry and Observation:

a. Reviewing records for the method of accounting and other information.
b. Observing accounting procedures.
c. Discussing methods of accounting and reporting with taxpayer.
d. Scanning documents for possible issues.

- Analytical Review Procedures:
  a. Comparing records, reports and other information.
  b. Recomputing or estimating amounts.
  c. Reviewing trends in reporting.
  d. Comparing similar businesses.

- One-Hundred Percent Examination:
  a. Reviewing all fixed asset purchases, where appropriate.
  b. Examining all contracts, where there are a small number.

SAMPLING AND NONSAMPLING RISK

The auditor, in every audit engagement, is faced with uncertainty that material errors may occur and remain undetected. This uncertainty is categorized into sampling and non-sampling risk.

SAMPLING RISK

Sampling risk means the possibility that the auditor's conclusion, based on a sample, may be different from the conclusion that would have been reached if the entire population were subjected to the same audit procedure.

Exhibit 9.1 shows the sampling risk the auditor faced in both tests of control and substantive procedures.

EXHIBIT 9.1 Sampling Risk the Auditor Faced in Tests of Control and Substantive Procedures

TESTS OF CONTROL	SUBSTANTIVE PROCEDURES
▪ **Risk of Under Reliance** The risk that, although the sample result does not support the auditor's assessment of control risk, the actual compliance rate would support such an assessment.	▪ **Risk of Incorrect Rejection** The risk that, although the sample result supports the conclusion that a recorded account balance or class of transactions is materially misstated, in fact it is not materially misstated.
▪ **Risk of Over Reliance** The risk that, although the sample result supports the auditor's assessment of control risk, the actual compliance rate would not support such an assessment.	▪ **Risk of Incorrect Acceptance** The risk that, although the sample result supports the conclusion that a recorded account balance or class of transactions is not materially misstated, in fact it is materially misstated.

The risk of under reliance and the risk of incorrect rejection affect audit efficiency as they would ordinarily lead to additional work being performed by the auditor, or the entity, which would establish that the initial conclusions were incorrect. The risk of over reliance and the risk of incorrect acceptance affect audit effectiveness and are more likely to lead to an erroneous opinion on the financial statements than either the risk of under reliance or the risk of incorrect rejection.

Sample size is affected by the level of sampling risk the auditor is willing to accept from the results of the sample. The lower the risk the auditor is willing to accept, the greater the sample size will need to be.

Sampling Risk — Sample Size
lower — greater
higher — lesser

NON-SAMPLING RISK

Non-sampling risk is the risk of auditor error and arises from:

- Inappropriate or ineffective audit procedures.
- Failure to recognize errors in the sample tested.
- Misinterpretation of evidence obtained.

CONTROLLING THE RISKS

There are ways to control or minimize the sampling and non-sampling risks. Auditors control sampling risk by:

- Adjusting the sample size, and
- Using the appropriate method of selecting sample items from the population.

Auditors minimize the non-sampling risk by:

- Careful design of the audit procedures, and
- Proper instruction, adequate training, effective supervision, and review of the audit team.

STATISTICAL AND NON-STATISTICAL SAMPLING

Audit sampling methods can be divided into two general approaches: statistical and non-statistical.

STATISTICAL SAMPLING

Statistical sampling is a sampling approach that applies the laws of probability to aid the auditor in designing an efficient sample, in measuring the sufficiency of evidence obtained and in evaluating the sample results.

Table 9.1 shows the advantages and disadvantages of Statistical Sampling.

TABLE 9.1 Advantages and Disadvantages of Statistical Sampling

ADVANTAGES	DISADVANTAGES
▪ Design an efficient sample. ▪ Measure the sufficiency of evidence obtained. ▪ Quantify the sampling risk.	▪ Additional costs of ✓ Training auditors in the proper use of sampling techniques. ✓ Designing and conducting the sampling. ✓ Selecting items for examination

TYPES OF STATISTICAL SAMPLING TECHNIQUES

A. Attribute sampling
B. Monetary unit sampling
C. Classical variable sampling

NON-STATISTICAL SAMPLING

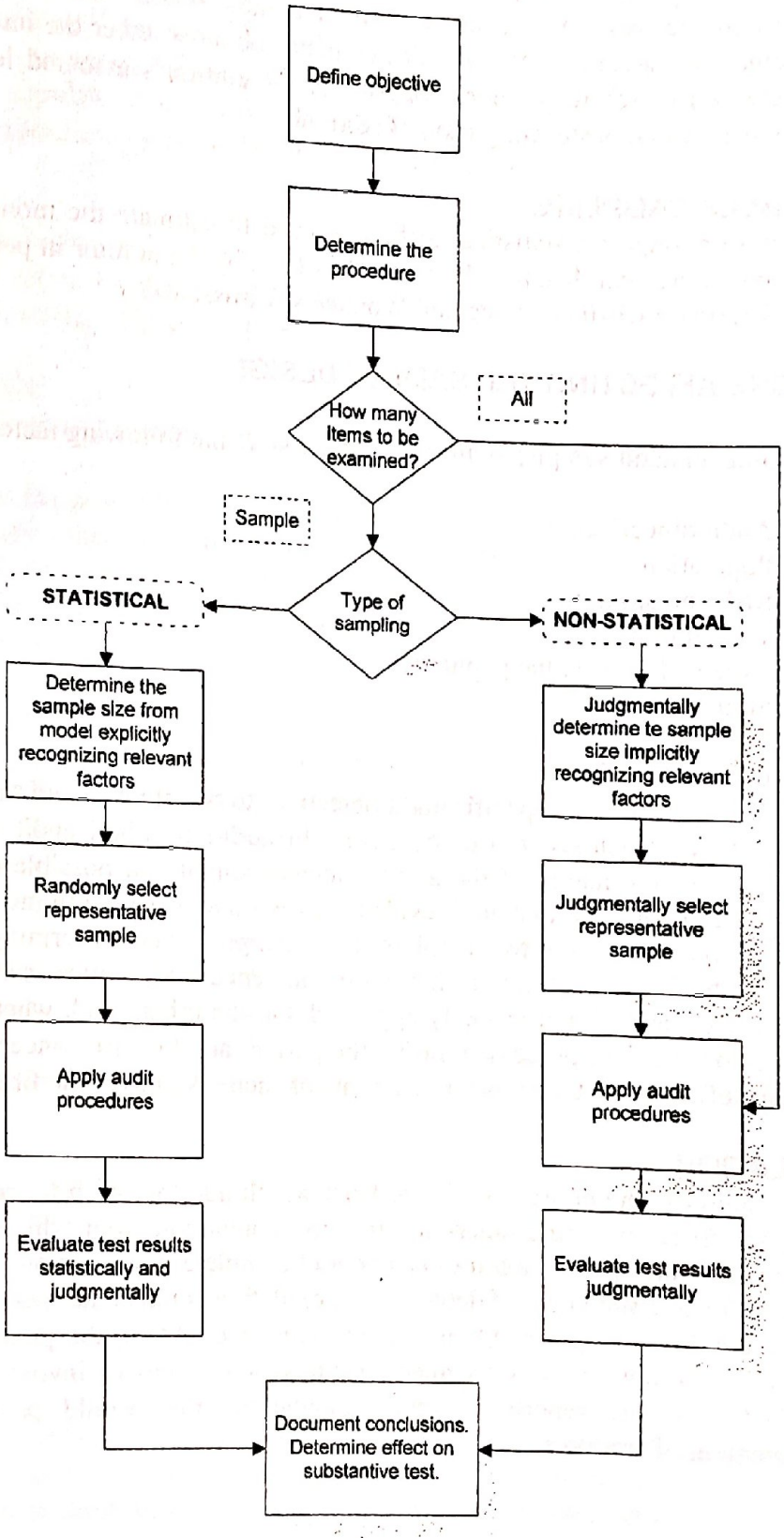
Non-statistical (judgmental) sampling is a sampling approach that relies exclusively on subjective judgment to determine the sample size and to evaluate the sample results.

TYPES OF SELECTION METHOD FOR NON-STATISTICAL SAMPLING

A. Haphazard sampling
B. Block selection
C. Judgmental sampling

Both approaches (statistical and non-statistical sampling) require the use of the auditor's professional judgment to plan, perform, and evaluate the sample evidence. In other words, the use of statistical methods does not eliminate the need to exercise judgment. A properly designed non-statistical sampling can provide results as effective as those from a properly designed statistical sampling. Both approaches are acceptable and can provide auditors with sufficient competent evidential matter. The difference between statistical and non-statistical sampling is that statistical sampling allows the auditor to measure quantitatively the sampling risk associated with the procedure. Figure 9-1 shows the relationship between the statistical and non-statistical sampling.

Figure 9-1 Relationship between Statistical and Non-Statistical Sampling



ATTRIBUTE AND VARIABLES SAMPLING

The auditor may use either attribute or variables sampling when using statistical sampling.

ATTRIBUTE SAMPLING

Attribute sampling is a statistical sampling technique used to estimate the proportion of a population that possesses a specified characteristic. The auditor wants to determine the deviation rate (occurrence rate) for a control implemented within the entity's accounting system. Measurement of deviation rate provides evidence about whether the internal control is operating effectively and therefore provides support for the auditor's assessed level of control risk. It is normally used when performing tests of controls.

VARIABLES SAMPLING

Variables sampling is a statistical technique used to estimate the monetary value of a class of transactions or account balance. It is normally used by the auditor in performing the substantive tests to determine whether an account is materially misstated.

FACTORS AFFECTING THE SAMPLE DESIGN

In designing an audit sample, auditor should consider the following factors:

- Audit objectives
- Population
- Risk and assurance
- Tolerable error
- Expected error in the population
- Stratification

AUDIT OBJECTIVES

Auditors first consider the specific audit objectives to be achieved and the audit procedures which are likely to best achieve those objectives. In addition, when audit sampling is appropriate, consideration of the nature of the audit evidence sought and possible error conditions or other characteristics relating to that audit evidence assists auditors in defining what constitutes an error and what population to use for sampling. For example, when performing tests of control over an entity's purchasing procedures, auditors are concerned with matters such as whether an invoice was clerically checked and properly approved. On the other hand, when performing substantive procedures on invoices processed during the period, auditors are concerned with matters such as the proper reflection of the monetary amounts of such invoices in the financial statements.

POPULATION

The population is the entire set of data from which auditors wish to sample in order to reach a conclusion. Auditors would determine that the population from which the sample is drawn is appropriate for the specific audit objective and complete. For example, if the auditors' objective was to test for overstatement of debtors, the population could be defined as the debtors listing. On the other hand, when testing for understatement of creditors, the population would not be the creditors listing but rather subsequent disbursements, unpaid invoices, suppliers' statements, unmatched receiving reports or other populations that would provide audit evidence of understatement of creditors.

EXAMPLE: AUDIT OBJECTIVE: TEST THE ACCURACY OF CASH DISBURSEMENTS
POPULATION: ALL CASH DISBURSEMENTS FOR 2024
SAMPLING UNIT: EACH CHECK NUMBER
PHYSICAL REPRESENTATION: THE VOUCHER FILE ROOM

The individual items that make up the population are known as *sampling units*. The population can be divided into sampling units in a variety of ways. For example, if the auditors' objective were to test the validity of debtors, the sampling unit could be defined as customer balances or individual customer invoices. Auditors define the sampling unit in order to obtain an efficient and effective sample to achieve the particular audit objectives.

The population is physically represented by some form of record. For instance, sales invoices, entries in a sales journal or summary entries in a ledger may represent total sales. The auditor actually selects sampling units from this physical representation and so must confirm that all sample units from this record are included in the entire population. If the physical representation differs from the actual population, the auditor might make erroneous conclusions about the population. A simple example of this is testing a depreciation schedule where a page of the schedule is missing.

Therefore, the auditor should be careful to determine that the records used to draw the sample are complete and reflect the actual population being tested. One means of doing this is comparing different records and reconciling differences found.

RISK AND ASSURANCE

When determining sample sizes, auditors should consider the risk involve in the audit.

Sampling risk arises from the possibility that the auditors' conclusion, based on a sample, may be different from the conclusion that would be reached if the entire population were subjected to the same audit procedure. Sampling risk for substantive procedures is one form of detection risk, which is the risk that the auditors' procedures do not detect a misstatement that exists in an account balance or class of transactions.

Sample size is affected by the level of sampling risk auditors are willing to accept from the results of the sample. The level of acceptable sampling risk depends upon the importance of the results of the audit procedure involving sampling to the auditors' conclusions. The greater the reliance on the results, the lower the sampling risk auditors are willing to accept and the greater the sample size needs to be.

The extent of reliance on the results of the procedure is related to the extent to which other substantive procedures provide audit evidence regarding the same financial statement assertion. The more other substantive procedures lower the detection risk for a particular assertion, and therefore the lower the reliance on the results of the substantive procedure using audit sampling, the higher the acceptable sampling risk relating to the sampling procedure and consequently, the smaller the sample size.

AUDIT SAMPLING IS DONE TOGETHER WITH OTHER AUDIT PROCEDURES > IF OTHER PROCEDURES ARE ALSO GIVE STRONG EVIDENCE, DR IS LOW > DR IS LOW, RELY LESS ON AUDIT SAMPLING, ACCEPT A HIGH SAMPLING RISK > HIGHER, SMALLER SAMPLE SIZE

TOLERABLE ERROR

Tolerable error is the maximum error in the population that auditors would be willing to accept and still conclude that the result from the sample has achieved the audit objective. Tolerable error is considered during the planning stage and, for substantive procedures, is related to the auditors' judgement about materiality. The smaller the tolerable error, the greater the sample size needs to be.

In tests of control, the tolerable error is the maximum rate of deviation from a prescribed control procedure that auditors would be willing to accept and still conclude that the preliminary assessment of control risk is valid. In substantive procedures, the tolerable error is the maximum

monetary error in an account balance or a class of transactions that auditors would be willing to accept so that when the results of all audit procedures are considered, auditors are able to conclude, with reasonable assurance, that the financial statements are not materially misstated.

EXPECTED ERROR IN THE POPULATION

If auditors expect errors to be present in the population, a larger sample than when no error is expected ordinarily needs to be examined to conclude that the actual error in the population is not greater than the planned tolerable error. Smaller sample sizes are justified when the population is expected to be error free.

In determining the expected error in a population, auditors would consider such matters as error levels identified in previous audits, changes in the entity's procedures and evidence available from other procedures, including tests of control.

STRATIFICATION

To assist in the efficient and effective design of the sample, stratification may be appropriate. Stratification is the process of dividing a population into sub-populations, each of which is a group of sampling units, which have similar characteristics (often monetary value). The strata need to be explicitly defined so that each sampling unit can belong to only one stratum. This process reduces the variability of the items within each stratum. Stratification enables auditors to direct audit efforts towards the items which, for example, contain the greatest potential monetary error. For example, auditors may direct attention to larger value items for debtors to detect overstated material misstatements. Consequently, stratification may result in a smaller sample size.

SAMPLE SELECTION METHOD

According to PSA 530, auditors should select sample items in such a way that the sample can be expected to be representative of the population in respect of the characteristics being tested. For a sample to be representative of the population, all items in the population are required to have an equal or known probability of being selected. While there are a number of selection methods, four methods commonly used are set out below:

- **RANDOM NUMBER SELECTION**
  Under this method, the auditor ensures that all items in the population have an equal chance of selection, for example, by use of random number tables.
- **SYSTEMATIC SELECTION**
  Systematic selection involves selecting items using a constant interval between selections, the first interval having a random start. The interval might be based on a certain number of items (for example, every 20th voucher number) or on monetary totals (for example, every P1000 increase in the cumulative value of the population). When using systematic selection, auditors would determine that the population is not structured in such a manner that the sampling interval corresponds with a particular pattern in the population. For example, if in a population of branch sales, a particular branch's sales occur only as every 100th item and the sampling interval selected is 50, the result would be that all, or none, of the sales of that particular branch would have been selected.

- **JUDGMENTAL SELECTION**
  Judgmental selection, which may be an acceptable alternative to random selection, provides the auditors an attempt to draw a representative sample from the entire

population with no intention to either include or exclude specific units. When auditors use this method, care needs to be taken to guard against making a selection that is biased, for example, towards items which are easily located, as they may not be representative.

- **STRATIFIED RANDOM SAMPLING**
  As explained previously, stratification is the process of dividing a population into sub-populations, each of which is a group of sampling units, which have similar characteristics (often monetary value).

SAMPLE SIZE

When determining the sample sizes, auditors should consider sampling risk, tolerable error, and the expected error. Table 9.2 and 9.3 shows examples of some factors affecting the sample size.

EVALUATION OF SAMPLE RESULTS

Having carried out, on each sample item, those audit procedures that are appropriate to the particular audit objective, auditors should:

- analyze any errors detected in the sample
- draw inferences for the population as a whole

ANALYSIS OF ERRORS IN THE SAMPLE

Before analyzing the errors detected in the sample, auditors would first determine that an item in question is in fact an error. In designing the sample, auditors define those conditions that constitute an error by reference to the audit objectives. For example, in a substantive procedure relating to the recording of debtors, a misposting between customer accounts does not affect the total debtors. Therefore, it may be inappropriate to consider this an error in evaluating the sample results of this particular procedure, even though it may have an effect on other areas of the audit such as the assessment of doubtful accounts.

When the expected audit evidence regarding a specific sample item cannot be obtained, auditors may be able to obtain sufficient appropriate audit evidence through performing alternative procedures. For example, if a positive debtor confirmation has been requested and no reply was received, auditors may be able to obtain sufficient appropriate audit evidence that the debtor is valid by reviewing subsequent payments from the customer. If auditors do not, or are unable to, perform satisfactory alternative procedures or if the procedures performed do not enable auditors to obtain sufficient appropriate audit evidence then the item would be treated as an error.

Auditors would also consider the qualitative aspects of the errors. These include the nature and cause of the error and the possible effect of the error on other phases of the audit.

In analyzing the errors discovered, auditors may observe that many have a common feature, for example, type of transaction, location, product line or period of time. In such circumstances, auditors may decide to identify all items in the population which possess the common feature, thereby producing a sub-population, and extend audit procedures in this area. Auditors would then perform a separate analysis based on the items examined for each sub-population.

INFERENCES TO BE DRAWN FOR THE POPULATION AS A WHOLE

This covers the projection of errors and the re-assessment of sampling risk. Auditors project the error results of the sample to the population from which the sample was selected in order to form a conclusion about the possible level of error in the population as a whole. The projection of the error results of the sample to the population as a whole involves estimating the probable error in the population by extrapolating the errors found in the sample. When projecting error results, auditors would ensure that the method of projection is consistent with the method used to select the sampling unit. This is in addition to considering the qualitative aspects of the errors found. When the population has been divided into sub-populations, the projection of errors is done separately for each sub-population and the results are combined.

Auditors would consider whether errors in the population might exceed the tolerable error. To accomplish this, auditors compare the projected population error to the tolerable error taking into account the results of other audit procedures relevant to the specific control or financial statement assertion. The projected population error used for this comparison in the case of substantive procedures is net of adjustments made by the entity. When the projected error exceeds tolerable error, auditors re-assess the sampling risk and if that risk is unacceptable, consider extending the audit procedure or perform alternative audit procedures, either of which may result in proposing an adjustment to the financial statements.

TABLE 9.2 Examples of Factors Influencing Sample Sizes for Tests of Control

Factor	Conditions Leading to	
	Smaller sample size	Larger sample size
Preliminary assessment of control risk	Higher preliminary assessment of control risk (1)	Lower preliminary assessment of control risk
Tolerable error	Higher tolerable error (ie. rate of deviation)	Lower tolerable error (ie. rate of deviation)
Acceptable risk of over reliance	Higher acceptable risk of over reliance	Lower acceptable risk of over reliance
Expected error	Lower expected error (ie. rate of deviation) in population	Higher expected error (ie. rate of deviation) in population (2)
Number of items in population	Virtually no effect on sample size unless population is small	

(1) A high preliminary assessment of control risk may result in a decision *not to perform tests of control.*

(2) High expected deviation rates may result in a decision *not to perform tests of control.*

- Preliminary assessment of control risk is inversely related to sample size. Therefore, a decrease in preliminary assessment of control risk will cause the sample size to increase.
- Tolerable error is inversely related to sample size. The smaller the tolerable error, the larger the sample size.
- Acceptable risk of over reliance is inversely related to sample size.
- Expected error has a direct effect on the sample size. The larger the expected deviation rate, the larger would be the sample size.

TABLE 9.3 Examples of Factors Influencing Sample Sizes for Substantive Tests

Factor	Conditions Leading to	
	Smaller sample size	Larger sample size
Assessment of control risk, supported by tests of control	Lower control risk	Higher control risk
Reduction in detection risk because of other substantive tests relating to the same financial statement assertions	Greater use of other substantive tests	Reduced use of other substantive tests
Tolerable error	Larger measure of tolerable error	Smaller measure of tolerable error
Expected error	Smaller expected errors, individually or in aggregate	Larger expected errors, individually or in aggregate
Population value	Smaller monetary significance to the financial statements	Larger monetary significance to the financial statements
Number of items in population	Virtually no effect on sample size unless population is small	
Acceptable level of detection risk	Higher acceptable level of detection risk	Lower acceptable level of detection risk
Stratification	Stratification of the population, if appropriate	No stratification of the population

BASIC STEPS IN AUDIT SAMPLING

Audit sampling is applied to tests of controls and substantive tests through a set of basic defined steps. The following basic steps are divided into three sections: planning, performance, and evaluation.

Planning

1. Define the test objectives.
2. Define the population characteristics.
3. Determine the sample size.

Performance

4. Select sample items.
5. Perform the auditing procedures.

Evaluation

6. Analyze exceptions.
7. Draw final conclusions.

AUDIT SAMPLING FOR TESTS OF CONTROLS

Audit sampling for tests of control is generally appropriate when application of the control leaves evidence of performance.

STEPS IN THE APPLICATION OF SAMPLING IN TESTS OF CONTROLS

Planning

1. Define the test objectives.

2. Define the population characteristics.
   - Define the sampling population.
   - Define the sampling unit.
   - Define the control deviation conditions.

3. Determine the sample size using the following inputs:
   - The desired confidence level or risk of incorrect acceptance.
   - The tolerable deviation rate.
   - The expected population deviation rate.

Performance

4. Select sample items.

5. Perform the auditing procedures.

Evaluation

6. Analyze exceptions.
   - Calculate the sample deviation and the computed upper deviation rates.

7. Draw final conclusions.

ILLUSTRATION OF ATTRIBUTE SAMPLING FOR TESTS OF CONTROLS

Planning

Step 1: Determine the Test Objectives

The objective of tests of control is to provide evidence about the design and operating effectiveness of controls. It will support the auditor's planned assessed level of control risk.

EXAMPLE

The objective of the test is to determine if the revenue process is functioning as documented. More particularly, the auditor wants to determine if the sales contracts are properly authorized for credit approval. The auditor wants to determine this control identified as reliable are operating effectively and thus allow control risk to be set below maximum level.

Step 2: Define the Population Characteristics

Define the sampling population. Auditors would determine that the population from which the sample was drawn is appropriate for the specific audit objective and complete.

Define the sampling unit. Auditors define the sampling unit in order to obtain an efficient and effective sample to achieve the particular audit objectives.

EXAMPLE

The physical representation of the population is the sales contracts maintained in the sales department. The population of the sales contracts for the year contains 125,000 items that are numbered from 1 to 125,000. The sampling unit for this test is defined as the sales contract. Auditor can perform all tests for the control.

Define the control deviation conditions. Professional judgment is used by the auditor in defining the attributes and deviation conditions for particular tests of controls. Attributes are characteristics that provide evidence that a control was actually performed. Deviation happens when a sample item does not have one or more attributes.

EXAMPLE

The deviation is the failure of the credit department personnel to follow proper credit approval procedures for new and existing customer such as

- *Checking the creditworthiness of new customers and establishing credit limit based on the evaluation and*
- *Comparing the total accounts receivable after the new order to the customer's credit limit. If it is less than the credit limit, the order is processed. If more than the credit limit, it is subject for review of the credit manager before the sale is approved.*

Step 3: Determine the Sample Size

The three factors affecting the sample size for tests of controls are:

The desired confidence level or risk of incorrect acceptance. Professional judgment is used by the auditor in determining the appropriate risk of assessing control risk too low and the tolerable deviation rate for a test of control. The risk of assessing control risk too low - that is, the risk of the actual deviation rate exceeds the tolerable deviation rate-is a critical risk in the tests of control. This is because this risk influences the effectiveness of the audit. Since the results of tests of controls play a major role in determining the nature, timing, and extent of other audit procedures, auditors usually specify a low level of risk - 5 or 10 percent is often used.

The tolerable deviation rate. Auditors specify the tolerable deviation rate based on (1) their planned assessed level of control risk, and (2) the degree of assurance desired from the evidential matter in the sample. The lower the planned level of control risk (or more assurance desired from the sample), the lower tolerable deviation rate.

The AICPA's *Auditing Procedure Study*, titled "Audit Sampling", includes the following overlapping ranges to illustrate the relationship between the planned assessed level of control risk and tolerable deviation rate:

Planned Assessed Level of Control Risk	Tolerable Deviation Rate
Low	2%-7%
Moderate	6%-12%
Slightly below maximum	11%-20%
Maximum	omit test

The expected population deviation rate. The expected population deviation rate also affects the sample size in attribute sampling. This deviation rate is significant because it represents the rate that the auditors expect to discover in their sample from the population.

In estimating the expected population deviation rate, the auditors often use the sample results from prior years, as documented in the working papers. The auditors may also estimate the rate based on their experience with similar tests for other clients or by examining a small pilot sample.

Table 9.2 shows the factors influencing sample size for tests of controls.

EXAMPLE

The auditor decides to set the desired confidence level at 95 percent (the risk of incorrect acceptance is 5 percent), the tolerable deviation rate at 6 percent, and the expected population deviation rate at 1 percent. The auditor has planned a high confidence level. The sample size is 78. (Table 9.4)

Table 9.4 is used to determine the sample size for the 95 percent desired confidence level (5 percent risk of incorrect acceptance).

Performance

Step 4: Select Sample Items

It is essential for the auditor that the sample items are selected in random manner. Random samples may be selected using random number tables, random number generators, or systematic sampling. When selecting the sample, auditors often select extra items to be substituted for any voided, unused, or inapplicable items.

Voided documents. The auditor may occasionally select voided document in a sample. If the transaction has been properly voided, it does not represent a deviation. The item should be replaced with a new sample item.

Unused or inapplicable documents. Sometimes a selected item is not appropriate for the definition of the control. The auditor would simply replace the item with another item.

EXAMPLE

Since the invoices are serially numbered, the auditor decides to use generalized audit software program to generate a list of random numbers to select the sample for testing.

Table 9.4 **Statistical Sample Sizes for Tests of Controls - 95 percent Desired Confidence Level**

Expected Population Deviation Rate (in percentage)	Tolerable Deviation Rate							
	2%	3%	4%	5%	6%	7%	8%	9%
0.00	149(0)	99(0)	74(0)	59(0)	49(0)	42(0)	36(0)	32(0)
0.25	236(1)	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)
0.50	*	157(1)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)
0.75	*	208(2)	117(1)	93(1)	78(1)	66(1)	58(1)	51(1)
1.00	*	*	156(2)	93(1)	78(1)	66(1)	58(1)	51(1)
1.25	*	*	156(2)	124(2)	78(1)	66(1)	58(1)	51(1)
1.50	*	*	192(3)	124(2)	103(2)	66(1)	58(1)	51(1)
1.75	*	*	227(4)	153(3)	103(2)	88(2)	77(2)	51(1)
2.00	*	*	*	181(4)	127(3)	88(2)	77(2)	68(2)
2.25	*	*	*	208(5)	127(3)	88(2)	77(2)	68(2)
2.50	*	*	*	*	150(4)	109(3)	77(2)	68(2)
2.75	*	*	*	*	173(5)	109(3)	95(3)	68(2)
3.00	*	*	*	*	195(6)	129(4)	95(3)	84(3)
3.25	*	*	*	*	*	148(5)	112(4)	84(3)
3.50	*	*	*	*	*	167(6)	112(4)	84(3)
3.75	*	*	*	*	*	185(7)	129(5)	100(4)
4.00	*	*	*	*	*	*	146(6)	100(4)
5.00	*	*	*	*	*	*	*	158(8)
6.00	*	*	*	*	*	*	*	*
7.00	*	*	*	*	*	*	*	*

* Sample size too large to be cost-effective for most audit applications

The number in parentheses represents the maximum number of deviations in a sample of that size that allows the auditor to conclude that the tolerable deviation rate is not exceeded.

Step 5: Perform the Audit Procedures

When testing the sample items, an auditor examines each sample item for the attributes of interest. Each item will be classified as to whether or not it contains a deviation from the prescribed control. The auditor performing the test should also be alert for evidence of any unusual matters, such as evidence of fraud or related-party transactions.

EXAMPLE

The auditors proceed to test the 78 sales contracts for proper credit authorization procedures by credit department personnel. The result can be documented in a working paper (Exhibit 9.1). Performing these tests, auditors must be alert for evidence of any unusual matters such as evidence of fraud.

Before calculating the sample results and drawing final conclusions on the sampling plan, the auditor investigates the nature and cause of the exceptions. The auditor also considers whether the deviations may impact the other phases of audit.

EXAMPLE

Two deviations were detected during the test. Auditor's investigation indicates that both deviations had occurred when sales in excess of credit limits were made to existing customers. Further investigation disclosed that the sales manager instead of credit manager had approved the sale. The auditor now knows the nature and cause of the errors.

Step 6: Calculate the Sample Deviation and the Computed Upper Deviation Rates

After testing the sample items and summarizing the deviations from a control, the auditors evaluate the sample result. Auditor may use the following steps:

1. Determine the sample deviation rate.

$$\text{Sample deviation rate} = \frac{\text{Number of deviations observed}}{\text{Sample size}}$$

2. Determine the upper deviation rate by using Table 9.5. The column for the actual number of deviations is read down until the appropriate sample size is found. Allowance for sampling risk is the difference of the upper deviation rate and sample deviation rate.

EXAMPLE

The auditor calculates the sample deviation rate and the computed upper deviation rate. The sample deviation rate is 2.6%. The upper deviation rate is 8.2% from table 9.5. The allowance for sampling risk is 5.6% (8.2%-2.6%)

Step 7: Draw Final Conclusions

The statistical conclusion about the control is made by comparing the upper deviation rate and the tolerable deviation rate.

If the upper deviation rate is less than the tolerable deviation rate, the auditor can assume that the sample results supported the planned degree of reliance on internal control or the control is operating effectively.

If the upper deviation rate exceeds the tolerable deviation rate, the auditor can conclude that the sample results do not support the auditor's preliminary assessment of control risk and therefore the scope of substantive tests should be increased.

EXAMPLE

The computed upper deviation rate (8.2%) is higher than the tolerable rate (6%) and therefore the sample results do not support the operating effectiveness or do not support the reliability of the control.

DOCUMENTATION

The auditor will document the significant aspects of the steps in application of sampling in tests of control. Exhibit 9-1 is a sample of working paper for recording the results of tests of control.

Exhibit 9.1 A Sample of Working Paper for Recording the Results of Tests of Controls

A120
RNB
4/23/11

XYZ Company
Controls Tested-Revenue Process
(Sales Contracts Are Properly Authorized for Credit Approval)
12/31/10

Sample Item	Sales Invoice Number	Remarks
1	78002	√
2	98912	√
°	°	°
23	12003	√
24	34699	D
°	°	°
55	12990	√
°	°	°
77	41902	D
78	27910	√

Number of deviations	2
Sample size	78
Sample deviation rate	2.6%
Computed deviation upper rate	8.2%
Tolerable deviation rate	6%
Auditor's decision	Does not support reliance

Tick Mark Legend

√ Sales contract examined for proper performance of control activity. No exception.
D Control not performed properly.

Table 9.5 Statistical Sampling Results Evaluation Table for Tests of Control: Achieved Upper Deviation Rate at 5 percent Risk Assessing Control Too Low

Sample Size	Actual Number of Deviations Found							
	0	1	2	3	4	5	6	7
25	11.3	17.6		*	*	*	*	*
30	9.5	14.9	19.6	*	*	*	*	*
35	8.3	12.9	17.0	*	*	*	*	*
40	7.3	11.4	15.0	18.3	*	*	*	*
45	6.5	10.2	13.4	16.4	19.2	*	*	*
50	5.9	9.2	12.1	14.8	17.4	19.9	*	*
55	5.4	8.4	11.1	13.5	15.9	18.2	*	*
60	4.9	7.7	10.2	12.5	14.7	16.8	18.8	*
65	4.6	7.1	9.4	11.5	13.6	15.5	17.4	19.3
70	4.2	6.6	8.8	10.8	12.6	14.5	16.3	18.0
75	4.0	6.2	8.2	10.1	11.8	13.6	15.2	16.9
80	3.7	5.8	7.7	9.5	11.1	12.7	14.3	15.9
90	3.3	5.2	6.9	8.4	9.9	11.4	12.8	14.2
100	3.0	4.7	6.2	7.6	9.0	10.3	11.5	12.8
125	2.4	3.8	5.0	6.1	7.2	8.3	9.3	10.3
150	2.0	3.2	4.2	5.1	6.0	6.9	7.8	8.6
200	1.5	2.4	3.2	3.9	4.6	5.2	5.9	6.5

* Over 20 percent

NON-STATISTICAL SAMPLING FOR TESTS OF CONTROL

The major differences between statistical and non-statistical sampling are the steps for:

1. Determining the sample size.
2. Selecting the sample items.
3. Calculating the computed upper deviation rate.

As in the case of statistical sampling, auditors who use non-statistical sampling need to consider the risk of assessing control risk too low and the deviation rate when determining the required sample size. But these factors need not be quantified. When evaluating results, the auditors should compare the deviation rate of the sample and the tolerable deviation rate. If the sample size was appropriate and the sample deviation rate is somewhat lower than the tolerable deviation rate, the auditors can conclude that the risk of assessing control risk too low is at an acceptable level. As the sample deviation rate gets closer to the tolerable deviation rate, it becomes less and less likely that the population's deviation rate is lower than the tolerable deviation level. The auditor must use their professional judgment to determine the point at which the assessed level of control risk should be increased above the planned level.

OTHER SAMPLING APPLICATIONS FOR TESTS OF CONTROLS

SEQUENTIAL SAMPLING (STOP-OR-GO SAMPLING)

The objective of stop-or-go sampling is to reduce the sample size. The auditor examines only enough sample items to be able to state that the deviation rate is below a prespecified rate at a prespecified level of confidence. Sample size is not fixed, so the auditor can achieve the desired result, even if the deviations are found, by enlarging the sample sufficiently.

DISCOVERY SAMPLING

Discovery sampling is a form of attribute sampling that is appropriate only when a single deviation would be critical. The occurrence rate is assumed to be at or near 0%, and the method cannot be used to evaluate the results statistically if deviations are found in the sample. Hence, discovery sampling may be used for testing controls. The sample size is calculated so that the sample will include at least one example of a deviation if it occurs in the population at a given rate. This is used most often to try to detect fraud or malfeasance when the auditor has been tipped off that there is a problem.

REVIEW QUESTIONS

1. Define audit sampling?
2. Why do auditors sample instead of examine every transaction?
3. List audit evidence choices that do not involve sampling.
4. Define and differentiate between non-statistical and statistical sampling.
5. Define attribute sampling. Why is this sampling technique appropriate for tests of controls?
6. What are the factors to be considered in designing an audit sample?
7. What is meant by stratification in audit sampling?
8. How can the auditor control sampling risk?
9. What are the factors that enter into the sample size decision?
10. In performing certain audit procedures the auditor may encounter voided documents, inapplicable documents, or missing documents. How should each of these situations be handled within the sampling application?
11. How does the relationship between the tolerable occurrence rate and the upper occurrence limit affect the auditor's decision concerning control risk assessment?
12. The auditor should perform error analysis when deviations are found in a sampling application. What are the purposes of performing error analysis?

MULTIPLE CHOICE QUESTIONS

1. In auditing sampling applications, Type I and Type II errors may occur. These risks
   a. Can be decreased by using more reliable, albeit more expensive, audit procedures.
   b. Have a magnitude based only on the economic consequences of incorrect sample-based conclusions.
   c. Refer respectively to the risks that (1) internal controls will fail and (2) the resultant error will go undetected.
   d. Result directly from the chance that the sample obtained by the auditor is unrepresentative of the population.

2. Using random numbers to select a sample
   a. Results in a representative sample.
   b. Is required for a variables sampling plan.
   c. Is likely to result in an unbiased sample.
   d. Allows auditors to use smaller samples.

3. The appropriate sampling plan to use to identify at least one irregularity, assuming some number of such irregularities exist in a population, and then to discontinue sampling when one irregularity is observed is
   a. Variables sampling.
   b. Stop-or-go sampling.
   c. Discovery sampling.
   d. Attribute sampling.

4. In a sampling application, the group of items about which the auditor wants to estimate some characteristic is called the
   a. Sampling unit.
   b. Sample.
   c. Population.
   d. Attribute of interest.

5. Which sampling plan requires no additional sampling once the first error is found?
   a. Stratified sampling.
   b. Stop-or-go sampling.
   c. Discovery sampling.
   d. Attribute sampling.

6. The risk of incorrect acceptance and the likelihood of assessing control risk too low relate to the
   a. Preliminary estimates of materiality levels.
   b. Efficiency of the audit.
   c. Effectiveness of the audit.
   d. Allowable risk of tolerable misstatements.

7. If an auditor is sampling to test compliance with a particular company policy, which of the following factors should not affect the allowable level of sampling risk?
   a. The acceptable level of risk of making an incorrect audit conclusion.
   b. The adverse consequences of noncompliance.

c. The cost of performing auditing procedures on sample selections.
d. The experience and knowledge of the auditor.

8. Random numbers can be used to select a sample only when each item in the population
   a. Can be assigned to a specific stratum.
   b. Can be identified with a unique number.
   c. Is expected to be within plus or minus three standard deviations of the population mean.
   d. Is independent of outside influence.

9. The most appropriate methodology for drawing a sample from 3,000 time cards to check for signatures would be
   a. Variables sampling.
   b. Stratified sampling.
   c. Interval sampling.
   d. Cluster sampling.

10. An advantage of using statistical over nonstatistical sampling methods in tests of controls is that the statistical methods
    a. Provide an objective basis for quantitatively evaluating sample risk.
    b. Eliminate the need to use judgment in determining appropriate sample sizes.
    c. Can more easily convert the sample into dual-purpose test useful for substantive testing.
    d. Afford greater assurance than nonstatistical sample of equal size.

11. Which one of the following is not an important consideration in determining the appropriate sample size?
    a. The amount of variability in the population under study.
    b. The cost per sample observation.
    c. The sensitivity of the decision using this sample to errors of estimation.
    d. Whether the sample is designed to estimate a mean or a proportion.

12. Management is legally required to prepare a shipping document for all movement of hazardous materials. The document must be filed with bills of lading. Management expects 100% compliance with the procedure. Which of the following sampling approaches is most appropriate?
    a. Variables sampling.
    b. Targeted sampling.
    c. Discovery sampling.
    d. Attribute sampling.

13. In assessing sampling risk, the risk of incorrect rejection and the risk of assessing control risk too high relate to
    a. Selection of the sample.
    b. Efficiency of the audit.
    c. Effectiveness of the audit.
    d. Audit quality controls.

14. For which of the following audit tests would an auditor most likely use attribute sampling?

a. Selecting accounts receivable for confirmation of account balances.
b. Making an independent estimate of the amount of a FIFO inventory.
c. Inspecting employee timecards for proper approval by supervisors.
d. Examining invoices to support of the valuation of fixed asset addition.

15. Which of the following statistical selection techniques is least desirable for use by an auditor?
a. Systematic selection.
b. Stratified selection.
c. Sequential selection.
d. Block selection.

16. If certain forms are not consecutively numbered
a. Systematic sampling may be appropriate.
b. Stratified sampling should be used.
c. Selection of a random sample probably is not possible.
d. Random number tables cannot be used.

17. As a result of tests of controls, an auditor assessed control risk too low and decreased substantive testing. This assessment occurred because the true deviation rate in the population was
a. More than the risk of assessing control risk too low, based on the auditor's sample.
b. More than the deviation rate in the auditor's sample.
c. Less than the risk of assessing control risk too low, based on auditor's sample.
d. Less than the deviation rate in the auditor's sample.

18. Which of the following statements is correct concerning statistical sampling in tests of controls?
a. There is an inverse relationship between the sample size and the tolerable rate.
b. The qualitative aspects of deviations are not considered by the auditor.
c. Deviations from control procedures at a given rate usually result in misstatements at a higher rate.
d. As the population size doubles, the sample size should also be double.

19. Which of the following combinations is a decrease in sample size in a sample for attributes?

	Risk of assessing Control risk ***Too low***	*Tolerable* ***deviation rate***	*Expected Population* ***deviation rate***
a.	Increase	Increase	Increase
b.	Increase	Increase	Decrease
c.	Increase	Decrease	Increase
d.	Decrease	Increase	Decrease

20. An auditor is planning to use attribute sampling to test the effectiveness of a specific internal control related to approvals for cash disbursements. In attribute sampling, decreasing the estimated occurrence rate from 5% to 4% while keeping all other sample size planning factors exactly the same would result in a revised sample size that would be
a. Indeterminate.
b. Larger.

c. Smaller.
d. Unchanged.

21. When an auditor's sampling objective is to obtain a measurable assurance that a sample will contain at least one occurrence of a specific critical exception existing in a population, the sampling approach to use is
a. Discovery.
b. Probability proportional to size.
c. Random.
d. Variables.

22. To project the frequency of shipments to wrong addresses, an auditor chose a random sample from the busiest month of each of the four quarters of the most recent year. What underlying concept of statistical sampling did the auditor violate?
a. Attempting to project a rate of occurrence rather than an error rate.
b. Failing to adequately describe the population.
c. Failing to give each item in the population an equal chance of selection.
d. Using multistage sampling in conjunction with attributes.

23. When planning an attribute sampling application, the difference between the expected error rate and the maximum tolerable error rate is the planned
a. Dispersion.
b. Precision.
c. Reliability.
d. Skewness.

24. In an attribute sampling application, holding other factors constant, sample size will increase as which of the following becomes smaller?
a. Population.
b. Planned precision.
c. Expected rate of occurrence.
d. Confidence coefficient.

25. A specified range is based on an estimate of a population characteristic calculated from a random sample. The probability that the range contains the true population value is the
a. Standard error of the mean.
b. Lower precision limit.
c. Error rate.
d. Confidence level.

26. Which one of the following statements about sampling is true?
a. A larger sample is always more representative of the underlying population than a smaller sample.
b. For a given sample size, a simple random sample always produces the most representative sample.
c. For very large populations, the absolute size of the sample has more impact on the precision of its results than does its size relative to its population.
d. The limitations of an incomplete sample frame can almost always be overcome by careful sampling techniques.

27. Which one of the following statements is true regarding two random samples drawn in the same way from the same population, one of size 30 and one of size 300?
    a. The larger sample is more likely to produce a large sample mean.
    b. The smaller sample will have a smaller 95% confidence interval for the mean.
    c. The smaller sample will, on the average, produce a lower estimate of the variance of the population.
    d. The two samples would have the same expected value.

28. A distinguishing characteristic of random number sample selection is that each
    a. Item in the population has an equal chance of being selected.
    b. Item is selected from a stratum having minimum variability.
    c. Item's chance for selection is proportional to its peso value.
    d. Stratum in the population has an equal number of items selected.

29. An auditor tested a population by examining 60 items selected judgmentally and found one error. The main limitation of the auditor's sample is the inability to
    a. Determine whether the sample is random.
    b. Project the population's error rate.
    c. Quantify sampling risk.
    d. Quantify the acceptable error rate.

30. The degree to which the auditor is justified in believing that the estimate based on a random sample will fall within a specified range is called
    a. Confidence level.
    b. Non-sampling risk.
    c. Precision.
    d. Sampling risk.

31. An important difference between a statistical and a judgmental sample is that with a statistical sample:
    a. Population estimates with measurable reliability can be made.
    b. No judgment is required because everything is computed according to a formula.
    c. More accurate results are obtained.
    d. A smaller sample can be used.

32. The likelihood of assessing control risk too high is the risk that the sample selected to test controls
    a. Does not support the tolerable error for some or all of management's assertions.
    b. Does not support the auditor's planned assessed level of control risk when the true operating effectiveness of the control structure justifies such assessment.
    c. Contains proportionately fewer monetary error or deviations from prescribed controls than exist in the balance or class as a whole.
    d. Contains misstatements that could be material to the financial statements when aggregated with misstatements in other account balances of transactions classes.

33. Which of the following best illustrates the concept of sampling risk?
    a. The documents related to the chosen sample may not be available for inspection.
    b. An auditor may select audit procedures that are not appropriate to achieve the specific objective.

c. An auditor may fail to recognize errors in the documents examined for the chosen sample.
d. A randomly chosen sample may not be representative of the population as a whole on the characteristic of interest.

34. The expected population deviation of client billing error is 3%. The auditor has established a tolerable rate of 5%. In the review of client invoices the auditor should use
a. Attribute sampling
b. Discovery sampling
c. Stratified sampling
d. Variable sampling

35. An underlying feature of random-based selection of items is that each
a. Item in the accounting population be randomly ordered.
b. Item in the accounting population should have an opportunity to be selected.
c. Item must be systematically selected using replacement.
d. Stratum of the accounting population be given equal representation in the sample

36. Which of the following statistical sampling plans does not use a fixed sample size to tests of controls?
a. Peso-unit sampling.
b. PPS sampling.
c. Sequential sampling.
d. Variables sampling.

37. When performing a test of a control with respect to control over cash receipts, an auditor may use a systematic sampling technique with a start at any randomly selected item. The biggest disadvantage of this type of sampling is that the items in the population
a. May occur in a systematic pattern, thus destroying the sample randomness.
b. May systematically occur more than once in the sample.
c. Must be recorded in a systematic pattern before the sample can be drawn.
d. Must be systematically replaced in the population after sampling.

38. Which of the following factors is (are) considered in determining the sample size for tests of controls?

	Expected deviation rate	*Tolerable deviation rate*
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

39. In determining the sample size for a tests of controls, an auditor should consider the likely rate of deviations, the allowable risk of assessing the control risk too low, and the
a. Nature and cause of deviations.
b. Population size.
c. Risk of incorrect acceptance.
d. Tolerable deviation rate.

40. An auditor is testing internal control procedures that are evidenced on an entity's vouchers by matching random numbers with voucher numbers. If a random number

matches the number of a voided voucher, that voucher ordinarily should be replaced by another voucher in the random sample if the voucher
a. Cannot be located.
b. Constitutes a deviation.
c. Has been properly voided.
d. Represents an immaterial peso amount.

41. The objective of the tolerable rate in sampling for tests of controls of internal control is to
a. Determine that financial statements taken as a whole are not materially in error.
b. Determine the probability of the auditor's conclusion based upon reliance factors.
c. Estimate the range of procedural deviations in the population.
d. Estimate the reliability of substantive tests.

42. Which of the following factors is generally not considered in determining the sample size for a test of controls?
a. Population size.
b. Tolerable rate.
c. Risk of overreliance.
d. Expected population deviation rate.

43. In planning a statistical sample for a test of controls, an auditor increased the expected population deviation rate from the prior year's rate because of the results of the prior year's test of controls and the overall control environment. The auditor most likely would then increase the planned
a. Tolerable rate.
b. Allowance for sampling risk.
c. Risk of assessing control risk too low.
d. Sample size.

44. Statistical sampling generally may be applied to test compliance with internal accounting control when the client's internal accounting control procedures
a. Depend primarily on appropriate segregation of duties.
b. Are carefully reduced to writing and are included in client accounting manuals.
c. Leave an audit trail in the form of documentary evidence of compliance.
d. Enable the detection of material irregularities in the accounting records.

45. An advantage of statistical sampling over nonstatistical sampling is that statistical sampling helps an auditor to
a. Eliminate the risk of nonsampling errors.
b. Reduce the level of audit risk and materiality to a relatively low amount.
c. Measure the sufficiency of the evidential matter obtained.
d. Minimize the failure to detect errors and irregularities.

46. An auditor makes separate compliance and substantive tests in the accounts payable area which has good internal control. If auditor uses statistical sampling for both of these tests, the confidence level established for the substantive test is normally
a. The same as that for tests of compliance
b. Greater than that for tests of compliance
c. Less than that for tests of compliance
d. Totally independent of that for tests of compliance

47. A CPA who believes the occurrence rate of a certain characteristic in a population being examined is 3% and who has established a maximum acceptable occurrence rate at 5% should use a (an)
    a. Attribute sampling plan.
    b. Discovery sampling plan.
    c. Stratified sampling plan.
    d. Variable sampling plan.

48. An example of sampling for attributes would be estimating the
    a. Quantity of specific inventory items
    b. Probability of losing a patent infringement case
    c. Percentage of overdue accounts receivable
    d. Peso value of accounts receivable

49. An example of sampling for attributes would be estimating the
    a. Quantity of specific inventory items
    b. Probability of losing a patent infringement case
    c. Percentage of overdue accounts receivable
    d. Dollar value of accounts receivable

50. The purpose of tests of controls is to provide reasonable assurance that the accounting control procedures are being applied as prescribed. The sampling method that is **most** useful when testing for compliance is _____.
    a. Judgment sampling
    b. Attribute sampling
    c. Unrestricted random sampling with replacement.
    d. Stratified random sampling

51. In performing a review of his client's cash disbursements, a CPA uses systematic sampling with a random start. The primary **disadvantage** of systematic sampling is that population items
    a. Must be reordered in a systematic pattern before the sample can be drawn.
    b. May occur in a systematic pattern, thus negating the randomness of the sample.
    c. May occur twice in the sample.
    d. Must be replaced in the population after sampling to permit valid statistical inference.

52. From prior experience, a CPA is aware of the fact that cash disbursements contain a few unusually large disbursements. In using statistical sampling, the CPA's best course of action is to
    a. Eliminate any unusually large disbursements which appear in the sample.
    b. Continue to draw new samples until no unusually large disbursements appear in the sample.
    c. Stratify the cash-disbursements population so that the unusually large disbursements are reviewed separately.
    d. Increase the sample size to lessen the effect of the unusually large disbursements.

53. In connection with his test of the accuracy of inventory counts, a CPA decides to use discovery sampling. Discovery sampling may be considered a special case of
    a. Judgmental sampling

b. Sampling for variables
c. Stratified sampling
d. Sampling for attributes

54. An auditor who uses statistical sampling for attributes in testing internal controls should reduce the planned reliance on a prescribed control when the
a. Sample rate of deviation is less than the expected rate of deviation used in planning the sample.
b. Tolerable rate less the allowance for sampling risk exceeds the sample rate of deviation.
c. Sample rate of deviation plus the allowance for sampling risk exceeds the tolerable rate.
d. Sample rate of deviation plus the allowance for sampling risk equals the tolerable rate.

COMPREHENSIVE CASES

CASE 1

Sampling for attributes is often used to allow an auditor to reach a conclusion concerning a rate of occurrence in a population. A common use in auditing is to test the rate of deviation from a prescribed internal control procedure to determine whether the planned assessed level of control risk is appropriate.

Required:

1. When an auditor samples for attributes, identify the factors that should influence the auditor's judgment concerning the determination of
   a. Acceptable level of risk of assessing control risk too low,
   b. Tolerable deviation rate, and
   c. Expected population deviation rate.

2. State the effect on sample size of an increase in each of the following factors, assuming all other factors are held constant:
   a. Acceptable level of risk of assessing control risk too low,
   b. Tolerable deviation rate, and
   c. Expected population deviation rate.

3. Evaluate the sample results of a test for attributes if authorizations are found to be missing on seven check requests out of a sample of 100 tested. The population consists of 2500 check requests, the tolerable deviation rate is 8%, and the acceptable level of assessing control risk too low is considered to be low.
4. How may the use of statistical sampling assist the auditor in evaluating the sample results described in #3 above?

CASE 2

BEM, CPA, is planning to use attribute sampling in order to determine the degree of reliance to be placed on an audit client's system of internal control over sales. BEM has begun to develop an outline of the main steps in the sampling plan as follows:

1. State the objective(s) of the audit test (e.g., to test the reliability of internal control over sales).
2. Define the population.
3. Define the sampling unit (e.g., client copies of sales invoices).

Required:

1. What are the remaining steps in the above outline which BEM should include in the statistical test of sales invoices? *Do not present a detailed analysis of tasks which must be performed to carry out the objectives of each step. Parenthetical examples need not be provided.*
2. How does statistical methodology help auditors to develop a satisfactory sampling plan?

Chapter 10
AUDIT SAMPLING FOR SUBSTANTIVE TESTS

LEARNING OBJECTIVES

Upon completion of this chapter you will

1. **Identify the various statistical techniques used for substantive testing.**
2. **Describe how the auditors plan, perform, and evaluate an audit sample using probability-proportional-to-size sampling.**
3. **Distinguish between mean-per-unit, ratio, and difference estimation techniques.**
4. **Describe how the auditors plan, perform, and evaluate an audit sample using the classical variables sampling methods.**

This chapter demonstrates the application of audit sampling to substantive tests of details of account balances. In Chapter 9, attribute sampling was used to determine whether the controls were operating effectively and could therefore be relied on by the auditor to generate accurate accounting information. Thus, the objective of attribute sampling was to determine the reliability of the entity's controls. In this chapter, the purpose of the sampling application is to determine if a financial statement account is fairly stated.

RISKS IN SUBSTANTIVE TESTS

As discussed in the previous chapter, the auditor, in every audit engagement, is faced with uncertainty that material errors may occur and remain undetected. This uncertainty is categorized into sampling and non-sampling risk.

Sampling risk for substantive procedures is one form of detection risk, which is the risk that the auditors' procedures do not detect a misstatement that exists in an account balance or class of transactions. Auditors are faced with sampling risk in substantive procedures as set out below:

- Risk of Incorrect Rejection (alpha risk): the risk that, although the sample result supports the conclusion that a recorded account balance or class of transactions is materially misstated, in fact it is not materially misstated. This risk affects audit efficiency as they would ordinarily lead to additional work being performed by the auditor, or the entity, which would establish that the initial conclusions were incorrect.

- Risk of Incorrect Acceptance (beta risk): the risk that, although the sample result supports the conclusion that a recorded account balance or class of transactions is not materially misstated, in fact it is materially misstated. This risk affects audit effectiveness and is more likely to lead to an erroneous opinion on the financial statements.

TYPES OF STATISTICAL TECHNIQUES

- Probability-proportional-to-size sampling technique
- Classical variables sampling technique

PROBABILITY-PROPORTIONAL-TO-SIZE (PPS) SAMPLING

PPS applies the theory of attributes sampling to estimate the total peso amount of misstatement in a population. Population is defined by the individual pesos comprising the population's book value (₱1 = 1 item).

Assumptions underlying PPS sampling:

- Expected misstatement rate in the population is small.
- Amount of misstatement in physical unit should not exceed recorded BV of the item.
- PPS focuses on overstatements.

PPS can accommodate understatement errors if special considerations are made during the evaluation of sample results.

Table 10.1 shows the advantages and disadvantages of using PPS Sampling.

TABLE 10.1 Advantages and Disadvantages of Using PPS

ADVANTAGES	DISADVANTAGES
▪ Relatively easy to use. ▪ No estimate of the standard deviation of the population is needed. ▪ Automatically stratifies the population because items are selected based on their peso amount. The larger the transactions or amounts in the population, the more likely a transaction or an amount will be selected. ▪ When there are few misstatements, the technique will generally result in a smaller sample size. ▪ Sample selection can begin before the entire population is available.	▪ Special considerations are required to handle understated amounts and negative balances. ▪ Each item in the population must have a book value. ▪ When misstatements are found, the technique might overstate the allowance for sample risk. ▪ For accounts with many misstatements, the sample size may exceed that of the classical techniques.

CLASSICAL VARIABLES SAMPLING

Classical variables sampling uses normal distribution theory to evaluate the characteristics of a population based on sample data. Auditors commonly use classical variables sampling to estimate the size of misstatement.

Table 10.2 shows the advantages and disadvantages of using Classical Variable Sampling.

TABLE 10.2 Advantages and Disadvantages of Using Classical Variable Sampling

ADVANTAGES	DISADVANTAGES
▪ When there are many misstatements in the population, variables sampling techniques will result in a smaller sample size. ▪ Items with zero and negative balances do not require any special treatment. ▪ Sample size may be somewhat easier to expand that it becomes necessary.	▪ To determine the sample size, the standard deviation of the population must be estimated. ▪ To evaluate the results, sample's standard deviation must be calculated. ▪ Variables sampling (especially mean-per-unit) usually must be stratified, requiring the use of computer to perform the computations.

There are primarily 3 kinds of classical variables samplings:

- **Difference estimation:** a sampling plan that uses the average difference between the audited or correct value of an item and its book value to project to the actual population value. DE is typically used instead of ratio estimation in cases where the differences are not proportional to book values.
- **Ratio estimation:** a sampling plan that uses the ratio of the audited or correct value of an item to its book value to project the true population value. We use RE when the calculated audit amounts are proportional to the client's book amounts.
- **Mean per unit estimation:** a sampling plan that uses the average value of sample items to estimate the true population value. It does not require the book value to estimate the true population value. MPU is sensitive to variability in a population so we usually stratify the population when we use MPU.

STEPS IN THE APPLICATION OF SAMPLING IN SUBSTANTIVE TESTS

Planning

1. Define the test objectives.

2. Define the population characteristics.
   - Define the population.
   - Define the sampling unit.
   - Define a misstatement.

3. Determine the sample size using the following inputs:
   - The desired confidence level or risk of incorrect acceptance.
   - The tolerable misstatement.
   - The expected population misstatement.
   - Population size.

Performance

4. Select sample items.

5. Perform the auditing procedures.
   - Understand and analyze any misstatements observed.

Evaluation

6. Analyze exceptions.
   - Calculate the projected misstatement and the upper limit on misstatement.

7. Draw final conclusions.

APPLICATION OF THE STEPS USING PPS TECHNIQUE FOR SUBSTANTIVE TESTS

Planning

Step 1: Determine the Test Objectives

The objective of PPS for substantive tests of details is to test the assertion that no material misstatements exist in an account balance.

The most frequent application of sampling as a substantive procedure in a financial statement audit is to test the reasonableness of assertions about a financial statement amount. It tests the assertion or hypothesis that a financial statement account is fairly stated.

EXAMPLE

The objective of the test is to determine the existence and gross valuation of recorded accounts receivable of the client. The auditor wish to test the book value of accounts receivable by confirming a sample of the accounts through direct correspondence with the customers.

Step 2: Define the Population Characteristics

Define the sampling population. The population consists of all the items that constitute the financial statement balance. The auditor must determine that the population selected is appropriate for the objective of the test.

Define the sampling unit. Auditors define the sampling unit in order to obtain an efficient and effective sample to achieve the particular audit objectives. Sampling unit is any of the individual elements that make up the population.

EXAMPLE

The client's records have 100,000 accounts recorded at a total book value of P6,250,000. The auditor believes that the customers will be able to confirm the total outstanding balance. Therefore, the account balance is used as the sampling unit instead of the individual transactions making up the balance.

Define a misstatement. A misstatement is defined as the difference between monetary amounts in the client's records and the amounts supported by audit evidence. A clear misstatement definition is important because definitions that are too narrow or too broad may result in inefficient testing.

EXAMPLE

If an accounts receivable confirmation reports a difference between the customer records and the client's records, it would not be considered a misstatement if the difference is explainable and supportable by the circumstances, such as timing differences and other documentation that supports the client's recorded value.

Step 3: Determine the Sample Size

There are factors affecting the sample size for PPS:

The desired confidence level or risk of incorrect acceptance. The risk of incorrect acceptance relates directly to the effectiveness of the substantive test of details. It measures the extent of the evidence obtained from the test – the lower the risk of incorrect acceptance, the greater amount of evidence obtained from the test.

The tolerable misstatement. The sample size is affected by the amount of tolerable misstatement – that is the maximum monetary misstatement that may exist in the account without causing the financial statements to be materially misstated.

The expected misstatement. The expected misstatement is the peso amount of misstatement that the auditor believes in the population. The auditor can develop this expectation based on the assessment of inherent risk, prior years' results, a pilot sample, the results of related substantive procedures, or the results of tests of controls. As the expected misstatement draws near the tolerable misstatement, the auditor needs more precise information from the sample. There is a direct relationship between the expected misstatement and the sample size. The larger the expected misstatement, the larger is the sample size.

Population size. Population size is directly related to sample size.

Table 10-3 summarizes the effects of the various factors on the required sample size for substantive test.

TABLE 10.3 Factors Affecting Sample Size for Substantive Tests

Factor	Examples		
	Relationship to Sample Size	Change in Factor	Effect on Sample
Desired confidence level	Direct	Lower Higher	Decrease Increase
Tolerable misstatement	Inverse	Lower Higher	Increase Decrease
Expected misstatement	Direct	Lower Higher	Decrease Increase
Population size	Direct	Lower Higher	Decrease Increase

Specifically, the sample size for PPS may be computed as follows:

$$n = \frac{PBV \times RF}{TM - (EM \times EF)}$$

n = sample size
PBV = population book value
RF = reliability factor (Table 10.4)
TM = tolerable misstatement
EM = expected misstatement
EF = expansion factor (Table 10.5)

Risk of Incorrect Acceptance (RIA)

Modification of audit risk model:

$$AR = IR \times CR \times DR$$

DR comprised of two types of substantive procedures, each with an associated type of risk:

- Risk associated with AP and other procedures that do not involve audit sampling (AP)
- Risk associated with procedures involving audit sampling (RIA)

$$AR = IR \times CR \times AP \times RIA$$

$$RIA = AR / (IR \times CR \times AP)$$

Table 10.4 Reliability Factors for Misstatements of Overstatement

Number of Overstatement Misstatements	Risk of Incorrect Acceptance						
	1%	5%	10%	15%	20%	25%	30%
0*	4.61	3.00	2.31	1.90	1.61	1.39	1.21
1	6.64	4.75	3.89	3.38	3.00	2.70	2.44
2	8.41	6.30	5.33	4.72	4.28	3.93	3.62
3	10.05	7.76	6.69	6.02	5.52	5.11	4.77
4	11.61	9.16	8.00	7.27	6.73	6.28	5.90
5	13.11	10.52	9.28	8.50	7.91	7.43	7.01
6	14.57	11.85	10.54	9.71	9.08	8.56	8.12
7	16.00	13.15	11.78	10.90	10.24	9.69	9.21
8	17.41	14.44	13.00	12.08	11.38	10.81	10.31
9	18.79	15.71	14.21	13.25	12.52	11.92	11.39
10	20.15	16.97	15.41	14.42	13.66	13.02	12.47

Source: AICPA, Auditing Procedure Study, "Audit Sampling", New York, 1996

Table 10.5 Expansion Factors for Expected Misstatement

	Risk of Incorrect Acceptance						
	1%	5%	10%	15%	20%	25%	30%
Factor	1.9	1.6	1.5	1.4	1.3	1.3	1.2

Source: AICPA, Auditing Procedure Study, "Audit Sampling", New York, 1996

EXAMPLE

The population had a book value of P6,250,000 and the auditor decided on a tolerable misstatement for the account of P364,000. Auditor assesses control risk at the maximum level and inherent risk at 100 percent and decides a 5 percent risk of incorrect acceptance (RIA). Additionally, based on prior audits, the auditor expect P50,000 of misstatement in the population.

$$n = \frac{PBV \times RF}{TM - (EM \times EF)}$$

$$n = \frac{P6{,}250{,}000 \times 3.00}{P364{,}000 - (P50{,}000 * 1.6)}$$

$$n = 66$$

Performance

Step 4: Select Sample Items

Auditor usually uses a systematic selection approach when using PPS. However, since the sampling unit is based on pesos, not individual accounts, sampling interval is also based on pesos. The sampling interval is calculated as follows:

$$SI = \frac{PBV}{n}$$

SI = sampling interval
PBV = population book value
n = sample size

$$SI = \frac{P6{,}250{,}000}{66} = P95{,}000$$

A schedule of the customer's accounts (logical sampling units) with cumulative peso total is then prepared. To determine the starting point for sampling, auditor uses a random number table, with a starting point being less than or equal to sample interval.

Step 5: Perform the Audit Procedures

The auditor conducts the planned audit procedures on the logical units containing the selected sampling units. If it involves confirming accounts receivable, the auditor performs all procedures involved in confirming accounts receivable, including following up requests for which no response was received.

EXAMPLE

The auditor sends confirmation letter to the customers selected.

Table 10.6 PPS Selection Process

Account Number	Book Value	Cumulative Total	Peso Selected	Sample Item Book Value
000001	80,000.00	80,000.00	95,000.00	80,000.00
000002	50,000.00	130,000.00		
000003	70,000.00	200,000.00	190,000.00	70,000.00
000004	60,000.00	260,000.00		
000005	1,500.00	261,500.00		
000006	5,000.00	266,500.00		
000007	20,000.00	286,500.00	285,000.00	20,000.00
°	°	°	°	°
°	°	°	°	°
°	°	°	°	°
		P6,250,000		

Evaluation

Step 6: Calculate the Projected Misstatement and the Upper Limit on the Misstatement

After the sample has been selected and procedures applied to arrive audited values for the individual accounts, the PPS is evaluated. It involves calculating the upper limit on misstatement, which is an estimate of the maximum amount of misstatement in the account. It has two components: the projected misstatement and the allowance for sampling risk. The allowance for sampling risk is made up of two other components, the basic precision and the incremental allowance. The equation to compute for upper misstatement limit is

$$ULM = PM + \underbrace{BP + IA}_{\text{Allowance for sampling}}$$

ULM = upper limit on misstatement
PM = projected misstatement
BP = basic precision
IA = incremental allowance

The projected misstatement (PM) is determined by summing the projected misstatement for each account, or other logical unit, in the sample. When the sample includes no misstatements, the projected misstatement is zero.

If misstatements do exist in the sample, the method used to project the misstatements in a particular account depends on whether or not the book value of the account found to be in error is less than the sampling interval. For accounts with book value that are less than the amount of sampling interval, the projected misstatement is calculated by multiplying the percent of misstatement in the account **(tainting)** times the sampling interval. For accounts with book values equal to or greater than the sampling interval, the actual misstatement in the account is equal to the projected misstatement.

The next step in determining the ULM involves calculating the components of the allowance for sampling risk – the basic precision (BP) and the incremental allowance (IA). The BP is always found by multiplying the reliability factor (RF) for zero misstatements from Table 10.4 by the sampling interval (SI).

When misstatements are discovered in the sample, the incremental allowance is found by:

1. Ranking the projected misstatements for the accounts with book values less than the sampling interval from largest projected misstatement to smallest projected misstatement.
2. Multiplying each projected misstatement by an incremental factor calculated from reliability factors in Table 10.4.
3. Summing the resulting amounts.

When no misstatements of accounts with book values less than the sampling interval are found in the sample, the incremental allowance is zero.

Projected misstatement (PM)

If BV < SI, PM = TF x SI

TF = tainting factor = (BV – AV) / BV
» BV = book value
» AV = audit value

If BV $\geq$ SI, PM = actual misstatement

Allowance for sampling risk

- Basic precision = SI x RF
- Incremental allowance (IA)
  - ✓ If no misstatements in sample found, IA = 0
  - ✓ If misstatements found:
    For misstatements in which BV < SI, rank order projected misstatements from largest to smallest, multiply by corresponding incremental factor (from Table 10.4) and sum to calculate IA.

After computing the incremental allowance, auditor computes for the total upper limit on misstatements (ULM). When misstatements are found, the ULM is computed by adding together the projected misstatement, the basic precision, and the incremental allowance. If no misstatements are found in the sample, the ULM consists only the basic precision.

EXAMPLE

After performing confirmation procedures, the auditor found the following three misstatements.

Book Value	Audited Value
P100	P90
2,000	1,900
102,000	102

Table 10.7 **Calculation of Upper Limit on Misstatement**

Projected **Misstatement:**

Book Value	Audited Value	Misstatement	Tainting Percentage	Sampling Interval	Projected Misstatement	
100	90	10	10%	95,000	9,500	
2,000	1,900	100	5%	95,000	4,750	
102,000	102	101,898	NA	NA	101,898	
104,100	2,092	102,008				116,148
Basic Precision		(RF 3.0 * SI P95,000)				285,000

Incremental Allowance:

Reliability Factor	Increment	(Increment-1)	Projected Misstatement	Incremental Allowance	
3.00					
4.75	1.75	0.75	9,500	7,125	
6.30	1.55	0.55	4,750	2,613	9,738
Upper Limit on Misstatement					**410,886**

Step 7: Draw Final Conclusions

After calculating the upper limit on misstatements, the auditor compares it to the tolerable misstatement for the account. If the upper limit on misstatement is less than or equal to tolerable misstatement, the sample results support the conclusion that the population is not misstated by more than tolerable misstatement at a specified level of sampling risk. If the upper limit misstatement exceeds the amount of tolerable misstatement, the sample results do not provide the auditor with enough assurance that the misstatement in the population is less than the tolerable misstatement.

Compare ULM to TM:

If ULM $\leq$ TM, conclude that population is not misstated by more than TM at the specified level of sampling risk.

If ULM > TM, conclude that the sample results do not provide enough assurance that the population misstatement is less than the TM and balance adjustment may be warranted.

EXAMPLE

Based on Table 10.7 calculation of ULM, the auditor compares the computed ULM to TM. ULM (P410,886) exceeds the amount of TM (P364,000). Auditor would not accept the population as being materially correct.

The auditor may do the following:

- *Adjustment of the account,*
- *expansion of the test,*
- *or audit report modification*

Adjustment of the account. Adjust the P102,008 in actual misstatement found in the sample (Table 9-5). After the adjustment, the ULM was reduced to P308,878 (P410,886-102,008) and enable auditor to accept the account as being materially correct.

APPLICATION OF THE STEPS USING CLASSICAL VARIABLES TECHNIQUE FOR SUBSTANTIVE TESTS

Classical variables sampling plans enable auditors to estimate a numerical quantity such as peso amount of an account balance. This makes these techniques particularly useful for performing substantive tests. Classical variables sampling method includes:

- Mean-per-unit estimation
- Ratio estimation
- Difference estimation

MEAN-PER-UNIT ESTIMATION (MPU)

MPU uses the mean audited value of the items in a sample to calculate an estimate of the total audited value of the account. An estimate of the total value of the population is obtained by multiplying the mean audited value of the sample (the sample mean) to the number of items in the population. The projected misstatement may then be calculated as the difference between the estimated total audited value and the client's book value. The general assumption for MPU is that a sample's mean audited value will, for a certain sampling risk and allowance for sampling risk, represent the true audited mean of the population.

Familiarity of the concepts of normal distribution and standard deviation is important.

The steps in the application of sampling in substantive tests will also be followed.

The following formulas are used in the MPU estimation:

Determining the Sample Size

$$n = \left(\frac{N \times U_r \times SD_E}{A} \right)^2$$

N = population size
U_r = incorrect rejection coefficient (Table 10.8)
SD_E = estimated population standard deviation
A = planned allowance for sampling risk

Standard deviation

- **Population SD** $$\sigma = \sqrt{\frac{\sum (x - \bar{X})^2}{N}}$$
- **Sample SD** $$s = \sqrt{\frac{\sum (x - \bar{X})^2}{n-1}}$$

Calculation of planned allowance for sampling risk (A)

$$A = \frac{TM}{1 + \frac{U_a}{U_r}}$$

TM = tolerable misstatement
U_a = Incorrect acceptance coefficient (Table 10.8)
U_r = incorrect rejection coefficient (Table 10.8

Adjusted Allowance for Sampling Risk (A')

$$A' = TM - \frac{N \times U_a \times SD_C}{\sqrt{n}}$$

TM = Tolerable misstatement
U_a = Incorrect acceptance coefficient (Table 10.8)
SD_C = Sample (calculated) standard deviation
n = sample size

ILLUSTRATION OF MPU ESTIMATION

(Using the same example in PPS)

Planning

Step 1: Determine the Test Objectives

EXAMPLE

The objective of the test is to determine the existence and gross valuation of recorded accounts receivable of the client. The auditor wish to test the book value of accounts receivable by confirming a sample of the accounts through direct correspondence with the customers.

Step 2: Define the Population Characteristics

EXAMPLE

The client's records have 100,000 accounts recorded at a total book value of P6,250,000. The auditor believes that the customers will be able to confirm the total outstanding balance. Therefore, the account balance is used as the sampling unit instead of the individual transactions making up the balance.

Step 3: Determine the Sample Size

EXAMPLE

The population had a book value of P6,250,000 and the auditor decided on a tolerable misstatement for the account of P364,000. Auditor assesses control risk at the maximum level and inherent risk at 100 percent and decides a 5 percent risk of incorrect acceptance (RIA). Additionally, based on prior audits, the auditor expect P50,000 of misstatement in the population. 4.6 percent of risk of incorrect rejection is planned by the auditor.

Calculation of planned allowance for sampling risk (A)

$$A = \frac{TM}{1 + \frac{U_a}{U_r}}$$

$$A = \frac{P364{,}000}{1 + \frac{1.64}{2.00}}$$

$$A = P200{,}000$$

Determining the Sample Size

$$n = \left(\frac{N \times U_r \times SD_E}{A} \right)^2$$

$$n = \left(\frac{100{,}000 \times 2.00 \times P15}{P200{,}000} \right)^2$$

$$n = 225$$

The standard deviation of P15 is calculated using the generalized audit software program used by the auditor.

Table 10.8 Risk Coefficients

Acceptable Level of Risk	Incorrect Acceptance Coefficient	Incorrect Rejection Coefficient
1.0%	2.33	2.58
4.6	1.68	2.00
5.0	1.64	1.96
10.0	1.28	1.64
15.0	1.04	1.44
20.0	0.84	1.28
25.0	0.67	1.15
30.0	0.52	1.04
40.0	0.25	0.84
50.0	0.00	0.67

Performance

Step 4: Select Sample Items

EXAMPLE

The client's accounts receivable are from residential customers and do not vary greatly in size. The auditor decides to use a random number table to select an unstratified random sample.

Step 5: Perform the Audit Procedures

EXAMPLE

The auditor sends confirmation letter to the customers selected.

Evaluation

Step 6: Evaluate the Sample Results

EXAMPLE

Using table 10.9 (summary of confirmation of 225 accounts), the mean audited value is P61 and the mean book value is P63. The mean book value of the entire population is 62.50 (P6,250,000/100,000). The difference of P0.50 per account is due to chance and is not directly used in the MPU analysis.

The confirmation results also indicate a standard deviation equals that used in planning and the adjusted allowance for sampling risk also equals the planned allowance of P200,000.

Estimated total audited value

= Mean audited value x Number of accounts
= P61 x 100,000 accounts
= P6,100,000

Acceptance interval

= Estimated total audited value +/- Adjusted allowance for sampling risk
= P6,100,000 +/- P200,000
= [P5,900,000-P6,300,000]

Projected misstatement

= Estimated total audited value – Book value of population
= P6,100,000 – P6,250,000
= P150,000 overstatement

Table 10.9 Auditors' Sample of Accounts Receivable

XYZ COMPANY
Sample of Accounts Receivable
31-Dec-21

Sample Item Number	Account Number	Account Name	Book Value	Audited Value	Difference
001	000002	Baldres, Ramil	66.44	66.44	0.00
002	000005	de Leon, Edward	44.96	43.00	1.96
003	001100	Magadia, Glenn	92.16	92.16	0.00
004	002200	Oliveros, Ma. Luisa	72.12	68.50	3.62
005	003000	Payongayong, Luzviminda	65.00	65.00	0.00
°	°	°	°	°	°
°	°	Rante, Gloria	°	°	°
°	°	Rimorin, Andrea	°	°	°
224	093212	Sarmiento, Sylvia	82.50	82.50	0.00
225	100000	Villas, Flaviniano	99.20	92.00	7.20
TOTAL VALUE (SAMPLE)			14,175.00	13,725.00	450.00
MEAN VALUES (Total Value/225)			63	61	2

Step 7: Draw Final Conclusions

When the auditors' estimate of the population's standard deviation is exactly the same as that found in the sample, the planned allowance for sampling risk may be used for evaluation purposes. If the book value falls within the interval, the sample results support the conclusion that the account balance is materially correct. If the client's book value

does not fall within the interval, the sample results indicate that the risk that the account balance is materially misstated is too high.

EXAMPLE

The client's book value of P6,250,000 falls within the acceptance interval. The sample results indicate that the client's valuation of accounts receivable is not materially misstated. The projected misstatement of P150,000 will be considered by the auditor when analyzing the total amount of potential misstatement in the financial statements. The auditor may suggest that the client correct any accounts that their test revealed to be misstated, even though the misstatements are less than tolerable misstatement amount.

RATIO ESTIMATION

In ratio estimation, the auditor uses a sample to estimate the ratio of the misstatement in a sample to its book value and project it to the entire population. The ratio of misstatements is simply the sample net misstatement divided by the book value of the items in the sample.

The projected misstatement (PM) is obtained by:

$$PM = \left(\frac{SNM}{BS}\right) PB$$

SNM = Sample net misstatement (Table 10.9)
BS = Book value sample (Table 10.9)
PB = Population book value

The estimated total audited value (ETAV) is equal to the book value of the account plus/minus the projected misstatement.

ILLUSTRATION OF RATIO ESTIMATION

(Using the same example in PPS)

$$PM = \left(\frac{SNM}{BS}\right) PB$$

$$PM = \left(\frac{P450}{P14{,}175}\right) P6{,}250{,}000$$

$$PM = P198{,}413$$

The estimated total audited value (ETAV) is P6,051,587 obtained from

$$ETAV = PB +/- PM$$

$$ETAV = P6{,}250{,}000 - P198{,}413$$

$$ETAV = P6{,}051{,}587$$

Because the PM indicates an overstatement, this difference is subtracted from the book value. (Table 10.9)

DIFFERENCE ESTIMATION

In difference estimation, the auditor uses a sample to estimate the average difference between the audited value and the book value of items in the population. The average difference is estimated by dividing the net misstatement in the sample by the number of the items in the sample. The total difference between the population book value and its estimated total audited value is determined by multiplying the estimated average difference by the number of items in the population.

$$PM = \left(\frac{SNM}{S}\right) P$$

SNM = Sample net misstatement (Table 10.9)
S = Sample items
P = Population items

ILLUSTRATION OF DIFFERENCE ESTIMATION

(Using the same example in PPS)

$$PM = \left(\frac{SNM}{S}\right) P$$

$$PM = \left(\frac{P450}{225}\right) 100{,}000$$

$$PM = P200{,}000$$

The estimated total audited value (ETAV) is P6,050,000 obtained from

$$ETAV = PB +/- PM$$

$$ETAV = P6{,}250{,}000 - P200{,}000$$

$$ETAV = P6{,}050{,}000$$

Because the PM indicates an overstatement, this difference is subtracted from the book value. (Table 10.9)

USING OF RATIO AND DIFFERENCE ESTIMATION

In using ratio and difference estimation technique, the following are required:

- Each population item has a book value
- An audited value may be determined for each sample item
- Differences between audited and book values (misstatements) are relatively frequent

When these requirements are met, ratio estimation or difference estimation is often more efficient than mean-per-unit estimation. Ratio estimation is most appropriate when the size of misstatements is nearly proportional to the book value of the items. Larger accounts have large misstatements and smaller accounts have smaller misstatements. Difference estimation is more appropriate when the size of the misstatements is not approximately proportional to book value.

NONSTATISTICAL SAMPLING FOR SUBSTANTIVE TESTS

When conducting a nonstatistical sampling for substantive tests, the auditor considers each of the steps in the application using statistical technique of sampling in substantive tests. The sampling unit for nonstatistical sampling is usually a customer account, an individual transaction, or a line item on a transaction. The following items need further explanation when using nonstatistical sampling:

- Identifying individually significant items.
- Determining the sample size.
- Selecting sample items.
- Calculating the sample results.

Identifying Individually Significant Items. The auditor determines which items should be tested and which items should be subjected to sampling. The items that will be tested individually are items that may contain potential misstatements that individually exceed the tolerable misstatement. These items are tested 100 percent because the auditor is not willing to accept any sampling risk.

Determining the Sample Size. The formula used by auditor based on AICPA Audit Guide, Audit Sampling is

$$S = \left(\frac{PB}{TM}\right) AF$$

PB = Population book value
TM = Tolerable misstatement
AF = Assurance factor

Selecting Sample Items. When using nonstatistical sampling, the auditor may use some form of random sample or systematic selection method including the haphazard sampling.

Calculating the sample Results. The AICPA Guide, Audit sampling, describes to acceptable methods of projecting the amount of misstatement found in the nonstatistical sample. These methods are:

- Ratio method (ratio estimation)
- Average difference method (difference estimation)

REVIEW QUESTIONS

1. What are the two types of statistical techniques used for substantive tests?

2. List the steps in a statistical sampling application for substantive testing.

3. How is the sampling unit defined when probability-proportional-to-size sampling is used for statistical sampling? How is the sampling unit defined when classical variables sampling is used?

4. How are the desired confidence level, tolerable misstatement and the expected misstatement related to sample size?

5. Identify advantages and disadvantages of probability-proportional-to-size sampling.

6. What are the advantages and disadvantages of classical variables sampling?

7. "When no misstatements are found in a PPS sample, the upper limit on misstatement is equal to zero." Is this statement is correct? Explain.

8. What conditions are necessary for auditors to use either the ratio or difference estimation techniques?

MULTIPLE CHOICE QUESTIONS

1. In statistical sampling methods used in substantive testing, an auditor most likely would stratify a population into meaningful groups if
   a. PPS sampling is used.
   b. The auditor's estimated tolerable misstatement is extremely small.
   c. The population has highly variable recorded amounts.
   d. The standard deviation of recorded amount is relatively small.

2. In the application of statistical technique to the estimation of peso amounts, a preliminary sample is usually taken primarily for the purpose of estimating the population
   a. Median
   b. Mode
   c. Range
   d. Variability

3. Use of ratio estimation sampling technique to estimated peso amounts is inappropriate when
   a. A book value for each sample item is unknown.
   b. The audited values are nearly proportional to the book values.
   c. The total book value is known and corresponds to the sum of all the individual book values.
   d. There are some observed differences between audited values and book values.

4. The major reason that the difference and ratio estimation methods would be expected to produce audit efficiency is that the
   a. Variability of the populations of differences or ratios is less than that of the population of book values or audited values.
   b. Calculations required in using difference or ratio estimation are less arduous and fewer than those required when using direct estimation.
   c. Beta risk may be completely ignored.
   d. A number of members of the population of differences and ratios is smaller than the number of members of the population of book values.

5. Which of the following most likely would be an advantage in using classical variables sampling rather than PPS sampling?
   a. The auditor rarely needs the assistance o f computer program to design an efficient sample.
   b. Inclusion of zero and negative balance generally does not require special design considerations.
   c. Any amount that is individually significant is automatically identified and selected.
   d. An estimate of the standard deviation of the population's recorded amounts is not required.

6. When an auditor uses peso-unit statistical sampling to examine the total value of invoices, each invoice
   a. Has an unknown probability of being selected.
   b. Has an equal probability of being selected.
   c. Has a probability proportional to its peso value of being selected.
   d. Can be represented by no more than one dollar unit.

7. The use of probability-proportional-to-size sampling is inefficient if
   a. Bank accounts are being examined.
   b. Each account is of equal importance.
   c. Statistical inferences are to be made.
   d. The number of sampling units is large.

8. An auditor for the state highway and safety department needs to estimate the average highway weight of tractor-trailer trucks using the state's highway system. Which estimation method must be used?
   a. Mean-per-unit.
   b. Difference.
   c. Ratio.
   d. Probability proportional to size.

9. Difference estimation sampling would be appropriate to use to project the peso error in a population if
   a. Virtually no differences between the individual carrying amounts and the audited amounts exist.
   b. Subsidiary ledger book balances for some individual inventory items are unknown.
   c. Observed differences between carrying amounts and audited amounts are proportional to carrying amounts.
   d. A number of nonproportional differences between carrying amounts and audited amounts exist.

10. In selecting a sample of items for variables testing, an auditor must consider the desired precision, the standard deviation, and the
    a. Sampling interval.
    b. Recorded a peso amount of the population.
    c. Expected occurrence rate.
    d. Acceptable risk level.

11. What effect does an increase in the standard deviation have on the required sample size of mean-per-unit estimation and probability-proportional-to-size sampling? Assume no change in any of the other characteristics of the population and no change in desired precision and confidence.

	Mean-per-Unit Estimation	*Probability Proportional to Size*
a.	No change in sample size	Decrease in sample size
b.	Increase in sample size	No change in sample size
c.	Increase in sample size	Increase in sample size
d.	Decrease in sample size	No change in sample size

12. The auditor for an insurance company is conducting an audit of claims processing and wants to assess the average length of time that it takes to process automobile claims to determine whether processing is being completed within standards set by company policy. The auditor plans to take a sample of claims made during the year and perform the needed analysis.
    The most appropriate sampling method is
    a. Probability proportional to size.
    b. Mean-per-unit variables sampling.
    c. Discovery sampling.
    d. Attribute sampling.

13. How would increases in tolerable misstatements and assessed level of control risk affect the sample size in substantive test of details?

	Increase in tolerable Misstatement	*Increase in assessed level of control risk*
a.	Decrease sample size	Decrease sample size
b.	Decrease sample size	Increase sample size
c.	Increase sample size	Decrease sample size
d.	Increase sample size	Increase sample size

14. Which of the following sample planning factors would influence the sample size for a substantive test of details for a specific account?

	Expected Amount of Misstatements	*Measure of tolerable Misstatements*
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

15. A number of factors influences the sample size for a substantive test of details of an account balance. All other factors being equal, which of the following would lead to a larger sample size?
    a. Smaller measure of tolerable misstatement.
    b. Smaller expected frequency of errors.
    c. Greater reliance on internal control.
    d. Greater reliance on analytical procedures.

16. An auditor established a P60,000 tolerable misstatement for an asset with an account balance of P1,000,000. The auditor selected a sample of every twentieth item from the population that represented the asset account balance and discovered overstatements of P3,700 and understatements of P200. Under these circumstances, the auditor most likely would conclude
    a. There is an unacceptably high risk that the tolerable misstatement exceeds the sum of actual overstatements and understatements.
    b. There is an unacceptably high risk that the actual misstatements in the population exceed the tolerable misstatement because the total projected misstatement is more than the tolerable misstatement.
    c. The asset account is fairly stated because the total projected misstatement is less than the tolerable misstatement.
    d. The asset account is fairly stated because the tolerable misstatement exceeds the net projected actual overstatements and understatements.

17. The measure of variability of a statistical sample that serves as an estimate of the population variability is the
    a. Basic precision.
    b. Range.
    c. Standard deviation.
    d. Confidence interval.

18. Using statistical sampling to assist in verifying the year-end accounts payable balance, an auditor has accumulated the following data:

	Number of Accounts	*Book balances*	*Balance determined by the auditor*
Population	4,100	P5,000,000	?
Sample	200	250,000	P300,000

    Using the ratio estimation technique, the auditor's estimate of year-end accounts payable balance would be?
    a. P5,050,000
    b. P5,125,000
    c. P6,000,000
    d. P6,150,000

19. An auditor is designing a stratified, mean-per-unit variables sampling plan. To which one of the following strata should the auditor allocate the largest proportion of the overall sample size?

	Number of Items	Expected Mean	Expected Standard Deviation	Total Peso Value
a.	3,100	P150	P1	P465,000
b.	3,000	P80	P2	P240,000
c.	2,250	P200	P4	P450,000
d.	2,000	P100	P9	P200,000

20. An auditor is performing a test to determine whether a gas and electric appliance manufacturer should move its service center from one location to another. The service center houses the service trucks that are used to drive to the customers' locations to service their appliances. The auditor wants to determine the reduction in average miles driven as a result of moving to the other location. Which of the following statistical sampling methods would be most appropriate for this test?
    a. Probability-proportional-to-size (peso-unit) sampling.
    b. Mean-per-unit sampling.
    c. Discovery sampling.
    d. Attribute sampling.

21. In which of the following situations will monetary-unit sampling be more effective and efficient than ratio estimation?
    a. The population is expected to contain few differences between the recorded amount and the actual amount.
    b. The population has a low degree of variability in peso amount.
    c. The population has a high degree of variability in peso amount.
    d. The population contains a large number of differences between the recorded amount and the actual amount.

22. An auditor is determining the sample size for an inventory observation using mean-per-unit estimation. To calculate the required sample size, the auditor usually determines the

	Variability in the Peso amounts of Inventory items	Risk of incorrect acceptance
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

23. The use of ratio estimation sampling technique is most effective when
    a. A relatively small number of differences exist in the population.
    b. Estimating population whose records consist of quantities, but not book values.
    c. Large overstatement differences and larger understatement differences exist in the population.
    d. The calculated audit amounts are approximately proportional to the client's book amounts.

24. An auditor is performing substantive tests of pricing and extensions of perpetual inventory balances consisting of a large number of items. Past experience indicates numerous pricing and extension errors. Which of the following statistical sampling approaches is most appropriate?

a. PPS
b. Ratio estimation
c. Stop or go
d. Unstratified mean-per-unit

25. Ram has decided to use PPS sampling. Ram plans to use the following PPS sampling table:

Reliability Factors for Misstatements of Overstatement

Number of Overstatement Misstatements	Risk of Incorrect Acceptance						
	1%	5%	10%	15%	20%	25%	30%
0*	4.61	3.00	2.31	1.90	1.61	1.39	1.21
1	6.64	4.75	3.89	3.38	3.00	2.70	2.44
2	8.41	6.30	5.33	4.72	4.28	3.93	3.62
3	10.05	7.76	6.69	6.02	5.52	5.11	4.77
4	11.61	9.16	8.00	7.27	6.73	6.28	5.90
5	13.11	10.52	9.28	8.50	7.91	7.43	7.01
6	14.57	11.85	10.54	9.71	9.08	8.56	8.12
7	16.00	13.15	11.78	10.90	10.24	9.69	9.21
8	17.41	14.44	13.00	12.08	11.38	10.81	10.31
9	18.79	15.71	14.21	13.25	12.52	11.92	11.39
10	20.15	16.97	15.41	14.42	13.66	13.02	12.47

Additional information:

Tolerable misstatement (net of effect of expected misstatements)	P24,000
Risk of incorrect acceptance	20%
Number of misstatements	1
Recorded amount of accounts receivable	P240,000
Number of accounts	360

What sample size should Ram use?
a. 30
b. 60
c. 108
d. 120

26. In a PPS with sampling interval of P5,000, an auditor discovered that a selected accounts receivable with a recorded amount of P10,000 had an amount of P8,000. If this were the only error discovered by the auditor, the projected error of this sample would be
a. P5,000
b. P4,000
c. P2,000
d. P1,000

27. Which of the following statements is correct concerning the auditor's use of statistical sampling?
a. The selection of zero balances usually does not require special sample design considerations when using PPS sampling.
b. An auditor needs to estimate the peso amount of the standard deviation of the population to use classical variables sampling.

c. An assumption of PPS sampling is that the underlying accounting population is normally distributed.
d. A classical variables sample needs to be designed with special considerations to include negative balance in the sample.

28. An auditor is planning to use monetary-unit sampling for testing the dollar value of a large accounts receivable population. The advantages of using monetary-unit sampling (MUS) include all of the following except
a. It results in a smaller sample size than classical variables sampling for larger numbers of misstatements.
b. It is an efficient model for establishing that a low error rate population is not materially misstated.
c. It does not require the normal distribution approximation required by variables sampling.
d. It can be applied to a group of accounts because the sampling units are homogenous.

29. Monetary-unit sampling (MUS) is most useful when the auditor
a. Is testing the accounts payable balance.
b. Is concerned with overstatements.
c. Expects to find several material misstatements in the sample.
d. Cannot cumulatively arrange the population items.

30. When relatively few items of high peso-value constitute a large proportion of an account balance, stratified sampling techniques and complete testing of the high peso-value items will generally result in a
a. Smaller nonsampling error.
b. Simplified evaluation of sample results.
c. Reduction in sample size.
d. Larger estimate of population variability.

31. If all other factors in a sampling plan are held constant, changing the measure of tolerable misstatement to a smaller value will cause the sample size to be
a. Unchanged.
b. Smaller.
c. Larger.
d. Indeterminate.

32. Which of the following techniques could be used to estimate the standard deviation for a sampling plan?
a. Regression.
b. Ratio estimation.
c. Pilot sample.
d. Discovery sampling.

33. The auditor wishes to sample the perpetual inventory records to develop an estimate of the dollar amount of misstatement, if any, in the account balance. The account balance is made up of a large number of small value items and a small number of large value items. The auditor has decided to audit all items over P50,000 plus a random selection of others. This audit decision is made because the auditor expects to find a large amount of errors in the perpetual inventory records, but is not sure that it will be enough to justify taking a

complete physical inventory. The auditor expects the errors to vary directly with the value recorded in the perpetual records.
The most efficient sampling procedure to accomplish the auditor's objectives is
a. Attribute sampling.
b. Peso unit sampling.
c. Ratio estimation.
d. Stratified mean-per-unit sampling.

34. Which of the following courses of action would an auditor most likely follow in planning a sample of cash disbursements if auditor is aware of several unusually large cash disbursements?
a. Continue to draw new samples until all unusually large disbursements appear in the sample.
b. Increase the sample size to reduce the effect of the unusually large disbursements.
c. Set the tolerable rate of deviation at a lower level than originally planned.
d. Stratify the cash disbursements population so that unusually large disbursements are selected.

35. When planning a sample for a substantive test of details, an auditor should consider tolerable misstatements for the sample. This consideration should
a. Be related to preliminary judgments about materiality levels.
b. Be related to the auditor's business risk.
c. Not be adjusted for qualitative factors.
d. Not be changed during the audit process.

36. In estimation sampling for variables, which of the following must be known in order to estimate the appropriate sample size required to meet the auditor's needs in given situation?
a. The acceptable level of risk.
b. The estimated rate of misstatements in the population.
c. The peso amount of the population.
d. The qualitative aspects of errors.

37. For which of the following sample results is sampling risk the smallest?

	Sample Size	*Tolerable Deviation Rate*	*Sample Deviation Rate*
a.	100	1%	1%
b.	40	5%	2%
c.	60	5%	1%
d.	80	4%	3%

38. Which of the following factors would most likely preclude the auditor from using monetary-unit sampling?
a. Individual accounts are not assigned a number, but are listed only alphabetically.
b. The auditor expects to find a limited number of understatements of individual account balances.
c. The auditor expects to find more errors in the larger peso value items than in the smaller peso value items.

d. The auditor expects to find that a large percentage of items sampled have misstatements.

39. Which of the following statements is correct concerning PPS sampling?
    a. Overstated units have a lower probability of sample selection than units that are understated.
    b. The auditor controls the risk of incorrect acceptance by specifying that risk level for the sampling plan.
    c. The sampling distribution should approximate the normal distribution.
    d. The sampling interval is calculated by dividing the number of physical units in the population by the sample size.

40. Ratio estimation sampling would be inappropriate to use to project the peso error in a population if
    a. A number of observed differences exist between carrying amounts and audited amounts.
    b. Observed differences between carrying amounts and audited amounts are proportional to carrying amounts.
    c. Subsidiary ledger book balances for some inventory items are unknown.
    d. The recorded carrying amounts and audited amounts are approximately proportional.

41. Which of the following techniques could be used to estimate the standard deviation for a sampling plan?
    a. Difference estimation.
    b. Discovery sampling.
    c. Pilot sample.
    d. Regression analysis.

42. Which of the following would be designed to estimate a numerical measurement of a population, such as a peso value?
    a. Sampling for variables
    b. Sampling for attributes.
    c. Discovery sampling.
    d. Judgmental sampling.

43. In estimation sampling for variables, which of the following must be known in order to estimate the appropriate sample size required to meet the auditor's needs in a given situation?
    a. The total amount of the population.
    b. The desired standard deviation.
    c. The desired confidence level.
    d. The estimated rate of error in the population.

44. In statistical sampling methods used in substantive testing, an auditor most likely would stratify a population into meaningful groups if
    a. Probability proportional to size (PPS) sampling is used.
    b. The population has highly variable recorded amounts.
    c. The auditor's estimated tolerable misstatement is extremely small.
    d. The standard deviation of recorded amounts is relatively small.

45. The use of the ratio estimation sampling technique is most effective when
    a. The calculated audit amounts are approximately proportional to the client's book amounts.
    b. A relatively small number of differences exist in the population.
    c. Estimating populations whose records consist of quantities, but **not** book values.
    d. Large overstatement differences and large understatement differences exist in the population.

46. In estimation sampling for variables, which of the following must be known in order to estimate the appropriate sample size required to meet the auditor's needs in a given situation?
    a. The total amount of the population.
    b. The desired standard deviation.
    c. The desired confidence level.
    d. The estimated rate of error in the population.

47. While performing a substantive test of details during an audit, the auditor determined that the sample results supported the conclusion that the recorded account balance was materially misstated. It was, in fact, not materially misstated. This situation illustrates the risk of
    a. Incorrect rejection.
    b. Incorrect acceptance.
    c. Overreliance.
    d. Underreliance.

48. As a result of tests of controls, an auditor overrelied on internal control and decreased substantive testing. This overreliance occurred because the true deviation rate in the population was
    a. Less than the risk of overreliance on the auditor's sample.
    b. Less than the deviation rate in the auditor's sample.
    c. More than the risk of overreliance on the auditor's sample.
    d. More than the deviation rate in the auditor's sample.

49. In performing substantive tests, the auditor is concerned with two risks or errors of sampling: the risk of incorrect rejection (also known as Alpha or Type I error) and the risk of incorrect acceptance (also known as Beta or Type II error). Which of the following is **true** about alpha and beta errors?
    a. Neither the alpha error nor the beta error need be considered by the auditor.
    b. The alpha error is of greater concern to the auditor than the beta error.
    c. The beta error and the alpha error are of equal importance to the auditor.
    d. The beta error is greater concern to the auditor than the alpha error.

COMPREHENSIVE CASES

CASE 1

An auditor has obtained the following data by selecting a random sample from an inventory population:

	Number of Items	*Audited Value*	*Carrying Amount*
Sample	200	P220,000	P200,000
Population	5,000		5,200,000

Required:

1. The estimate of the population peso value using mean-per-unit sampling is
2. The estimate of the population peso value using difference estimation sampling is
3. The estimate of the population peso value using ratio estimation is

CASE 2

RNB has decided to use PPS sampling in an audit of client's accounts receivable balance. RNB has evaluated the client's internal control and anticipates that misstatements will be found in the account balance.

RNB plans to use the following PPS sampling tables:

Expansion Factors for Expected Misstatement

	Risk of Incorrect Acceptance						
	1%	5%	10%	15%	20%	25%	30%
Factor	1.9	1.6	1.5	1.4	1.3	1.3	1.2

Source: AICPA, Auditing Procedure Study, "Audit Sampling", New York, 1996

Reliability Factors for Misstatements of Overstatement

Number of Overstatement Misstatements	Risk of Incorrect Acceptance						
	1%	5%	10%	15%	20%	25%	30%
0*	4.61	3.00	2.31	1.90	1.61	1.39	1.21
1	6.64	4.75	3.89	3.38	3.00	2.70	2.44
2	8.41	6.30	5.33	4.72	4.28	3.93	3.62
3	10.05	7.76	6.69	6.02	5.52	5.11	4.77
4	11.61	9.16	8.00	7.27	6.73	6.28	5.90
5	13.11	10.52	9.28	8.50	7.91	7.43	7.01

Source: AICPA, Auditing Procedure Study, "Audit Sampling", New York, 1996

RNB also determined the following information:

Tolerable misstatement	P 40,000
Expected misstatement	10,000
Recorded amount of accounts receivable	600,000
Risk of incorrect acceptance	5%

	Recorded Amount	Audit Amount
1st misstatement	P1,500	P1,200
2nd misstatement	9,000	8,750
3rd misstatement	200	0
4th misstatement	4,000	3,800

Required:

1. Compute for the sample size.
2. Compute for the sample interval.
3. Compute for the projected misstatement.
4. Compute for the basic precision.
5. Compute for the incremental allowance.

CASE 3

An auditor has been assigned to take a peso-unit sample of a population of vouchers in the purchasing department. The population has a total carrying amount of P300,000. The auditor believes that a maximum misstatement of P900 is acceptable and would like to have 95% confidence in the results. (The reliability factor at 95% and zero misstatements = 3.00.)

Additional information is provided as follows:

Table of First 10 Vouchers in Population

Voucher #	*Balance*	*Cumulative Balance*
1	P100	P 100
2	150	250
3	40	290
4	200	490
5	10	500
6	290	790
7	50	840
8	190	1,030
9	20	1,050
10	180	1,230

Required:

1. Given a random start of P50 as the first peso amount, what is the number of the fourth voucher to be selected, assuming that the sample size will be 1,000?
2. In examining the sample, one overstatement was detected causing an extension of P270 to the tolerable misstatement. Assuming that the sample size was 1,000 and that the maximum peso amount of overstatement if no misstatements were found was established to be P900 before the sampling analysis, what conclusion should the auditor now draw from the sampling information?

Chapter 11
AUDITING IN A COMPUTERIZED INFORMATION SYSTEMS ENVIRONMENT

LEARNING OBJECTIVES

Upon completion of this chapter you will

1. **Describe the nature of various types of computer systems.**
2. **Distinguish between general control activities and application control activities.**
3. **Explain the manner in which the auditors obtain an understanding of internal control in a computer environment.**
4. **Discuss the ways in which the auditors may test controls in a computer environment.**
5. **Describe the nature of some audit techniques and the ways that they are used by the auditors.**
6. **Learn the basic concept of electronic commerce and its effect on the audit of financial statements.**

The challenge of auditing in a computerized information systems environment, as it is known nowadays, is a consequence of a most important current trend, namely the change from an Industrial to an Information Society. We are involved in profound changes of all kinds leading us into the 21st century. Organizations depend on the economical, industrial and social environment in which they develop, so, if technological tendencies, economical environments and industries change, they have to adapt fast to the new circumstances in order to survive. Such a fast change is affecting the whole world and its understanding is fundamental for all kinds of organizations, especially in relation to Information Systems and Related Technologies. For better or worse, the whole Society is more and more dependent on information and communication systems. On the other hand, the development of information technologies in the last twenty years has been constant and impressive. The past five years can be considered as a true technological revolution in depth and impact. Nowadays the majority of organizations consider that information and its associated technology represent their most important assets. The quality, control and security requirements that are implemented for other companies' assets are also required for information systems and technology. Management must establish an adequate system of internal controls, and such systems should support business processes and resources properly.

This chapter examines how the client's integration of information technology (IT) into the accounting system affects risks and internal control.

THE COMPUTER ENVIRONMENT

INTRODUCTION TO AN ELECTRONIC DATA PROCESSING SYSTEM

Before considering the impact of IT on the work of the certified public accountant, some understanding of the nature of a computer and capabilities is needed.

Hardware

A computer is a machine that can be programmed to accept data (input), process it to useful information (output), and store it away (in a secondary storage device) for safekeeping or later reuse. The processing of input to output is directed by the software but performed by the hardware. To function, a computer system requires four main aspects of data handling: input, processing, output, and storage. The hardware responsible for these four areas is as follows:

- Input devices accept data or commands in a form that the computer can use; they send the data or commands to the processing unit.
- The processor (CPU) has electronic circuitry that manipulates input data into the information people want.
- Output devices show people the processed data – information – in understandable and usable form.
- Storage (secondary storage) which consists of secondary storage devices such as disk.

Software

The software really makes the computer useful. Generally, it is categorized as systems software or application software.

- System software (operating system) is the underlying software found on all computers. It serves as intermediary software between the application software and the hardware. Some important tasks of an operating system are managing the computer's resources (CPU, disk drives, printers) and running the applications software.
- Application software may be either custom or packaged.

UNIQUE CHARACTERISTICS OF SPECIFIC EDP SYSTEMS

Computer information systems differ as to their characteristics. A system, regardless of its size, may possess the following elements:

- Batch processing.
- Online capabilities.
- Database storage.
- Computer networks.
- End user computing.

Batch Processing

It is a common EDP system. The input data are gathered and processed periodically in discreet groups. While batch computer systems do not provide up-to-the-minute information, they are often more efficient than other types of systems.

Online Capabilities

It allows users to have a direct (online) access to the data stored in the system. When an online system is in use, individual transactions may be entered directly from the originators at remote locations. The transactions may be held in a transaction file and later posted to the records as a batch, or real-time processing may be used. In online, real-time (OLRT) systems, transactions are processed immediately and all accounting records are updated instantaneously.

The use of OLRT system results in a significant changes in internal control. Original source documents may not be available to support input to the computer and the overall amount of the

hard copy audit trail may substantially reduced. Essential controls should be programmed into the computer.

Database Storage

In a database system, separate application files (master files) are replaced with integrated databases that are shared by many users and application programs. It eliminates much of data redundancy, and since database is normally stored on a direct access device, the system responds quickly to users' requests for information.

It is essential that the database be secured against improper access or alteration. Organizations that use database systems often create a data administrator function, with responsibility for implementing and maintaining central databases and controlling access to the data.

Computer Networks

Networks of computers linked together through telecommunication links enable companies to communicate information back and forth between geographically dispersed business locations.

Networks that span a large geographical area are called wide area networks (WANs). Local area network (LAN) is a communications network that allows resources, data, and program sharing within limited geographical area.

Networking enables companies to implement distributed data processing, in which information and programs are shared by large number of users.

Computer security should be established at each location to ensure that the data can be changed or accessed by authorized personnel.

End User Computing

The user departments are responsible for the development and execution of certain computer application when a company implements end user computing. A user department both generates and uses its own information. The information systems department is generally not involved in these applications.

Computer security should be established at each location to prevent unauthorized access to the company's data.

IMPACT OF COMPUTERS ON ACCOUNTING SYSTEMS

The use of computers in business information systems has fundamental effects on the nature of business transacted, the procedures followed, the risks incurred, and the methods of mitigating those risks. These effects flow from the characteristics that distinguish computer-based from manual processing.

- Consistency of performance
- Concentration of duties
- Systems generated transactions
- Documents are not maintained in readable form
- Reports can be generated easily

Consistency of Performance
If the computer is programmed to perform specific task, it will run consistently so long as failures do not occur.

Concentration of Duties
Incompatible duties are frequently combined within the system provided there are compensating controls that are put in place.

Systems Generated Transactions
There are programs that automatically compute certain transaction without the need for an input document.

Documents are Not Maintained in Readable Form
Data can be entered into the system without supporting documents. For example, in an electronic data interchange (EDI) system a purchase transaction may be automatically initiated by the client's computer by sending an electronic message (purchase order) directly to a supplier's computer system. Invoicing and payment for the purchase may also be processed electronically.

Reports can be Generated Easily
In online, real-time systems, transactions are processed immediately and all accounting records are updated instantaneously.

COMPUTER FRAUD

Computer fraud is rampant, as the use of computers becomes part of our daily lives, with greater and greater frequency. The definition of what constitutes computer fraud becomes even more complex with the ingenuity of people who intend to deceive, misrepresent, destroy, steal information, or cause harm to others by accessing information through deceptive and illegal means. More and more people across the globe are becoming comfortable with the online purchasing process. But as more people start buying things online, computer fraud is becoming a much larger problem than anyone could have guessed. Just as you have to be careful when you're walking down the street, or in your own home when you lock up at night, you've got to be careful of the many examples of computer fraud that will make their way onto your computer.

Today's fraudsters aren't just bored teenagers anymore. The online criminals of today are skilled computer experts who know how to manipulate your computer into giving them the information they need for their computer fraud schemes. And the worst part is that you can have crucial information stolen from you without ever knowing what had happened.

Frauds have typically relied on techniques (malicious code) unique to computers such as Virus, Trojan horse, Worm, Bomb, and Trap door.

Virus
A virus infects programs already in existence by inserting new code. The primary purpose of a virus is to reproduce. It may also have a secondary function such as destroying data. When the target program is executed, the virus infects another program. The secondary viral function is then performed at some later time, perhaps using a bomb as a trigger. Characteristics of a virus include replication, requires a host program as a carrier, activated by external action, and replication limited to system.

Trojan Horse
A Trojan horse is a program that performs a useful (normal) function, but also performs an unexpected action – a form of virus (attack or trap door).

Worm
A worm differs from a virus in that it reproduces on its own, rather than requiring a program host. Characteristics of a worm include replication, does not require a host (self-contained) activated by creating a process (needs a multitasking system), and replication occurs across communication links for network worms.

Bomb
A logic bomb goes off when program being normally arrives at a prespecified event (e.g., a financial calculation exceeds a certain peso amount). A time bomb goes off at a prespecified time.

Trap Door
A trap door allows a user to gain more access to more system functions than are normally available. These access privileges can be obtained through a keyboard sequence or system condition (e.g., an aborted system start-up). Once the access is obtained, the user can then manipulate, change, or destroy data.

Auditors should be alert to the potential for these types of techniques used in fraud when evaluating control risk for clients using computerized systems.

INTERNAL CONTROL IN THE COMPUTER INFORMATION SYSTEM

AUDITOR'S RESPONSIBILITIES

Management has the responsibility to maintain controls that provide reasonable assurance that adequate controls exists over the entity's assets and records. Management needs a control system that generates reliable information for decision making. The auditor should give adequate considerations to these controls because the quality of the entity's internal control systems can have an impact on the overall audit strategy. The auditor must obtain an understanding of internal control sufficient to plan the audit. The auditor's responsibilities with respect to internal control over EDP systems remain the same as with manual systems.

Auditors should also consider the following risks to computer information system environment:

- Reliance on the functioning capabilities of hardware and software.
- Visibility of audit trail.
- Reduced human involvement.
- Unauthorized access.
- Reduced segregation of duties.
- Lack of traditional authorization.

INTERNAL CONTROL OVER EDP ACTIVITIES

Internal control over EDP activities are classified as either general controls or application controls. Exhibit 11.1 describes the categories of general controls and application controls.

EXHIBIT 11.1	Categories of General and Application Controls
Control Type	Category of Control
General controls	Organizational and operation controls Systems development and documentation controls Access controls Data recovery controls Hardware controls
Application controls	Input controls Processing controls Output controls

General Controls

General controls apply to all computer activities. They often include controls over the development, modification, and maintenance of computer programs and controls over the use of and changes to data maintained on computer files.

- **Organizational and Operation Controls**

  - ✓ **Organizational controls** address the proper segregation of duties and responsibilities within the computer processing environment.

    - ➢ **Segregation of Duties**. This general control is vital because a segregation of functions (authorization, recording, and access to assets) may not be feasible in an IT environment. Accordingly, certain tasks should not be combined.

      1. *Database/network/web administrators.* They are responsible for management, supervision, and oversight of computing facilities.

         a. The database administrator (DBA) is the individual who has the overall responsibility for developing and maintaining the database and for establishing controls to protect its integrity. Thus, only the DBA should be able to update data dictionaries.

      2. *Data administrator.* They coordinate activities within the data administration department.

      3. *System analysts.* They are specifically qualified to analyze and design computer information systems. They survey the existing system, analyze the organization's information requirements, and design new systems to meet those needs. These design specifications will guide the preparation of specific programs by computer programmers.

      4. *Programmers.* Programmers design, write, test, and document the specific programs developed by the analysts. Programmers as well as the analysts may be able to modify programs, data files, and controls and should therefore have no access to computer equipment and files or to programs used in productions.

5. *Computer (console) operator*. Computer operators are responsible for the actual processing of data in accordance with the program run manual and messages received from the system. They load data, mount storage devices, and operate the equipment.

   a. Console operators should not be assigned programming duties or responsibility for systems design and should have no opportunity to make changes in programs and systems as they operate the equipment. Ideally, computer operators should not have a programming knowledge or access to documentation not strictly necessary for their work.

   b. Help desk are usually a responsibility of computer operations because of the operational nature of their functions. A help desk logs reported problems, resolves minor problems, and forwards more difficult problems to the appropriate information systems resources, such as technical support unit or vendor assistance.

6. *Data conversion operators*. Data conversion operators perform the tasks of data preparation and transmission, for example, conversion of source data to magnetic disk or tape and entry of transactions from remote terminals.

7. *Librarians*. Librarians should maintain control over and accountability for documentation, programs, and data files. Librarians should have no access to equipment or the skills to perpetrate fraud.

8. *Data control group*. The data control group must be independent of systems development, programming, and operations. The control group receives user input, logs it, transfers it to the computer center, monitors processing, reviews error, compares control totals, distributes output, and determines whether error corrections have been made by users.

9. *End users*. The end users need access to applications data and functions only.

✓ **Operating controls** ensure efficient and effective operation within the computer department. These controls also assure proper procedures in case of data loss because of error or disaster. Typical operating controls include the proper labeling of all files both internally and externally, halt and error procedures, duplicate files, and reconstruction procedures for files.

- **Systems Development and Documentation Controls**

These controls are concerned with the proper planning, development, writing, and testing computer applications. These activities require proper documentation, including flowcharts, listings, and run manuals for programs already written. Controls over proper authorization of any changes in existing programs are also necessary.

- **Access Controls**

Access controls provide assurance that only authorized individuals use the system and that usage is for authorized purposes. Examples of access controls are

- ✓ **Encryption.** Encryption involves using fixed algorithm to manipulate plaintext. The information is sent in its manipulated form and the receiver translates the information back into plaintext. Although data may be accessed by tapping into the transmission line, the encryption key is necessary to understand the data being sent.

- ✓ **Call back.** A call back feature requires the remote user to call the computer, give identification, hang up, and wait for the computer to call the user's authorized number. This control ensures acceptance of data transmissions only from authorized modems. However, call forwarding may thwart this control.

- ✓ **Password and ID numbers.** The use of passwords and identification numbers is an effective control in an online system to prevent unauthorized access to computer files. Lists of authorized persons are maintained in the computer. The entry of passwords or identification numbers; a prearranged set of personal questions; and the use of badges, magnetic cards, or optically scanned cards may be combined to avoid unauthorized access. To be more effective, passwords should consist of random letters, symbols, and numbers. They should contain words and phrases.

- ✓ **Security personnel.** An organization may need to hire security specialists. For example, developing an information security policy for the organization, commenting on security controls in new applications,

- ✓ **Controlled disposal of documents.** One method of enforcing access restrictions is to destroy data when they are no longer in use.

- ✓ **Biometric technologies.** These are automated methods of establishing an individual's identity using physiological or behavioral traits. These characteristics include fingerprints, retina patterns, hand geometry, signature dynamics, speech, and keystrokes dynamics.

- ✓ **Automatic log-off.** Automatic log-off (disconnection) of inactive data terminals may prevent the viewing of sensitive data on an unattended data terminal.

- ✓ **Utility software restrictions.** Utility software may have privileged access and therefore be able to bypass normal security measures. Performance monitors, tape and disk management systems, job schedulers, online editors, and report management systems are example of utility software. Management can limit the use of privileged software to security personnel and establish audit trails to document its use. The purpose is to gain assurance that its users are necessary and authorized.

- **Data Recovery Controls**

  Disasters such as power failures, fire, excessive heat or humidity, water damage, or even sabotage have serious consequences to business using IT. To address such risks, organizations develop detailed back up contingency plans. One key to a back up and contingency plan is to make sure that all critical copies of software and data files are backed up and stored off the premises. Also the plans should identify alternative hardware to process company data.

- **Hardware Controls**

  Hardware controls assure the proper internal handling of data as they are moved and stored. They include:

  ✓ **Parity check**. A special bit is added to each character stored in memory that can detect if the hardware loses a bit during the internal movement of a character similar to a check digit.

  ✓ **Echo checks**. It detects line errors by re-transmitting data back to the sending device (hardware) for comparison with the original transmission.

  ✓ **Read-after-write checks**

Application Controls

Application controls relate to specific tasks performed by the system. They should provide reasonable assurance that the recording, processing, and reporting of data are properly performed.

- **Input Controls**

  Input controls provide reasonable assurance that the data received for processing have been properly authorized, converted into machine-readable form, and identified. They also provide reasonable assurance that the data (including the data transmitted over communication lines) have not been lost, suppressed, added, duplicated, or otherwise improperly changed. Moreover, input controls relate to rejection, correction, and resubmission of data that were initially incorrect.

  ✓ **Edit checks**. They include:

  ➢ *Error listing*. Editing (validation) of data should produce a cumulative automated error listing that includes not only errors found in the current processing run but also uncorrected errors from earlier runs. Each error should be identified and described, and the date and time of detection should be given. Sometimes the erroneous transactions may need to be recorded in a suspensed file. This process is the basis for developing appropriate reports.

  ➢ *Field checks*. Field checks are tests of the characters in the field to verify that they are of an appropriate type for that field.

- *Financial totals*. Financial totals summarize peso amounts in an information field in a group of records.
- *Hash totals*. A hash total is a control total without a defined meaning, such as the total of employee numbers or invoice numbers, that is used to verify the completeness of data. Thus, the hash total for the employee listing by the personnel department could be compared with the total generated during the payroll run.

- *Limit and range checks*. Limit and range checks are based on known limits for given information.

- *Preformatting*. To avoid data entry errors in online systems, a screen prompting approach may be used, that is the equivalent of the preprinted forms routinely employed as source documents. The dialogue approach, for example, presents a series of question to the operator. The preformatted screen approach involves the display of a set of boxes for entry of specified data items. The format may even be in the form of a copy of a transaction document.

- *Reasonableness (relationship) tests*. Reasonableness tests check the logical correctness of relationship among the values of data items on an inputs and the corresponding master file record.

- *Record count*. It is a control total of the number of records processed during the operation of a program.

- *Self-checking digits*. It may be used to detect incorrect identification numbers. The digit is generated by applying an algorithm to the ID number. During the input process, the check digit is recomputed by applying the same algorithm to the code actually entered.

- *Sequence checks*. Sequence checks determine that records are in proper order.

- *Sign checks*. Sign checks assure that data in the field have the appropriate arithmetic sign.

- *Validity checks*. Validity checks are tests of identification numbers or transaction codes for validity by comparison with items already known to be correct or authorized.

✓ **Key verification**. It entails rekeying input and comparing the results.

✓ **Redundancy check**. A redundancy check requires sending additional data items to serve as a check on the other transmitted data.

✓ **Completeness checks**. Completeness checks of transmission of data determine whether all necessary information has been sent. The software notifies the sender if something is omitted.

- **Processing Controls**

Processing controls provide reasonable assurance that the processing has been performed as intended for the particular application, i.e., all transactions are processed as authorized, that no authorized transactions are omitted, and that no unauthorized transactions are added.

Some input controls are also processing controls, e.g., limit, reasonableness, and sign checks.

Other tests include:

- ✓ **Posting check**. Comparing the content of a record before and after updating.
- ✓ **Cross-footing**. Compares an amount to the sum of its components.
- ✓ **Zero-balance check**. Adds the positive and negative amounts posted. The result should be zero.
- ✓ **Run-to-run control totals**. (e.g., record counts or certain critical amounts) It should be generated and checked at designated points during processing.
- ✓ **Concurrency controls**. It manages situation in which two or more programs attempt to use a file or database at the same time.
- ✓ **Key integrity checks**. It prevents the updating process from creating inaccuracies in keys. Keys are attributes of records that permit them to be sorted.

- **Output Controls**

Output controls provide reasonable assurance that the processing result (such as account listing or displays, reports, magnetic files, invoices, or disbursement check) is accurate and that only authorized personnel receive the output.

The data control group supervises the output control.

- The daily proof account activity listings (changes in master files) should be sent to users for review.
- Error listings should be received directly from the system by the control group, which should make any necessary inquiries and send the errors to users for correction and resubmission.
- The console log should be reviewed for unusual interruptions, interventions, or other activity.
- Output should be distributed in accordance with distributions registers that list authorized users.
- An end-of-job marker on the last page of printed output permits verification that the entire report has been received.

- Spooler controls prevent access to spooled output, i.e., to the results of processing that are temporarily stored in an intermediate file rather than immediately printed.

An important detective control is user review of output. Users should be able to determine when output is incomplete or not reasonable, particularly when the user prepared the input. Thus, users as well as computer personnel have a quality assurance function.

BASIC APPROACH TO THE AUDIT OF ELECTRONICALLY PROCESSED DATA

INTRODUCTION

As organizations expand their use of IT, internal controls are often embedded in applications that are visible only in electronic form. When traditional source documents such as invoices, purchase orders, billing records, and accounting records such as purchases journals are only in electronic form rather than hard copy, the auditor must change his auditing approach. This approach is called auditing through the computer.

EFFECTS OF COMPUTERS ON THE AUDIT PROCESS

The overall objective and scope of an audit does not change in a CIS environment. However, the use of a computer changes the processing, storage, retrieval and communication of financial information and may affect the accounting and internal control systems employed by the entity. Accordingly, a CIS environment may affect:

- The procedures followed by the auditor in obtaining a sufficient understanding of the accounting and internal control system.
- The auditor's evaluation of inherent risk and control risk through which the auditor assesses the audit risk.
- The auditor's design and performance of tests of control and substantive procedures appropriate to meet the audit objective.

The auditor should have sufficient knowledge of the computer information systems to plan, direct, supervise, control and review the work performed. The sufficiency of knowledge would depend on the nature and extent of the CIS environment. The auditor should consider whether any specialized CIS skills are needed in the conduct of the audit. Specialized skills may be needed to:

- Obtain sufficient understanding of the effect of the CIS environment on accounting and internal control systems.
- Determine the effect of the CIS environment on the assessment of overall audit risk and of risk at the account balance and class of transactions level.
- Design and perform appropriate tests of control and substantive procedures.

If specialized skills are needed, the auditor would seek the assistance of an expert possessing such skills, who may either be the auditor's staff or an outside professional. If the use of such a professional is planned, the auditor should, in accordance with **PSA 620,** *Using the Work of an Expert*, obtain sufficient appropriate audit evidence that the work performed by the expert is adequate for the purposes of the audit.

PLANNING

In accordance with **PSA 315,** *Understanding the Entity and its Environment and Assessing the Risks of Misstatement,* the auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and to determine the nature, timing and extent of the audit procedures. Such an understanding would help the auditor to develop an effective audit approach.

In planning the portions of the audit which may be affected by the CIS environment, the auditor should obtain an understanding of the significance and complexity of the CIS activities and the availability of the data for use in the audit. This understanding would include such matters as:

- The computer information systems infrastructure [hardware, operating system(s), etc., and application software(s) used by the entity, including changes, if any, therein since last audit].

- The significance and complexity of computerized processing in each significant accounting application. Significance relates to materiality of the financial statement assertions affected by the computerized processing. An application may be considered to be complex when, for example:

  - ✓ The volume of transactions is such that users would find it difficult to identify and correct errors in processing.
  - ✓ The computer automatically generates material transactions or entries directly to another application.
  - ✓ The computer performs complicated computations of financial information and/or automatically generates material transactions or entries that cannot be (or are not) validated independently.
  - ✓ Transactions are exchanged electronically with other organizations [as in electronic data interchange (EDI) systems] without manual review for propriety or reasonableness.

- Determination of the organizational structure of the client's CIS activities and the extent of concentration or distribution of computer processing throughout the entity, particularly, as they may affect segregation of duties.

- Determination of the availability of data. Source documents, computer files, and other evidential matter that may be required by the auditor may exist for only a short period or only in machine-readable form. Computer information systems may generate reports that might be useful in performing substantive tests (particularly analytical procedures). The potential for use of computer-assisted audit techniques may permit increased efficiency in the performance of audit procedures, or may enable the auditor to economically apply certain procedures to the entire population of accounts or transactions.

When the computer information systems are significant, the auditor should also obtain an understanding of the CIS environment and whether it may influence the assessment of inherent and control risks. The nature of the risks and the internal control characteristics in CIS environments include the following:

- LACK OF TRANSACTION TRAILS
  Some computer information systems are designed so that a complete transaction trail that is useful for audit purposes might exist for only a short period of time or only in computer readable form. Where a complex application system performs a large number of processing steps, there may not be a complete trail. Accordingly, errors embedded in an application's program logic may be difficult to detect on a timely basis by manual (user) procedures.

- UNIFORM PROCESSING OF TRANSACTIONS
  Computer processing uniformly processes like transactions with the same processing instructions. Thus, the clerical errors ordinarily associated with manual processing are virtually eliminated. Conversely, programming errors (or other systemic errors in hardware or software) will ordinarily result in all transactions being processed incorrectly.

- LACK OF SEGREGATION OF FUNCTIONS
  Many control procedures that would ordinarily be performed by separate individuals in manual systems may become concentrated in a CIS environment. Thus, an individual who has access to computer programs or processing of data may be in a position to perform incompatible functions.

- POTENTIAL FOR ERRORS AND IRREGULARITIES
  The potential for human error in the development, maintenance and execution of computer information systems may be greater than in manual systems, partially because of the level of detail inherent in these activities. Also, the potential for individuals to gain unauthorized access to data or to alter data without visible evidence may be greater in CIS than in manual systems.

In addition, decreased human involvement in handling transactions processed by computer information systems can reduce the potential for observing errors and irregularities. Errors or irregularities occurring during the design or modification of application programs or systems software can remain undetected for long periods of time.

- INITIATION OR EXECUTION OF TRANSACTIONS
  Computer information systems may include the capability to initiate or cause the execution of certain types of transactions, automatically. The authorization of these transactions or procedures may not be documented in the same way as that in a manual system, and management's authorization of these transactions may be implicit in its acceptance of the design of the computer information systems and subsequent modification.

- DEPENDENCE OF OTHER CONTROLS OVER COMPUTER PROCESSING
  Computer processing may produce reports and other output that are used in performing manual control procedures. The effectiveness of these manual control procedures can be dependent on the effectiveness of controls over the completeness and accuracy of computer processing. In turn, the effectiveness and consistent operation of transaction processing controls in computer applications is often dependent on the effectiveness of general computer information systems controls.

- POTENTIAL FOR INCREASED MANAGEMENT SUPERVISION
  Computer information systems can offer management a variety of analytical tools that may be used to review and supervise the operations of the entity. The availability of these analytical tools, if used, may serve to enhance the entire internal control structure.

- POTENTIAL FOR THE USE OF COMPUTER-ASSISTED AUDIT TECHNIQUES
  The case of processing and analyzing large quantities of data using computers may require the auditor to apply general or specialized computer audit techniques and tools in the execution of audit tests.

Both the risks and the controls introduced as a result of these characteristics of computer information systems have a potential impact on the auditor's assessment of risk, and the nature, timing and extent of audit procedures.

ASSESSMENT OF RISK

The inherent risks and control risks in a CIS environment may have both a pervasive effect and an account-specific effect on the likelihood of material misstatements, as follows:

- The risks may result from deficiencies in pervasive CIS activities such as program development and maintenance, system software support, operations, physical CIS security, and control over access to special-privilege utility programs. These deficiencies would tend to have a pervasive impact on all application systems that are processed on the computer.

- The risks may increase the potential for errors or fraudulent activities in specific applications, in specific databases or master files, or in specific processing activities. For example, errors are not uncommon in systems that perform complex logic or calculations, or that must deal with many different exception conditions. Systems that control cash disbursements or other liquid assets are susceptible to fraudulent actions by users or by CIS personnel.

As new CIS technologies emerge for data processing, they are frequently employed by clients to build increasingly complex computer systems that may include micro-to-mainframe links, distributed databases, end-user processing, and business management systems that feed information directly into the accounting systems. Such systems increase the overall sophistication of computer information systems and the complexity of the specific applications that they affect. As a result, they may increase risk and require further consideration.

AUDIT PROCEDURES

The auditor's specific audit objectives do not change whether accounting data is processed manually or by computer. However, the methods of applying audit procedures to gather evidence may be influenced by the methods of computer processing. The auditor can use manual audit procedures, or computer-assisted audit techniques, or a combination of both to obtain sufficient evidential matter. However, in some accounting systems that use a computer for processing significant applications, it may be difficult or impossible for the auditor to obtain certain data for inspection, inquiry, or confirmation without computer assistance.

DOCUMENTATION

The auditor should document the audit plan, the nature, timing and extent of audit procedures performed and the conclusions drawn from the evidence obtained. In an audit in CIS environment, some of the audit evidence may be in the electronic form. The auditor should satisfy himself that such evidence is adequately and safely stored and is retrievable in its entirety and when required. The auditor should establish a system of identification of working papers in audit files on computer media. It is advisable to keep audit files for each entity on a separate computer medium.

AUDITING CLIENTS THAT USE COMPUTER INFORMATION SYSTEM (CIS)

The auditor must adequately consider the internal control regardless of how the client's financial statements are produced (manually or electronically). The auditor's consideration provides a basis in assessing control risk which affects the nature, timing, and extent of the work necessary to complete the audit.

The steps involved in studying and evaluating internal control in a CIS environment are:

1. Obtaining an understanding of internal control in a CIS environment.
2. Assessing the preliminary level of control risk.
3. Obtaining evidential matter to support the assessed level of control risk
4. Evaluating the results of evidential matter
5. Determining the necessary level of detection risk.

OBTAINING AN UNDERSTANDING OF INTERNAL CONTROL IN A CIS ENVIRONMENT

Specialized skills may be needed to obtain sufficient understanding of the effect of the CIS environment on accounting and internal control systems, to determine the effect of the CIS environment on the assessment of overall audit risk and of risk at the account balance and class of transactions level, and to design and perform appropriate tests of control and substantive procedures. Therefore, training and education about CIS and controls are an important part of the professional development of many CPA firms.

If specialized skills are needed, the auditor would seek the assistance of an expert possessing such skills, who may either be the auditor's staff or an outside professional. If the use of such professional is planned, the auditor should obtain sufficient appropriate audit evidence that the work performed by the expert is adequate for the purposes of the audit.

DOCUMENTING THE UNDERSTANDING OF INTERNAL CONTROL IN A CIS ENVIRONMENT

The auditor must document the understanding of the internal control in a CIS environment in their working papers to plan the audit. The form and extent of this documentation varies depending on the CIS. The documentation of CIS usually takes the form of:

- Internal control questionnaire
- Flowcharts

ASSESSING THE PRELIMINARY LEVEL OF CONTROL RISK

After obtaining an understanding of the entity's internal control necessary to plan an audit, an assessed level of control risk is established. This level of control risk is established either at the maximum level or below the maximum level. If the auditor believes the assessed level should be at the maximum level, no test of controls will be performed. However, whenever controls appear to be effective, the planned level of control risk may be established below the maximum level and test of controls are performed in order to decrease the substantive testing.

Depending upon the complexity and nature of CIS, the adequacy of audit trail, and the audit objectives the auditor chooses to either:

- Audit around the computer or
- Audit through the computer.

Audit Around the Computer

Auditing around the computer (without using the computer) means the auditor bypass the computer rather than use it in conducting their test. Under this approach, the auditor will process transactions manually on a test basis and the results then compared to those output obtained by the client's CIS and any discrepancies are investigated. This approach is applicable if there is an adequate audit trail (visible input documents).

Audit Through the Computer

Under this approach, computers are useful in conducting the audit. When CIS perform tasks for which no visible evidence is available, the auditor will have to audit through the client's computer program using computer assisted audit techniques.

OBTAINING EVIDENTIAL MATTER TO SUPPORT THE ASSESSED LEVEL OF CONTROL RISK

The auditor obtains evidential matter to support the assessed level of control risk. Tests of controls are tests performed to obtain audit evidence about the effectiveness of controls in preventing, or detecting and correcting, material misstatement at the assertion level. This includes obtaining audit evidence about how the controls were applied at relevant times during the period under audit, the consistency with which they are applied and by whom or by what means they were applied. Regardless of the nature of the client's CIS, auditor must perform tests of those controls he intends to consider in his assessment of control risk. The nature of the CIS may, however, affect the specific procedures employed by the auditor in testing the controls.

Procedures to Test General Control Activities

The auditor will normally begin his consideration of computer control activities by testing general controls. This is an efficient approach since the effectiveness of specific application controls is dependent on the existence of effective general controls over all computer activities.

- Test of effectiveness of controls for development of new programs and systems may include making inquiries of personnel, reviewing the minutes of meetings of users and computer staff, and inspecting the documentation of the tests conducted on the systems before they were implemented. The auditor may have discussions with the users to determine that they understand the systems and obtain their assessment of the operation of the system.
- Test of controls over program changes include review of the documentation of any changes made and compare them to the log of manager approvals. Auditor may inspect

manuals being used by the users and operators to determine if they are the most recent version.

- Controls over access to programs and data may be tested through inquiry of client personnel and observation of the segregation of duties and physical controls over equipment.
- Operation controls may be tested through inquiry of computer operators about adherence to policies and follow-up exceptions and other problems.

Procedures to Test Application Control Activities

Tests of application control activities vary significantly, depending on the nature of the system and application. The auditor uses some of computer assisted audit techniques (CAAT) to test application controls.

EVALUATING THE RESULTS OF EVIDENTIAL MATTER

After the auditor has completed the tests of controls, he will evaluate or reassess the control risk based on the results of the tests (general controls and application controls). The conclusion reached as a result of this evaluation is called **assessed level of control risk**. If the tests of controls are consistent with the auditor's planned assessment of control risk, no revision in the nature, timing, and extent of substantive test. On the other hand, if the tests of controls revealed that the level of control risk is higher than planned, the achieved/assessed level of control risk will have to be increased and the nature, timing, and extent of the substantive tests will have to be modified. For example, the auditor may perform substantive tests at year-end rather than at interim.

Documenting the Assessed Level of Control Risk

The auditor's assessed level of control risk must be documented. If the assessed control risk is at maximum level, the auditor should document his conclusion that control risk is at maximum level. If the assessed control risk is below the maximum level, the auditor should document his conclusion that the control risk is below the maximum level and the basis for that assessment. When auditing clients that use CIS, the auditors' tests of general controls and application controls will help provide the basis for auditors' assessment of control risk.

DETERMINING THE NECESSARY LEVEL OF DETECTION RISK

The auditor uses the assessed level of control risk (together with the assessed level of inherent risk) to determine the acceptable level of detection risk. The auditor uses the acceptable level of detection risk to determine the nature, timing, and extent of the substantive tests to be used to detect material misstatements in the financial statement assertions.

AUDIT TECHNIQUES USING EDP

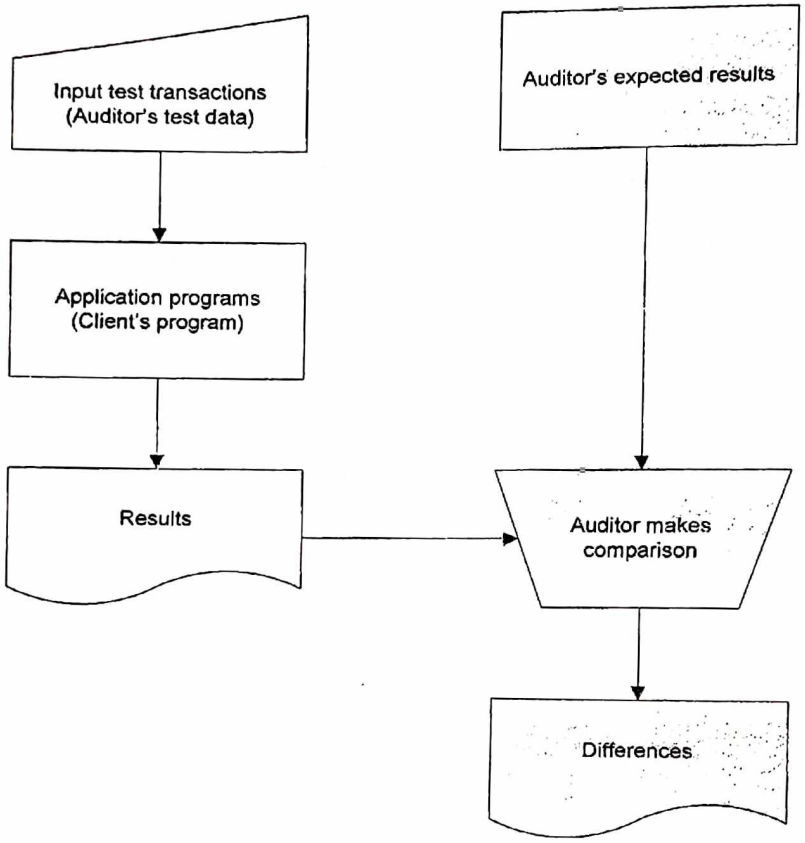
There are many techniques which are helpful to auditors in auditing through computer. Some of these techniques are:

- **Test Data**

  The test data approach involves processing the auditor's test data (dummy) using the client's computer system and the client's application program to determine whether the computer-performed controls correctly process the test data. Because the auditor designs the test data, the auditor is able to identify which items should be accepted or rejected by the client's system. The auditor then compares the results generated by the client's

system from the test data to the predetermined output to assess the effectiveness of the application program's internal control. Figure 11-1 illustrates the use of test data approach.

Figure 11.1 Test Data

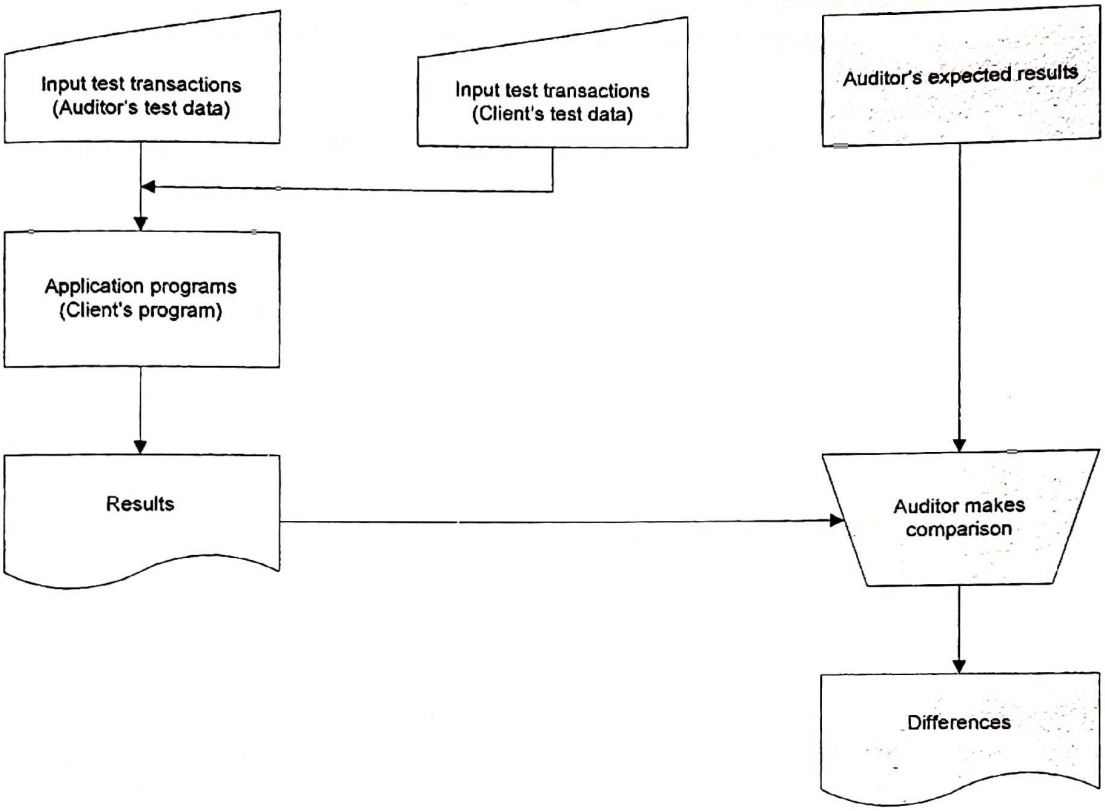


- **Integrated Test Facility (ITF)**

An integrated test facility is a subsystem of dummy records and files built into regular computer system. These dummy files permit test data to be processed simultaneously with regular (live) input without adversely affecting the live data files or output. The test data affect only the dummy files and dummy output. The auditor monitors the processing of test data, studying the effects upon the dummy files, exception reports, and other output produced.

When using ITF, auditor must be alert with the risk that someone may manipulate the real data files by transferring data to or from the dummy files. The ITF must be carefully designed to ensure that real files are not inadvertently contaminated with the fictitious test data. Figure 11-2 illustrates the use of ITF.

Figure 11.2 Integrated Test Facility



- **Snapshots**

  This technique involves taking pictures of a transaction as it flows through the computer system. Audit software routines are embedded at different points in the processing logic to capture images of the transaction as it progresses trough the various stages of processing.

- **Systems Control Audit Review Files (SCARF)**

  This uses audit software embedded in the client's system. It gathers information at predetermined points in a system and logs that collect information for review subsequently by the auditor.

- **Tagging and Tracing Transactions**

  This technique involves tagging transactions with an indicator when they are entered into the system. The computer provides the auditor with a printout of the details of the steps in processing tagged transactions. This printout is examined for evidence of unauthorized program steps. This technique is only possible when appropriate logic has been built into the computer system.

- **Parallel Simulation**

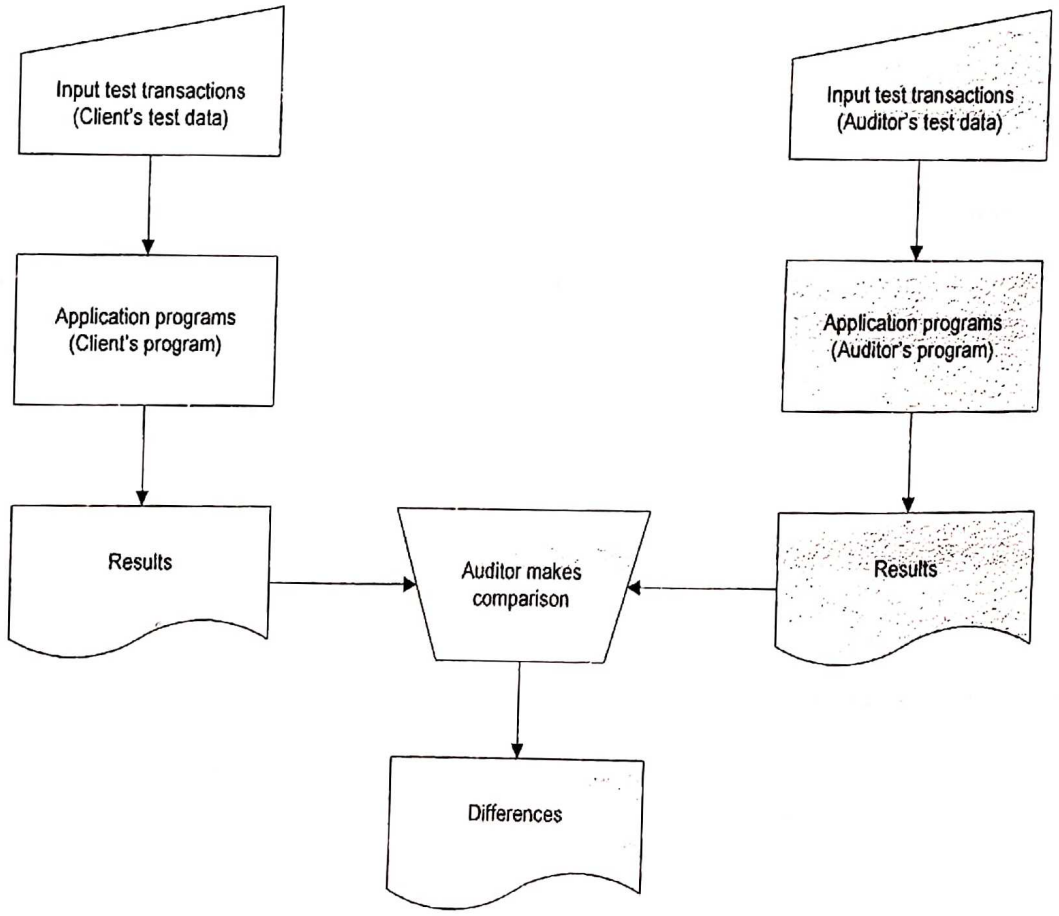
In parallel simulation, auditor prepares software to process the client's data on the client's or auditor's computer. If the client's controls have been operating effectively, the client's software should generate the same exceptions as auditor's software. The potential for control override is suggested when a client's software fails to detect exceptions detected by the auditor's software.

Parallel simulation provides auditor with independence from client computer personnel in that software prepared by the auditor rather than the client.

Parallel simulation provides no assurance that the client's software is actually used throughout the entire year to process all data. It is suggested that parallel simulation should be conducted on a surprise basis.

Figure 11-3 illustrates the use of parallel simulation.

Figure 11.3 Parallel Simulation



ELECTRONIC COMMERCE – EFFECT ON THE AUDIT OF FINANCIAL STATEMENTS

Electronic commerce (e-commerce) is one of the most popular e-business implementations. It is the buying and selling of goods online via Internet. Typically, a web site will advertise goods and services, and the buyer will fill in a form on the web site to select the items to be purchased and provide delivery and payment details, or banking services, such as transfers, payment orders, etc. The web site may gather details about customers and offer other items that may be of interest. The cost of a street store is avoided and the savings are often a benefit to the customers, sometimes leading to spectacular growth. The term e-business includes buying and selling online as well as other aspects of online business, such as customer support or relationships between businesses.

E-commerce, as a general model, uses technology to enhance the processes of commercial transactions among a company, its customers and business partners. The used technology can include the Internet, multimedia, web browser, propriety networks, ATMs and home banking, and the traditional approach to electronic data interchange (EDI). However, the primary area of growth in e-commerce is through the use of the Internet as an enabling technology.

E-COMMERCE MODELS

- Business-to-Consumer (B2C)
- Business-to-Business (B2B)
- Business-to-Employee (B2E)
- Business-to-Government (B2G)
- Consumer-to-Government (C2G)

SKILLS AND KNOWLEDGE

The level of skills and knowledge required to understand the effect of e-commerce on the audit will vary with the complexity of the entity's e-commerce activities. The auditor considers whether the personnel assigned to the engagement have appropriate IT and Internet business knowledge to perform the audit. When e-commerce has a significant effect on the entity's business, appropriate levels of both information technology (IT) and Internet business knowledge may be required to:

- Understand, so far as they may affect the financial statements:
  - ✓ The entity's e-commerce strategy and activities;
  - ✓ The technology used to facilitate the entity's e-commerce activities and the IT skills and knowledge of entity personnel; and
  - ✓ The risks involved in the entity's use of e-commerce and the entity's approach to managing those risks, particularly the adequacy of the internal control system, including the security infrastructure and related controls, as it affects the financial reporting process;
- Determine the nature, timing and extent of audit procedures and evaluate audit evidence; and
- Consider the effect of the entity's dependence on e-commerce activities on its ability to continue as a going concern.

In some circumstances, the auditor may decide to use the work of an expert, for example if the auditor considers it appropriate to test controls by attempting to break through the security layers of the entity's system (vulnerability or penetration testing). When the work of an expert is used, the auditor obtains sufficient appropriate audit evidence that such work is adequate for the purposes of the audit, in accordance with **PSA 620**, *Using the Work of an Expert.* The auditor also considers how the work of the expert is integrated with the work of others on the audit, and what procedures are undertaken regarding risks identified through the expert's work.

UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

PSA 310, *Knowledge of the Business* requires that the auditor obtain a knowledge of the business sufficient to enable the auditor to identify and understand the events, transactions and practices that may have a significant effect on the financial statements or on the audit report. Knowledge of the business includes a general knowledge of the economy and the industry within which the entity operates. The growth of e-commerce may have a significant effect on the entity's traditional business environment.

The auditor's knowledge of the business is fundamental to assessing the significance of e-commerce to the entity's business activities and any effect on audit risk. The auditor considers changes in the entity's business environment attributable to e-commerce, and e-commerce business risks as identified so far as they affect the financial statements. Although the auditor obtains much information from inquiries of those responsible for financial reporting, making inquiries of personnel directly involved with the entity's e-commerce activities, such as the chief information officer or equivalent, may also be useful. In obtaining or updating knowledge of the entity's business, the auditor considers, so far as they affect the financial statements:

- The entity's business activities and industry
- The entity's e-commerce strategy
- The extent of the entity's e-commerce activities
- The entity's outsourcing arrangements

THE ENTITY'S BUSINESS ACTIVITIES AND INDUSTRY

E-commerce activities may be complementary to an entity's traditional business activity. For example, the entity may use the Internet to sell conventional products (such as books or CDs), delivered by conventional methods from a contract executed on the Internet. In contrast, e-commerce may represent a new line of business and the entity may use its web site to both sell and deliver digital products via the Internet.

The Internet lacks the clear, fixed geographic lines of transit that traditionally have characterized the physical trade of many goods and services. In many cases, particularly where goods or services can be delivered via the Internet, e-commerce has been able to reduce or eliminate many of the limitations imposed by time and distance.

Certain industries are more conducive to the use of e-commerce, therefore e-commerce in these industries is in a more mature phase of development. When an entity's industry has been significantly influenced by e-commerce over the Internet, business risks that may affect the financial statements may be greater. Exhibit 11.2 is examples of industries that are being transformed by e-commerce.

EXHIBIT 11.2	Examples of Industries that are being Transformed by E-Commerce
Computer software Securities trading Banking Travel services Books and magazines Recorded music Advertising News media Education	

In addition many other industries, in all business sectors, have been significantly affected by e-commerce.

THE ENTITY'S E-COMMERCE STRATEGY

The entity's e-commerce strategy, including the way it uses IT for e-commerce and its assessment of acceptable risk levels, may affect the security of the financial records and the completeness and reliability of the financial information produced. Matters that may be relevant to the auditor when considering the entity's e-commerce strategy in the context of the auditor's understanding of the control environment, include:

- ✓ Involvement of those charged with governance in considering the alignment of e-commerce activities with the entity's overall business strategy;
- ✓ Whether e-commerce supports a new activity for the entity, or whether it is intended to make existing activities more efficient or reach new markets for existing activities;
- ✓ Sources of revenue for the entity and how these are changing (for example, whether the entity will be acting as a principal or agent for goods or services sold);
- ✓ Management's evaluation of how e-commerce affects the earnings of the entity and its financial requirements;
- ✓ Management's attitude to risk and how this may affect the risk profile of the entity;
- ✓ The extent to which management has identified e-commerce opportunities and risks in a documented strategy that is supported by appropriate controls, or whether e-commerce is subject to ad hoc development responding to opportunities and risks as they arise; and
- ✓ Management's commitment to relevant codes of best practice or web seal programs.

THE EXTENT OF THE ENTITY'S E-COMMERCE ACTIVITIES

Different entities use e-commerce in different ways. For example, e-commerce might be used to:

- ✓ Provide only information about the entity and its activities, which can be accessed by third parties such as investors, customers, suppliers, finance providers, and employees;
- ✓ Facilitate transactions with established customers whereby transactions are entered via the Internet;
- ✓ Gain access to new markets and new customers by providing information and transaction processing via the Internet;
- ✓ Access Application Service Providers (ASPs); and
- ✓ Create an entirely new business model.

The extent of e-commerce use affects the nature of risks to be addressed by the entity. Security issues may arise whenever the entity has a web site. Even if there is no third party interactive access, information-only pages can provide an access point to the entity's financial records. The

security infrastructure and related controls can be expected to be more extensive where the web site is used for transacting with business partners, or where systems are highly integrated.

As an entity becomes more involved with e-commerce, and as its internal systems become more integrated and complex, it becomes more likely that new ways of transacting business will differ from traditional forms of business activity and will introduce new types of risks.

THE ENTITY'S OUTSOURCING ARRANGEMENTS

Many entities do not have the technical expertise to establish and operate in-house systems needed to undertake e-commerce. These entities may depend on service organizations such as Internet Service Providers (ISPs), Application Service Providers (ASPs) and data hosting companies to provide many or all of the IT requirements of e-commerce. The entity may also use service organizations for various other functions in relation to its e-commerce activities such as order fulfillment, delivery of goods, operation of call centers and certain accounting functions.

When the entity uses a service organization, certain policies, procedures and records maintained by the service organization may be relevant to the audit of the entity's financial statements. The auditor considers the outsourcing arrangements used by the entity to identify how the entity responds to risks arising from the outsourced activities. **PSA 402**, *Audit Considerations Relating to Entities Using Service Organizations* provides guidance on assessing the effect that the service entity has on control risk.

RISKS

Some of the most elements at risk are:

- **Confidentiality**. Potential consumer are concerned about providing unknown vendors with personal, sometimes sensitive, information for a number of reasons including the possible theft of credit card information from the vendor following a purchase. Connecting to the Internet via a browser requires running software on the computer that has been developed by someone unknown to the organization. Moreover, the medium of the Internet is a broadcast network, which means that whatever is placed on it is routed over wide-ranging and essentially uncontrolled paths.

- **Integrity**. Data, both in transit or in storage, could be susceptible to unauthorized alteration or deletion. (i.e., hacking or the e-business system itself could have design or configuration problems).

- **Availability**. The Internet holds out the promise of doing business on a 24/7 basis. Hence, high availability is important with any system's failure becoming immediately apparent to customers and business partners.

- **Authentication and Non-repudiation**. The parties to an electronic transaction should be in a known and trusted business relationship, which requires that they prove their respective identities before executing the transaction in preventing man-in-the-middle attacks (i.e., preventing the seller from being an impostor). Then, after the fact, there must be some manner of ensuring that the transacting parties cannot deny the transaction which was entered into and the terms on which it was completed.

- **Power Shift to Customers**. The Internet gives consumers unparalleled access to market information and generally makes it easier to shift between suppliers. Firms participating

in e-business need to make their offerings attractive and seamless, in terms of service delivery. This will involve not only system design, but also reengineering of business process. Backend support processes need to be as efficient as possible because, in many cases, doing business over the Internet forces down prices, e.g., online share broking. To avoid losing their competitive advantage of doing business online, firms need to enhance their service, differentiate from the competition and build additional value. Hence, the drive to personalize web sites by targeting content based on analyzed customer behavior and allowing direct contact with staff through instant messaging technology and other means.

CONTROLS

Audit professionals should assess applicable use of the following items:

- A set of security mechanisms and procedures that, taken together, constitute security architecture for e-commerce (e.g., Internet firewalls, encryption, certificates and password management).
- Firewall mechanisms that are in place to mediate the public network (the Internet) and an organization's private network.
- A process whereby participants in an e-commerce transaction can be identified uniquely and positively (e.g., process of using some combination of public and private key encryption and certifying key pairs).
- Digital signatures, so the initiator of an e-commerce transaction can be uniquely associated with it. Attributes of digital signatures include:

  ✓ The digital signature is unique to the person using it.
  ✓ It can be verified.
  ✓ The mechanism of generating and affixing the signature is under the sole control of the person using it.
  ✓ It is linked to data in such a manner that if the data are changed, the digital signature is invalidated.

- The procedures in place to control changes to an e-commerce presence.
- Logs of e-commerce applications which should be monitored by responsible personnel. This includes operating system logs and console messages, network management messages, firewall logs and alerts, router management messages, intrusion detection alarms, application and server statistics, and system integrity checks.
- The methods and procedures to recognize security breaches when they occur.
- The protections in place to ensure that the data collected about individuals are not disclosed without their consent nor used for purposes other than that for which they are collected.
- The means to ensure confidentiality of data communicated between customers and vendors (safeguarding resources such as through encryption, secure sockets layer).

REVIEW QUESTIONS

1. Distinguish between system software from application software.
2. Distinguish between general controls activities from application controls activities and give examples of the types of controls included in each of these broad categories.
3. Explain briefly what is meant by an "online, real-time system (OLRT)".
4. Identify the risks for accounting systems that rely heavily on IT functions?
5. Describe the typical duties of computer personnel.
6. Define an audit trail. How might a computer system audit trail differ from one in a manual system?
7. What is the difference between the test data technique and integrated test facility technique?

MULTIPLE CHOICE QUESTIONS

1. GAM Company is a manufacturer of men's shirts. It distributes weekly sales reports to each sales manager. The quantity 2R5 appeared in the quantity sold column for one of the items on the weekly sales report for one of the sales managers. The most likely explanation for what has occurred is that
   a. The program did not contain a data checking routine for input data.
   b. The printer has malfunctioned and the "R" should have been a decimal point.
   c. The output quantity has been stated in hexadecimal numbers.
   d. The computer has malfunctioned during execution.

2. A catalog company has been experiencing an increasing incidence of problems in which the wrong products have been shipped to the customer. Most of the customer orders come in over the telephone, and an operator enters the data into the order system immediately. Which of the following control procedures, if properly implemented, would address the problem?
   I. Have the computer automatically assign a sequential order number to each customer order.
   II. Implement a self-checking digit algorithm for each product number and request entries by product number.
   III. Request entries by product number, have the computer program identify the product and price, and require the operator to orally verify the product description with the customer.

   a. II only.
   b. II and III only.
   c. I, II, and III.
   d. I and II only.

3. The key verification process associated with keying computer records for input to a computer system is
   a. Used to detect errors introduced by the keying process.
   b. Ordinarily used with a computer program written to check the data.
   c. Inexpensive and therefore widely used.
   d. Effectively used to detect the erroneous recording of data on source documents.

4. The marketing department's proposal was finally accepted, and the marketing employees attended a class in using the mainframe report writer. Soon, the marketing analysts found that it was easier to download the data and manipulate it on their own microcomputers than to perform all the data manipulation with the mainframe report writer directly. One analyst became highly skilled at downloading and wrote downloading command sequences for the other employees. When the analyst left the company for a better job, the department had problems making modifications to these command sequences. The department's problems are most likely due to inadequate
   a. Program testing.
   b. Documentation.
   c. Data backup.
   d. Anti-virus software.

5. An auditor is least likely to use computer software to
   a. Prepare spreadsheets.
   b. Construct parallel simulations.
   c. Assess computer control risk.
   d. Access client data files.

6. Passwords for personal computer software programs are designed to prevent
   a. Unauthorized use of the software.
   b. Unauthorized access to the computer.
   c. Incomplete updating of data files.
   d. Inaccurate processing of data.

7. The use of message encryption software
   a. Guarantees the secrecy of data.
   b. Increases system overhead.
   c. Reduces the need for periodic password changes.
   d. Requires manual distribution of keys.

8. An equipment manufacturer maintains dial-up ports into its order-entry system for the convenience of its customers worldwide so they may order parts as they need them. The manufacturer promises 48-hour delivery anywhere in the world for 95% of these parts orders. Because of the cost and sensitive nature of certain electronic parts, the manufacturer needs to maintain secure access to its order-entry system. The best technique for monitoring the security of access is
   a. Integrated test facility for the order-entry system.
   b. Logging of unsuccessful access attempts.
   c. Tracing of transactions through the order-entry system.
   d. Transaction selection of order-entry transactions.

9. An auditor has just completed a physical security audit of a data center. Because the center engages in top-secret defense contract work, the auditor has chosen to recommend biometric authentication for workers entering the building. The recommendation might include devices that verify all of the following except
   a. Fingerprints.
   b. Password patterns.
   c. Retina patterns.
   d. Speech patterns.

10. An organization installed antivirus software on all its personal computers. The software was designed to prevent initial infections, stop replication attempts, detect infections after their occurrence, mark affected system components, and remove viruses from infected components. The major risk in relying on antivirus software is that antivirus software may
   a. Consume too many system resources.
   b. Interfere with system operations.
   c. Make software installation overly complex.
   d. Not detect certain viruses.

11. Your firm has recently converted its purchasing cycle from a manual process to an online computer system. Which of the following is a probable result associated with conversion to the new automatic system?
   a. Traditional duties are less segregated.
   b. The firm's risk exposures are reduced.
   c. Processing time is increased.
   d. Processing errors are increased.

12. Which of the following statements most likely represents a disadvantage for an entity that keeps data files on a server rather than on a manual system?
   a. Random error associated with processing similar transactions in different ways is usually greater.
   b. It is usually more difficult to compare recorded accountability with the physical count of assets.
   c. It is usually easier for unauthorized persons to access and alter the files.
   d. Attention is focused on the accuracy of the programming process rather than errors in individual transactions.

13. For control purposes, which of the following should be organizationally segregated from the computer operations function?
   a. Systems development.
   b. Surveillance of screen display messages.
   c. Minor maintenance according to a schedule.
   d. Data conversion.

14. Application control objectives do not normally include assurance that
   a. Transaction data are complete and accurate.
   b. Review and approval procedures for new systems are set by policy and adhered to.
   c. Processing results are received by the intended user.
   d. Authorized transactions are completely processed once and only once.

15. Matthews Corp. has changed from a system of recording time worked on clock cards to a computerized payroll system in which employee's record time in and out with magnetic cards. The computer system automatically updates all payroll records. Because of this change
    a. Transactions must be processed in batches.
    b. The potential for payroll-related fraud is diminished.
    c. Part of the audit trail is altered.
    d. A generalized computer audit program must be used.

16. Systems analysts are the personnel within an organization who are responsible for the development of the company's information system. Which one of the following functions is least likely to be performed by a systems analyst?
    a. Design of computer applications.
    b. Developing, coding, and testing computer programs.
    c. Examining user information requirements.
    d. Preparation of specifications for computer programming.

17. Assigning passwords to computer users is a control to prevent unauthorized access. Because a password does not conclusively identify a specific individual, it must be safeguarded from theft. A method used to protect passwords is to
    a. Eliminate all records of old passwords.
    b. Require a minimum retention period.
    c. Require that they be displayed on computer screens but not printed on hard copy output.
    d. Set maximum character lengths.

18. A client installed the most sophisticated controls using biometric attributes of employees to gain access to their computer system. This technology most likely replaced which of the following controls?
    a. Passwords.
    b. Reasonableness tests.
    c. Use of security specialists.
    d. Virus protection software.

19. If a control total were to be computed on each of the following data items, which would best be identified as a hash total for a payroll computer application?
    a. Department numbers.
    b. Hours worked.
    c. Net pay.
    d. Total debits and total credits.

20. A customer intended to order 100 units of product Z96014, but incorrectly ordered nonexistent product Z96015. Which of the following controls most likely would detect this error?
    a. Redundant data check.
    b. Record count.
    c. Hash total.
    d. Check digit verification.

21. An accounts payable program posted a payable to a vendor not included in the online vendor master file. A control that would prevent this error is a
    a. Parity check.
    b. Range check.
    c. Reasonableness test.
    d. Validity check.

22. An employee in the receiving department keyed in a shipment from a remote terminal and inadvertently omitted the purchase order number. The best systems control to detect this error is
    a. Compatibility test.
    b. Completeness test.
    c. Reasonableness test.
    d. Sequence check.

23. Reconciling input with processing control totals to ensure that all transactions have been processed is an example of
    a. A processing control.
    b. An access control.
    c. An input control.
    d. An output control.

24. Which of the following should not be the responsibility of a database administrator?
    a. Protect the database and its software.
    b. Monitor and improve the efficiency of the database.
    c. Develop applications to access the database.
    d. Design the content and organization of the database.

25. Which of the following is a computer program that appears to be legitimate but performs some illicit activity when it is run?
    a. Web crawler.
    b. Trojan horse.
    c. Killer application.
    d. Hoax virus.

26. The practice of maintaining a test program library separate from the production program library is an example of
    a. A concurrency control.
    b. An input control.
    c. An organizational control.
    d. Physical security.

27. An organization's computer help-desk function is usually a responsibility of the
    a. Applications development unit.
    b. Computer operations unit.
    c. Systems programming unit.
    d. User departments.

28. A mail-order retailer of low-cost novelty items is receiving an increasing number of complaints from customers about the wrong merchandise being shipped. The order code for items has the format wwxxyyzz. The major category is ww, xx is the minor category, yy identifies the item, and zz identifies the catalog. In many cases, the wrong merchandise was sent because adjacent characters in the order code had been transposed. The best control for decreasing the number of orders with the wrong merchandise is to
    a. Add check-digits to the order codes and verify them for each order.
    b. Require customers to specify the name for each item they order.
    c. Separate the parts of the order code with hyphens to make the characters easier to read.
    d. Use a master file reference for all order codes to verify the existence of items.

29. Which of the following statements accurately describes the impact that automation has on the controls normally present in a manual system?
    a. Controls must be more explicit in a computer-based system because many processing points that present opportunities for human judgment in a manual system are eliminated.
    b. Responsibility for custody of information assets is more concentrated in user departments in a computer-based system than it is in a manual system.
    c. The quality of documentation becomes less critical in a computer-based system than it is in a manual system because data records are stored in machine-readable files.
    d. Transaction trails are more extensive in a computer-based system than in a manual system because there is always a one-for-one correspondence between data entry and output.

30. Which of the following computerized control procedures would be most effective in ensuring that data uploaded from personal computers to a mainframe are complete and that no additional data are added?
    a. Batch control totals, including control totals and hash totals.
    b. Field-level edit controls that test each field for alphanumerical integrity.
    c. Passwords that effectively limit access to only those authorized to upload the data to the mainframe computer.
    d. Self-checking digits to ensure that only authorized part numbers are added to the database.

31. When assessing application controls, which one of the following input controls or edit checks is most likely to be used to detect a data input error in the customer account number field?
    a. Control total.
    b. Hash total.
    c. Limit check.
    d. Validity check.

32. Payroll master file updates are sent from a remote terminal to a mainframe program on a real-time system. A control that works to ensure accuracy of the transmission is a(n)
    a. Protection ring.
    b. Integrated test facility.
    c. Hash total.
    d. Echo check.

33. When an auditor performs tests on a computerized inventory file containing over 20,000 line items, that auditor can maintain independence and perform most efficiently by
    a. Asking the console operator to print every item that cost more than P100.
    b. Obtaining a printout of the entire file and then selecting each nth item.
    c. Using a generalized audit software package.
    d. Using the systems department's programmer to write an extraction program.

34. Which of the following cannot be performed by an auditor using computer-assisted audit techniques (CAATs) software?
    a. Matching identical product information in separate data files.
    b. Identifying missing check numbers.
    c. Extracting data files containing only a two-digit year date field and changing it to hold four digits.
    d. Aging accounts receivable.

35. Computer technology makes it possible to perform paperless audits. For example, in an audit of computer-processed customer accounts receivable balances, an auditor might use a personal computer to access the accounts receivable files directly and copy selected customer records into the computer for audit analysis. Which of the following is an advantage of this type of paperless audit of accounts receivable balances?
    a. It reduces the amount of substantive testing required.
    b. It increases the amount of technical skill required of the auditor.
    c. It allows immediate processing of audit data on a spreadsheet working paper.
    d. It allows direct confirmation of customer account balances.

36. A primary advantage of using generalized audit software (GAS) packages in auditing the financial statements of a client that uses a computer system is that the auditor may
    a. Substantiate the accuracy of data through self-checking digits and hash totals.
    b. Reduce the level of required tests of controls to a relatively small amount.
    c. Consider increasing the use of substantive tests of transactions in place of analytical procedures.
    d. Access information stored on computer files without a complete understanding of the client's hardware and software features.

37. Which of the following is a control that will prevent accessing the accounts receivable files from a hardwired terminal located in a manufacturing department?
    a. Using data encryption.
    b. Providing only dial-up terminals.
    c. An echo check.
    d. A device authorization table.

38. Which of the following controls most likely could prevent computer personnel from modifying programs to bypass programmed controls?
    a. Segregation of duties within computer for computer programming and computer operations.
    b. Physical security of computer facilities in limiting access to computer equipment.
    c. Periodic management review of computer utilization reports and systems documentation.
    d. Participation of user department personnel in designing and approving new systems.

39. Which of the following strategies will a CPA most likely consider in auditing an entity that processes most of its financial data only in electronic form, such as a paperless system?
    a. Verification of encrypted digital certificates used to monitor the authorization of transactions.
    b. Increased reliance on internal control activities that emphasize the segregation of duties.
    c. Extensive testing of firewall boundaries that restrict the recording of outside network traffic.
    d. Continuous monitoring and analysis of transaction processing with an embedded audit module.

40. Which of the following is the primary reason that many auditors hesitate to use embedded audit modules?
    a. Auditors are required to be involved in the system design of the application to be monitored.
    b. Auditors are required to monitor embedded audit modules continuously to obtain valid results.
    c. Embedded audit modules can easily be modified through management tampering.
    d. Embedded audit modules cannot be protected from computer viruses.

41. Which of the following concepts distinguishes the retention of computerized audit documentation from the traditional hard copy form?
    a. Evidential support for all findings is copied and provided to local management during the closing conference and to each person receiving the final report.
    b. Computerized data files can be used in computer audit procedures.
    c. Audit programs can be standardized to eliminate the need for a preliminary survey at each location.
    d. Analyses, conclusions, and recommendations are filed on electronic media and are therefore subject to computer system controls and security procedures.

42. Operating controls include all of the following except
    a. Library security and use of proper file labels.
    b. Halt and error controls.
    c. Duplicate files and backup procedures.
    d. Batch controls.

43. Which of the following terms best describes the type of control practice evidenced by a segregation of duties between computer programmers and computer operators?
    a. Systems development control.
    b. Organizational control.
    c. Hardware control.
    d. Applications control.

44. Which of the following passwords would be most difficult to crack?
    a. 12 HOUSE 24
    b. errorsyntax
    c. pass89word
    d. e?KL!Bf09

45. Which of the following represents an internal control weakness in a computer-based system?
    a. Computer programmers write and revise programs designed by analysts.
    b. The data control group is solely responsible for distributing reports and other output.
    c. The computer librarian maintains custody and record keeping for computer application programs.
    d. Computer operators have access to operator instructions and the authority to change programs.

46. In the organization of the information systems function, the most important separation of duties is
    a. Assuring that those responsible for programming the system do not have access to data processing operations.
    b. Having a separate information officer at the top level of the organization outside of the accounting function.
    c. Not allowing the data librarian to assist in data processing operations.
    d. Using different programming personnel to maintain utility programs from those who maintain the application programs.

47. Which of the following security controls might prevent unauthorized access to sensitive data via an unattended workstation directly connected to a mainframe?
    a. Automatic log-off of inactive users.
    b. Encryption of data files.
    c. Use of a screen saver.
    d. Use of passwords to identify users.

48. When a new application is being created for widespread use in a large organization, the principal liaison between the information systems (IS) department and the rest of an organization is normally a(n)
    a. Systems analyst.
    b. Maintenance programmer.
    c. End user.
    d. Application programmer.

49. The best source of evidence to determine if ex-employees continue to have access to a company's automated databases is
    a. Reviewing computer logs of access attempts.
    b. Reviewing access control software to determine whether the most current version is implemented.
    c. Reconciling current payroll lists with database access lists.
    d. Discussing the password removal process with the database administrator.

50. Which one of the following input controls or edit checks would catch certain types of errors within the payment amount field of a transaction?
    a. Record count.
    b. Limit check.
    c. Echo check.
    d. Check digit.

COMPREHENSIVE CASES

CASE 1

The RNB Life Insurance Company has a database system that stores policy and payment information. The company is now planning to provide its branch offices with terminals that have online access to the central computer facility.

Required:

1. Define a database.
2. Give one fundamental advantage of a database.
3. Describe the security measures to safeguard the database system from improper access through the terminals.

CASE 2

CPAs may audit around or through computers in the audit of the financial statements of clients who use computers to process accounting data.

Required:

1. Describe the auditing approach referred to as "auditing around the computer".
2. Under what conditions do CPAs decide to audit through computer instead of around the computer?
3. In auditing through computer, CPAs may test data.
   a. What is test data?
   b. Why do CPAs use test data?
4. How can the CPAs be satisfied that the computer programs presented to them for testing are actually those used by the client for processing accounting data?

Chapter 12
USING THE WORK OF OTHERS

LEARNING OBJECTIVES

Upon completion of this chapter you will

1. **Understand the need to rely on the work of the component audits on the financial information of the components in its audit on the group financial statements.**
2. **Understand the auditor's consideration of using the work of an expert.**
3. **Know the auditor's consideration of using the work internal auditors.**
4. **Explain the impact of the expert, specialist, internal auditor or other auditor's work on the audit report of the principal auditor.**

This chapter discusses the external auditor's considerations when obtaining an understanding of, and determining whether to use the work of others (i.e., component auditors, auditor's experts and internal audit function), and the extent to which the external auditor may use that work.

AUDITS OF GROUP FINANCIAL STATEMENTS (INCLUDING THE WORK OF COMPONENT AUDITORS)

Auditing standards (i.e., PSA 600) discusses the matters that the group engagement team considers when determining the nature, timing and extent of its involvement in the risk assessment procedures and further audit procedures performed by the component auditors on the financial information of the components. The purpose of this involvement is to obtain sufficient appropriate audit evidence on which to base the audit opinion on the group financial statements.

Overall Responsibility of the Group Auditor

The group engagement partner is responsible for the direction, supervision and performance of the group audit engagement in compliance with professional standards and regulatory and legal requirements and in determining the appropriateness of the auditor's report.

As a result, the auditor's report on the group financial statements shall not refer to a component auditor. If such reference is required by law or regulation, the auditor's report shall indicate that the reference does not diminish the group engagement partner's or the group engagement partner's firm's responsibility for the group audit opinion.

Deciding to Serve as the Group Auditor

When requested to perform an audit of group financial statements, an audit firm is required to first evaluate whether the group engagement team will be able to obtain sufficient appropriate audit evidence through its own work or that of component auditors to act as the group auditor and report on the group financial statements.

The group engagement partner is required to determine whether it is reasonable to believe that sufficient appropriate audit evidence can be obtained regarding the consolidation process and the financial information of the components on which to base the group audit opinion. Making these

determinations requires sufficient understanding of the group, its components, and their environments to make a preliminary assessment of the significance of components and risk related to group-level activities.

In some cases, whenever a group engagement partner concludes that sufficient appropriate audit evidence cannot be obtain to support a group audit opinion or that it is unable to serve as group auditor, the group engagement partner should either decline to accept or resign from the engagement. In cases in which laws or regulations prohibits an auditor from declining or resigning from an engagement, the auditor should disclaim an opinion on the group financial statements after having performed the audit to the extent possible.

Developing the Overall Audit Strategy and Audit Plan

Having decided to serve as group auditor, the group engagement team is required to develop an overall group audit strategy and develop a group audit plan. Among other things, this requires the group auditor to further enhance its understanding of:

1. The business environment in which the group and its components operate.
2. Any group-wide controls important to the prevention or detection of errors in component financial information or in the consolidation process that may be material to the group financial statements.
3. The consolidation process, including controls and group reporting instructions.

This understanding is the basis for identifying and evaluating the significance of components and for assessing the risks of material misstatements of the group financial statements, whether due to error or fraud and thereby for developing planned audit procedures to appropriately assesses these risks.

Understanding the Group, Its Components and Their Environments

Auditors are required to identify and assess the risks of material misstatement by obtaining an understanding of the entity and its environment. Toward this end, the group engagement team should:

1. Enhance its understanding of the group, its components, and their environments, including group-wide controls that were obtained during the acceptance or continuance stage.
2. Obtain an understanding of the consolidation process, including the instructions issued by group management to components.
3. Obtain an understanding that is sufficient to confirm or revise its initial identification of components that are likely to be significant.
4. Obtain an understanding that is sufficient to assess the risks of material misstatement of the group financial statements, whether due to fraud or error.

Understanding Component Auditors

When the group engagement team plans to request the component auditor to perform work on the component's financial information, the group engagement team should obtain an understanding of:

1. **Ethical requirements and independence.** Whether the component auditor understands and will comply with the ethical requirements that are relevant to the group audit and, in particular, are independent.
2. **Professional competence.** The component auditor's professional competence.
3. **Ability to be involved in the component auditors' work.** Whether the group engagement team will be able to be involved in the work of the component auditors to the extent necessary to obtain sufficient appropriate audit evidence.
4. **Regulatory environment.** Whether the component auditors operate in a regulatory environment that actively oversees auditors.

The group engagement team's assessment of these factors provides a basis for determining whether to take responsibility for the work of the component auditor and, when taking responsibility, the nature and extent of involvement in component audit work.

As such, when a component auditor fails to meet the independence requirements that are relevant to the group audit, or when the group engagement team has serious concerns about the component auditor's professional competence, or understanding of and ability to comply with relevant ethical requirements, the group engagement team should not reference the component auditor in its report on the group financial statements, and should not otherwise use the component auditors work.

Materiality

The group engagement team determines materiality for the group financial statements as a whole when establishing the overall group audit strategy. The group engagement team also determines materiality to be applied to particular classes of transactions, account balances or disclosures in the group financial statements, when misstatements of lesser amounts than materiality level for the group financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the group financial statements.

COMPONENT MATERIALITY MUST BE LOWER THAN GROUP MATERIALITY SO THAT WHEN YOU COMBINE ALL THE POSSIBLE MIS STATEMENTS ACROSS COMPONENTS, YOU STILL DON'T EXCEED MATERIALITY FOR THE GROUP FS.

For those components where component auditors will perform an audit or a review for purposes of the group audit, group engagement team is also required to determine component materiality. Component materiality must be lower than the materiality level for the group financial statements as a whole to reduce to a sufficiently low level the probability that the aggregate of uncorrected and undetected misstatements in the component's financial information will exceed the materiality level for the group financial statements as a whole,.

LOWER THRESHOLD USED AS A BUFFER

Performance materiality and thresholds for communication of misstatements to group engagement team are also set by the group engagement team for the component. Performance materiality is the figure below that any misstatements in the financial statements may be considered trivial to the group financial statements.

Responding to Assessed Risks

Auditors are required to design and implement appropriate responses to address the assessed risks of material misstatement of the financial statements. The group engagement team should determine the type of work to be performed by the group engagement team, or the component auditors on its behalf, on the component's financial information. The group engagement team should also determine the nature, timing and extent of its involvement in the work of the component auditors.

The group engagement team should test, or request the component auditor to test, the operating effectiveness of controls over the consolidation process or over the financial information of the components, when the audit work is based on an expectation of the operating effectiveness of the group-wide controls, or when substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

Determining the Coverage of Components and the Type of Work to Be Performed

For the purposes of PSA 600, *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*, components such as subsidiaries, joint ventures and associates fall into one of two categories: significant and non-significant components. Significant components are either significant in financial terms or because of the degree of risk they present.

For components identified as significant because they are individually significant to the group, the group engagement team should perform an audit of the component's financial information using component materiality. In this context, adapting the component audit to meet the needs of the group engagement team may include, for example, not performing procedures on accounts or disclosures that will be audited by the group engagement team or communicating the results of the audit in a form that differs from the normal auditor's opinion.

For components identified as significant because they are likely to include significant risks of material misstatement to the group financial statements due to their specific nature or circumstances, the group engagement team should perform one or more of the following:

1. An audit of significant component's financial information using component materiality.
2. An audit of one or more account balances, classes of transactions or disclosures relating to the likely significant risks of material misstatement of the group financial statements.
3. Specified audit procedures relating to the likely significant risks of material misstatement of the group financial statements.

For components that are not significant, the group engagement team should perform analytical procedures at group level. If sufficient appropriate audit evidence on which to base the group audit opinion will not be obtained from the work performed on the financial information of significant components, group-wide controls, the consolidation process, and the analytical procedures performed at group level, the group engagement team should select additional components that are not significant and perform, or request a component auditor to perform, one or more procedures outlined in the previous paragraph or a review of the component's financial information using component materiality.

Involvement of the Group Engagement Team in the Component Auditor's Work

When a component auditor performs an audit of a significant component's financial information, the group engagement team should be involved in assessing the component's impact on risks of material misstatement of the group financial statements. At a minimum, this involvement should include discussions with the component auditor or component management of the business activities of the component that are significant to the group, as well as the susceptibility of the component to material misstatement of the financial information due to fraud or error. The group engagement team should also review the component auditor's documentation of identified significant risks of material misstatement of the group financial statements.

If significant risks of material misstatement of the group financial statements are identified in a component on which a component auditor performs the work, the group engagement team should evaluate the appropriateness of the further audit procedures to be performed and determine whether it is necessary to be involved in the further audit procedures based on the group engagement team understanding of the component auditor.

Consolidation Process

The group engagement team should:

1. Design and perform further audit procedures on the consolidation process to respond to the assessed risks of material misstatement of the group financial statements arising from the consolidation process.
2. Evaluate whether all components have been included in the group financial statements.
3. Evaluate the appropriateness, completeness and accuracy of consolidation adjustments and reclassifications.
4. Evaluate whether any fraud risk factors or indicators of possible management bias exist.
5. Evaluate whether the financial information of a component that has been prepared based on different accounting policies applied to the group financial statements is appropriately adjusted for purposes of preparing and presenting the group financial statements.
6. Determine whether the financial information identified in the component auditor's communication is the financial information that is incorporated in the group financial statements.
7. Evaluate whether appropriate adjustments have been made to component financial statements that have a different financial reporting period-end from that of the group.

Subsequent Events

The group engagement team or component auditors should perform procedures on the financial information of components designed to identify events at the component level that occur between the dates of the financial information of the components and the date of the auditor's report on the group financial statements that may require adjustment to or disclosure in the group financial statements.

The group engagement team should, if component auditors perform work other than audits of the financial information of components, request the component auditors to notify them if they become aware of subsequent events that may require an adjustment to or disclosure in the group financial statements.

Communication Between Auditors

The effective and efficient conduct of a group audit is directly and importantly affected by the quality of two-way communication between the group engagement team and component auditors. The group engagement team should clearly communicate its requirements to component auditors on a timely basis. These requirements include the scope of work to be performed by the component auditor and the required form and content of communications from the component auditor to the group auditor. Communications from component auditors are particularly important since they constitute all, or a substantial portion of, the evidence used by the group auditor in forming the group audit opinion.

Communications to component auditor. The group engagement team should communicate its requirements to the component auditors on a timely basis. This communication shall set out the work to be performed, the use to be made of that work and the form and content of the component auditor communications with the group engagement team. It shall also include the following:

1. A request that the component auditors, knowing the context in which the group engagement team will use their work, confirm that they will cooperate with the group engagement team.
2. The ethical requirements that are relevant to the group audit and, in particular, the independence requirements.
3. Identified significant risks of material misstatement of the group financial statements, whether due to fraud or errors, that are relevant to the work of the component auditor. The group engagement team shall request the component auditor to communicate on a timely basis any other identified significant risks of material misstatement of the group financial statements, due to fraud or error, in the component, and its responses to such risks.
4. A list of related parties prepared by group management, and any other related parties of which the group engagement team is aware. The group engagement team shall request the component auditor to communicate, on a timely basis, whether there are any related parties that neither group management nor group engagement team have previously identified. The group engagement team shall determine whether to identify such additional related parties to other component auditors.
5. In the case of an audit or review of the financial information of the component, component materiality (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) and the threshold above which misstatements cannot be regarded as clearly trivial to the group financial statements.

Communications from component auditor. The group engagement team should request the component auditor to communicate matters relevant to its conclusion with regard the group audit. Such communication shall include:

1. Whether the component auditors have complied with ethical requirements that are relevant to the group audit, including independence and professional competence.
2. Whether the component auditors have complied with the group engagement team's requirements.
3. Which component financial information the component auditors are reporting on.
4. Information on instances of non-compliance with laws or regulations that could give rise to a material misstatement of the group financial statements.
5. A list of uncorrected misstatements of the component's financial information (the list need not include misstatements that are below the threshold for clearly trivial misstatements communicated by the group engagement team).
6. Indicators of possible management bias.
7. Description of any identified significant deficiencies in internal control over financial reporting at the component level.
8. Other significant matters that the component auditors communicated or expect to communicate to those charged with governance of the component, including fraud or suspected fraud involving component management, employees who have significant roles in internal control at the component level or others where the fraud resulted in a material misstatement of the financial information of the component.

9. Any other matters that may be relevant to the group audit or that the component auditors wish to draw to the attention of the group engagement team, including exceptions noted in the written representations that they requested from component management.
10. The component auditors' overall findings, conclusions or opinion.

Evaluating the Sufficiency and Appropriateness of Audit Evidence Obtained

Evaluating the component auditor's communication and adequacy of their work. The group engagement team should:

1. Evaluate the component auditor's communication. The group engagement team should discuss significant matters arising from that evaluation with the component auditor, component management or group management, as appropriate, and determine whether it is necessary to review other relevant parts of the component auditors' audit documentation.
2. When the work of the component auditor is found insufficient, determine additional procedures to be performed and whether they are to be performed by the component auditor or by the group engagement team.

Sufficiency and appropriateness of audit evidence. The group engagement team should evaluate whether sufficient appropriate audit evidence has been obtained from the audit procedures performed on the consolidation process and the work performed by the group engagement team and the component auditors on the financial information of the components to support the group audit opinion.

The group engagement partner should evaluate:

1. The effect of any uncorrected misstatements (either identified by the group engagement team or communicated by component auditors) on the group audit opinion.
2. Any instances in which there have been an inability to obtain sufficient appropriate audit evidence.

Communications Between Group Auditors and Group Management and Those Charged with Governance

Communications on group audits are not just about group engagement team and component auditors. The group engagement team need to communicate a number of specifically group-related matters to group management and those charged with governance of the group.

Communication with group management. The group engagement team should communicate to group management material weaknesses and significant deficiencies in the design or operating effectiveness of group-wide internal control that are relevant to the group, regardless of whether they are identified by group auditors or brought to their attention by component auditors. The group engagement team should make the determination of which of these material weaknesses and significant deficiencies should be communicated to group management.

Any indication of fraud at group or component level also needs to be communicated on a timely basis to the appropriate level of group management.

Where component auditors report on component financial statements, group auditors are required to request group management to inform component management about anything group

engagement team are aware of that may be significant to the component's financial statements, but which component management may be unaware of. If group management declines to do this – group engagement team discuss the matter with those charged with governance of the group. If the matter remains unresolved, group engagement team consider whether to advise component auditors not to issue a report on the financial statements of the component.

Communication with those charged with governance of the group. In addition to the communications with those charged with governance required in other auditing standards, the group engagement team should communicate the following matters with those charged with governance of the group:

1. An overview of the type of work to be performed on the component's financial information.
2. An overview of the group engagement team's planned involvement in the work of component auditors on significant components e.g., whether they intended to visit the component, review files or attend meetings with component auditors.
3. Instances in which there is concerns about the quality of a component auditor's work.
4. Any limitations, if any, in the scope of the group audit e.g., where access to component auditor working papers has been denied.
5. Fraud or suspected fraud involving group management, component management, employees who have significant roles in group-wide controls or others where the fraud resulted in a material misstatement.

Documentation

The following documentation is required in a group audit, in addition to the other documentation requirements of other auditing standards:

1. An analysis of components, indicating those that are significant, and the type of work performed on the financial information of the components.
2. The nature, timing and extent of the group engagement team's involvement in the work performed by the component auditors on significant components including, where applicable, the group engagement team's review of relevant parts of the component auditors' audit documentation and conclusions thereon.
3. Written communications between the group engagement team and component auditors concerning the group engagement team's requirements.

USING THE WORK OF AN AUDITOR'S EXPERT

In some instances, the auditor may need to obtain, in conjunction with the entity or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert (specialist). The auditor's education and experience enable the auditor to be knowledgeable about accounting and auditing matters, however, an auditor is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation.

Auditing standards (i.e., PSA 620) define an **auditor's expert** as an individual or organization possessing expertise in a field other than accounting and auditing, whose work in that field is used by the auditor to assist the auditing in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an auditor's internal expert (who is a partner or staff, including temporary staff, of the auditor's firm or a network firm), or an auditor's external expert. This

would include individuals such as appraisers, geologists, actuaries, engineers and lawyers. Such individual may assist the auditor with valuation issues, determination of quantities or physical condition of assets, determination of amounts using specialized techniques or methods, measurement of work completed and to be completed on contracts in progress or legal opinions concerning interpretations of agreements or regulations. For example, an auditor might consult an actuary to determine the amount of the client's pension obligations or an engineer to estimate the remaining useful life of a client's plant and machinery.

TABLE 12.2 Examples of Activities that Involve the Work of Experts

Activities	Types of Experts
Valuation	
Assets acquired and liabilities assumed in business combinations	Valuation expert/ appraiser
Complex financial instruments	Valuation expert
Environmental remediation contingencies	Engineer
Goodwill impairments	Valuation expert
Insurance reserves	Actuary
Intangible assets	Valuation expert
Jewelry and art	Appraiser
Pension and other post-employment obligations	Actuary
Real estate	Appraiser
Stock options	Valuation expert
Evaluation of physical and other characteristics	
Materials stored in stockpiles	Geologist
Mineral reserves and condition	Geologist
Oil and gas reserves	Geologist
Property, plant and equipment useful lives and salvage value	Valuation expert/ appraiser
Interpretation of laws, regulations or contracts	
Legal title to property or interpretation of laws, regulations or contracts	Lawyer

Determining the Need to Use the Work of an Auditor's Expert

If expertise in a field other than accounting or auditing is necessary to obtain sufficient appropriate audit evidence, the auditor shall determine whether to use the work of an auditor's expert. In determining the need to use the work of an expert, the auditor ordinarily considers the following:

1. Whether management has used a management's expert in preparing the financial statements.
2. The nature and significance of the matter, including its complexity.
3. The risks of material misstatement in the matter.
4. The expected nature of procedures to respond to identified risks, including the auditor's knowledge of and experience with the work of experts in relation to such matters; and the availability of alternative sources of audit evidence.

The Competence, Capabilities and Objectivity of the Auditor's Expert

When planning to use the work of an auditor's expert, the auditor is expected to become satisfied as to the professional competence, capabilities and objectivity of the auditor's expert. Let's deal with each of these attributes:

- Competence – relates to the nature and level of expertise of the expert. Clearly, any expert employed should have a widespread recognition of their expertise in the stated discipline.

- Capability – relates to the expert's ability to exercise that competence in the circumstance of the audit engagement. For example, the expert must have the time and resources available to perform the task in hand.

- Objectivity – relates to the possible effects that bias, conflict of interest or the influence of others may have on the judgment of the expert. If an expert has a vested interest in expressing anything other than objective opinion with regard to the subject matter, then their opinion will be of no value to the auditor.

If an auditor's expert does not fulfill the requirement in respect of each of the above attributes, the risk of error or inaccuracy in the work carried out is increased and, therefore, the objective of minimizing the risk of not detecting material misstatement may not be achieved. Consequently, the auditor's quality control procedures should ensure that internal experts (who are part of the audit engagement team) are capable, competent and objective. Where an audit firm seeking to engage a new internal expert, or alternatively rely on the services of external expert, information about the competence, capability and objectivity of the expert may be sought from various sources.

The auditor, in assessing the professional competence, capabilities and objectivity of the auditor's expert, should consider the expert's:

1. Personal experience with previous work of the expert;
2. Discussion with the expert;
3. Discussion with other auditors who are familiar with the expert's work;
4. Knowledge of the expert's qualifications, membership of a professional body or industry association, license to practice, or other forms of external recognition; and
5. Published papers or books written by the expert.

Obtaining an Understanding of the Field of Expertise of the Auditor's Expert

The auditor should obtain a sufficient understanding of the field of expertise of the auditor's expert to enable the auditor to:

1. Determine the nature, scope and objectives of that expert's work for the auditor's purposes.
2. Evaluate the adequacy of that work for the auditor's purposes.

The auditor may obtain an understanding of the auditor's expert's field of expertise through discussion with that expert. The aspects of the auditor's expert's field relevant to the auditor's understanding may include the following:

1. Whether that expert's field has areas of specialty within it that are relevant to the audit.
2. Whether any professional or other standards and regulatory or legal requirements apply.
3. What assumptions and methods, including models where applicable, are used by the auditor's expert, and whether they are generally accepted within that expert's field and appropriate for financial reporting purposes.
4. The nature of internal and external data or information the auditor's expert uses.

Agreement with the Auditor's Expert

The nature, scope and objectives of the auditor's expert's work may vary considerably with the circumstances, as may the respective roles and responsibilities and the nature, timing and extent of communication between the auditor and the auditor's expert. It is therefore required that these matters are agreed regardless of whether the expert is an auditor's external expert or an auditor's internal expert.

The auditor shall agree, in writing when appropriate, on the following matters with the auditor's expert:

1. The nature, scope and objectives of that expert's work.
2. The respective roles and responsibilities of the auditor and that expert.
3. The nature, timing and extent of communication between the auditor and that expert, including the form of any report to be provided by that expert.
4. The need for the auditor's expert to observe confidentiality requirements.

The agreement between the auditor and an auditor's external expert is often in the form of an engagement letter. However, when there is no written agreement between the auditor and the auditor's expert, evidence of the agreement may be included in, for example, (1) planning memoranda, or related working papers such as the audit program and (2) policies and procedures of the auditor's firm.

Evaluating the Adequacy of the Auditor's Expert's Work

The auditor should evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including the: (1) relevance and reasonableness of that expert's findings or conclusions, and their consistency with other audit evidence, (2) relevance and reasonableness of the significant assumptions and methods used, and (3) relevance, completeness, and accuracy of the source data used.

When evaluating the findings and conclusions of the auditor's expert for audit purposes, the auditor may carry out various procedures, including:

- Inquiries of the auditor's expert;
- Reviewing the auditor's expert's working papers and reports
- Corroborative procedures such as: observing the auditor's expert work, examining reputable statistical reports and other authoritative published data, confirming relevant matters with third parties, performing detailed analytical procedures, and performing calculations;
- Discussion with another expert with relevant expertise; and
- Discussion with auditor's expert's report with management.

If the auditor concludes that the work of the auditor's expert is not adequate for the auditor's purpose, the auditor should resolve the matter by either agreeing that the expert should carry out further work or by the auditor carrying out additional procedures as appropriate to the circumstance.

Reference to an Auditor's Expert in the Auditor's Report

When issuing an unmodified auditor's report, the auditor should not refer to the work of an auditor's expert. If such reference is required by law or regulation, the auditor should indicate in the auditor's report that the reference does not reduce the auditor's responsibility for the audit opinion.

If, as a result of the work of an expert, the auditor decides to issue a modified auditor's report, in some circumstances it may be appropriate, in explaining the nature of the modification, to refer to or describe the work of the expert. In these circumstances, the auditor would obtain the permission of the expert before making such a reference.

USING THE WORK OF INTERNAL AUDITORS

Much of the work performed by a company's internal audit function can overlap with the work conducted by the external auditor, specifically in areas dealing with the assessment of control processes. It is likely that in carrying out detailed work evaluating and reviewing the company's internal control framework internal audit perform procedures on financial controls relevant to the external audit. As such, the external auditor, rather than duplicating these procedures, may be able to place reliance on the work carried out by the internal auditor.

Auditing standards highlight three ways in which internal auditors may be utilized by the external auditor in the audit of financial statements:

1. To obtain information relevant to the external auditor's assessments of the risks of material misstatement due to error or fraud (addressed in PSA 315, *Identifying and Assessing the Risk of Material Misstatements through Understanding the Entity and its Environment*).
2. To use the internal auditors' work in partial substitution for audit evidence to be obtained by external auditor.
3. To use internal auditors to perform audit procedures under the direction, supervision and review of the external auditor (i.e., provide direct assistance).

Determining Whether and to What Extent to Use the Work of the Internal Audit Function

The external auditor shall determine whether the work of the internal audit function can be used for purposes of the audit by evaluating the internal audit function's objectivity, level of competence and application by the internal audit function of a systematic and disciplined approach, including quality control.

TABLE 12.3 Evaluating the Internal Audit Functions

Definitions and Factors to Consider	
Objectivity	The ability to perform tasks without allowing bias, conflict of interest, or undue influence of others to override professional judgments Factors that may affect internal auditor's objectivity include whether the internal audit function's organizational status, including its authority and accountability, supports objectivity and prohibits constraints or restrictions placed on the internal audit function (*e.g.*, the internal audit function reports to those charged with governance or an officer with appropriate authority to ensure broad audit coverage and adequate consideration of, and action on, audit findings).

Competence	The ability to attain and maintain of knowledge and skills of the internal audit function as a whole at the level required to enable assigned tasks to be performed diligently and in accordance with applicable professional standards Factors that may affect the internal audit function's competence include: ▪ Whether the internal audit function is adequately and appropriately resourced relative to the size of the entity and the nature of its operations. ▪ Whether the internal auditors have adequate technical training and proficiency in auditing—*e.g.*, relevant professional designations, experience and knowledge of the entity's specific industry. ▪ Whether the internal auditors possess knowledge of the entity's financial reporting and the applicable financial reporting framework, including industry-specific factors, to perform work related the entity's financial statements.
Systematic and Disciplined Approach	The internal audit functions are adequate, demonstrated by applying a systematic and disciplined approach to planning, performing, supervising, reviewing and documenting its activities, including quality control. Factors that may affect internal audit's application of a systematic and disciplined approach, including quality control, include: ▪ Whether documented internal audit procedures or guidance covering such areas as risk assessments, work programs, documentation and reporting exist, are adequate and in use. ▪ Whether appropriate quality control policies and procedures exist, are adequate and in use—quality control policies, for example, relate to internal audit function leadership and engagement performance in standards set by relevant professional bodies for internal auditors, such as the requirements for periodic external quality assessments.

The external auditor shall not use the work of internal audit function if its organizational status and relevant policies and procedures do not adequately support the objectivity of internal auditors or if it lacks sufficient competence. Likewise, the external auditor shall not use the work of internal audit function if it does not apply a systematic and disciplined approach, including quality control.

External auditors evaluate the appropriateness of the internal audit's objectivity and competency on an ongoing basis. As such, external auditor's assessment of whether it should use the work of the internal audit function may change throughout the audit. The external auditor may gain additional insight, for example, into whether the entity's organizational structure and relevant policies and procedures adequately support the internal auditor's objectivity. The external auditor may learn the internal auditor's level of competence is not as planned. The external auditor's evaluation may even indicate the risks to the quality of the work of the function are too significant and, therefore, it is not appropriate to use any of the work of the function as audit evidence.

After the external auditor has determined that the work of the internal audit function can be used for purposes of the audit, the external auditor shall consider whether the planned nature and scope of the work of the internal audit function that has been performed, or is planned to be performed, is relevant to the overall audit strategy and audit plan that the external auditor has established.

In general, the greater the amount of judgment that is needed to be exercised in planning and performing audit procedures and evaluating the results thereof, the higher the risk of material misstatement and the more persuasive the audit evidence required by the external auditor will

need to be. In other words, the more likely that the external auditor may need to perform some procedures directly because considerations of the work of the internal audit function alone is unlikely to provide the external auditor with sufficient appropriate audit evidence.

Since the external auditor has sole responsibility for the audit opinion expressed, the external auditor shall make significant judgment in his audit engagement and plan to directly perform audit procedures regardless of the external auditor's decision to use the work of the internal audit function. Significant judgments include assessing the risks of material misstatement, evaluating the sufficiency of tests performed, evaluating the appropriateness of management's use of the going concern assumption, evaluating significant accounting estimates, and evaluating the adequacy of disclosures in the financial statements.

Using the Work of the Internal Audit Function

If the external auditor plans to use the work of the internal audit function, the external auditor shall discuss the planned used of its work with the function as a basis for coordinating their respective activities. As such, it may be useful to address the following:

1. The timing of such work.
2. The nature of the work performed.
3. The extent of audit coverage.
4. Materiality for the financial statements as a whole (and, if applicable, materiality level or levels for particular classes of transactions, account balances or disclosures), and performance materiality.
5. Proposed methods of items selection and sample sizes.
6. Documentation of the work performed.
7. Review and reporting procedures.

Coordination is effective when discussion takes place throughout the period; the external auditor is advised of and has access to relevant internal control reports and is informed of any significant matters that come to the attention of the internal audit function when such matters may affect the work of external auditors so that the external auditor may consider the implications of such matters for the audit engagement; and the external auditor informs the internal audit function of any significant matters that may affect the internal audit function.

The external auditor shall read the reports of the internal audit function relating to the work of the function that the external auditor plans to use to obtain understanding of the nature and extent of audit procedures it performed and related findings.

The external auditor shall perform sufficient audit procedures on the body of work of the internal audit function as a whole that the external auditor plans to use to determine its adequacy for purposes of the audit engagement. In determining the adequacy of such work, the external auditor shall evaluate whether the work of the internal audit function was properly planned, performed, supervised, reviewed and documented; whether sufficient appropriate audit evidence has been obtained to enable the internal audit function to draw reasonable conclusions; and whether the conclusions reached are appropriate and reports prepared by internal audit function are consistent with the results of the work performed.

Work of the internal audit function that may be used by the external auditor include testing of the operating effectiveness of controls, substantive procedures involving limited judgment, observation of inventory counts, tracing transactions through the information system relevant to

financial reporting, and in some circumstances, audits or reviews of the financial information of subsidiaries that are not significant components to the group.

The external auditor may perform procedures to appraise the quality of the work performed and conclusions reached by internal audit function. Such procedures include reviewing the work program and working papers of the internal audit function, re-performing some of the work of internal audit function, making inquiries of appropriate individuals within the internal audit function and observing the procedures performed by internal audit function.

Determining Whether and to What Extent to Use the Internal Auditors to Provide Direct Assistance

The external auditor may be prohibited by law or regulations from obtaining direct assistance from internal auditors. Therefore, the first task is to understand the law or regulation of the jurisdiction in which the auditor is operating.

If the external auditor is not prohibited by law or regulations to obtain direct assistance from internal auditors, the external auditor shall evaluate the existence and significance of threats to objectivity and competence of the internal auditors. If there are significant threats to the objectivity of the internal auditor or the internal auditor lacks sufficient competence to perform the proposed work, the external auditor should not obtain direct assistance from internal auditors.

The evaluation of the existence and significance of threats to objectivity of the internal auditors is considered as an important element in the external auditor's judgment as to whether internal auditors can provide direct assistance. Objectivity is regarded as the ability to perform the tasks without allowing bias, conflict of interest or undue influence of others to override professional judgment. The following factors are relevant to the external auditor's evaluation of objectivity:

1. Extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors.
2. Family and personal relationships with an individual working in, or responsible for, the aspect of the entity to which the work relates.
3. Association with the division or department in the entity to which the work relates.
4. Significant financial interest in the entity other than remuneration on terms consistent with those applicable to other employees at a similar level of seniority.

It should be noted that the main purpose here is to evaluate threats to objectivity. Take the first factor as an example – if evidence shows that the internal audit function's organizational status supports the objectivity of the internal auditors, the external auditor will feel more comfortable using direct assistance from the internal auditors. The following situations are likely to support the objectivity of the internal auditors:

1. The internal audit function reports to those charged with governance (e.g., the audit committee) rather than solely to management (e.g., the chief finance officer).
2. The internal audit function does not have managerial or operational duties that are outside of the internal audit function.
3. The internal auditors are members of relevant professional bodies obligating their compliance with relevant professional standards relating to objectivity.

In evaluating the level of competence of the internal auditors, competence of the internal audit function is likely to be deemed satisfactory where it can be evidenced that the function as a whole

operates at the level required to (i) enable assigned tasks to be performed diligently and (ii) in accordance with applicable professional standards. To make such evaluation, the external auditor can take into consideration the following factors:

1. Whether there are established policies for hiring, training and assigning internal auditors to internal audit engagements.
2. Whether the internal auditors have adequate technical training and proficiency in auditing (e.g., with relevant professional designation and experience).
3. Whether the internal auditors possess the required knowledge relating to the entity's financial reporting and the applicable financial reporting framework.
4. Whether the internal audit function possesses the necessary skills (for example, industry-specific knowledge) to perform work related to the entity's financial statements.

The external auditor should bear in mind that the assessment of competence and objectivity are of equal importance, and should be assessed individually and in aggregate. For example if the internal auditors are deemed appropriately competent but the external auditor identifies significant threats to objectivity it is unlikely that the external auditor will be able to use the internal auditors to provide direct assistance and vice versa.

If the external auditor determines that internal auditors can be used to provide direct assistance for purposes of the audit, the next decision to be made by the external auditor is to determine the nature and extent of work that can be assigned to internal auditors. This is a matter that requires the auditor to exercise professional judgment, due to the fact that extensive use of direct assistance could affect perceptions of the independence of external auditors.

Auditing standards (PSA 610) limits the circumstances in which direct assistance can be provided. The external auditor is advised to consider the following factors in such determination:

1. Extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors.
2. Competence level of the internal audit function.
3. Amount of judgment needed in (i) planning and performing relevant audit procedures and (ii) evaluating audit evidence gathered.
4. Assessed risk of material misstatements.

The external auditor should have performed the assessment of the first two factors when determining whether the internal auditors can provide direct assistance in the first instance. The less persuasive the evidence regarding the internal auditors' objectivity and competency, the more restrictive the nature and extent of work that can be assigned.

As a starting point, the external auditor should consider the amount of judgment needed in (i) planning and performing relevant audit procedures and (ii) evaluating audit evidence gathered. The greater the level of judgment required, the narrower the scope of work that can be assigned to internal auditors. The following activities are deemed to involve significant judgment and therefore are not expected to be assigned to internal auditors providing direct assistance:

1. Assessing risks of material misstatements.
2. Evaluating the sufficiency of tests performed.
3. Evaluating the appropriateness of management's use of the going concern assumption.
4. Evaluating significant accounting estimates.

For any particular account balance, class of transaction or disclosure, the external auditor has to take into consideration the assessed risk of material misstatement when determining the nature and extent of work that they propose to assign to internal auditors. The higher the assessed risk, the more restricted the nature and extent of work that should be assigned to internal auditors. If the risk of material misstatement is considered to be anything other than low, the more judgment that has to be involved and the more persuasive the audit evidence required. Therefore, in these circumstances, in order to reduce audit risk to an acceptably low level it is expected that the external auditor has to perform more procedures directly and place less reliance on assistance provided by internal auditors when collecting sufficient appropriate evidence.

Auditing standards (i.e., PSA 610) states that internal auditors cannot carry out procedures when providing direct assistance that:

1. Involve making significant judgment in the audit.
2. Relate to higher assessed risks of material misstatements where the judgment required in performing the relevant audit procedures or evaluating the audit evidence gathering is more than limited.
3. Relate to decisions the external auditor makes in accordance with PSA 610 regarding the internal audit function and the use of its work or direct assistance.
4. Relate to work with which the internal auditors have been involved and which has already been or will be reported to management (or those charged with governance) by the internal audit function. This restriction intends to minimize self-review threats.

Auditing standards (i.e., PSA 610) also states that the following should not be assigned to or involve internal auditors providing direct assistance:

1. Discussion of fraud risks.
2. Determination of unannounced (or unpredictable) audit procedures as addressed in PSA 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.
3. Maintaining control over external confirmation requests and evaluation of results of external confirmation procedures.

Responsibilities of the External Auditor Using Internal Auditors to Provide Direct Assistance

The external auditor should note the following responsibilities at different stages of the audit when using internal auditors to provide direct assistance:

1. After determining the use of internal auditors to provide direct assistance, the external auditor has to:

   - Communicate the nature and extent of the planned use of internal auditors with those charged with governance (in accordance with PSA 260, *Communication with Those Charged with Governance*) so as to reach a mutual understanding that such use is not excessive in the circumstances of the engagement. This communication not only dispels any perception that the external auditor's independence might be compromised by the use of direct assistance but also facilitates appropriate dialogue with those charged with governance.
   - Evaluate whether the external auditor is sufficiently involved in the audit.

2. Prior to the use of internal auditors to provide direct assistance, the external auditor has to obtain written agreement from two parties:
   - From an authorized representative of the entity stating that: (i) the internal auditors will be allowed to follow the external auditor's instructions, and (ii) the entity will not intervene in the work the internal auditor performs for the external auditors.
   - From internal auditors stating that they will: (i) keep confidential specific matters as instructed by the external auditor and (ii) inform the external auditor of any threat to their objectivity.

3. During the audit, the external auditor has to:
   - Direct, supervise and review the work performed by internal auditors on the engagement, bearing in mind that the internal auditors are not independent of the entity. It is therefore expected that such supervision and review will be of a different nature and more extensive than if members of the audit engagement team perform the work.
   - Remind the internal auditors to bring accounting and auditing issues identified during the audit to the attention of the external auditors.
   - Check back to the underlying audit evidence for some of the work performed by the internal auditors.
   - Make sure the internal auditors have obtained sufficient appropriate audit evidence to support the conclusions based on that work.

Documentation

If the external auditor uses the work of the internal audit function, the external auditor shall include the following items in the audit documentation:

1. The evaluation of the objectivity and competence level of the internal audit function and whether it applies a systematic and disciplined approach.
2. The nature and extent of the work used and the basis for that decision.
3. The audit procedures performed by external auditors to evaluate the adequacy of the work used.

If the external auditor uses internal auditors to provide direct assistance on the audit, the external auditor shall include the following items in the audit documentation:

1. Evaluation of the existence and significance of the threats to the objectivity and the level of competence of the internal auditors used to provide direct assistance.
2. The basis for the decision regarding the nature and extent of the work performed by the internal auditors.
3. The date and extent as well as the party that reviewed the work performed.
4. The written agreements from an authorized representative of the entity and the internal auditors.
5. The working papers prepared by the internal auditors providing direct assistance on the audit engagement.

REVIEW QUESTIONS

1. What is the difference between component auditor and group engagement partner? What are their respective responsibilities in the context of an audit of group financial statements?

2. What are the responsibilities of group engagement partner in the audits of group financial statements?

3. What are the factors that a group engagement partner should consider in its evaluation of significant components and its component auditors?

4. What are the matters that the group engagement team should timely communicate its requirements to the component auditor?

5. What are the matters that the group engagement team should request the component auditor to communicate matters relevant to its conclusion with regard the group audit?

6. What is an expert? Enumerates examples of experts. What are the areas of audit that an expert may assists an auditor?

7. What are the factors that an auditor ordinarily considers in determining the need to use the work of an expert?

8. What are the factors that the auditor considers in assessing the professional competence and objectivity of the expert?

9. What are the factors and procedures that the external auditors need to consider and perform in determining the areas and extent the work of the internal audit function can be used?

10. What are the audit considerations that the external auditors need to consider in using the work of the internal audit function?

11. What are the factors and procedures that the external auditors need to consider and perform in determining the areas and extent the internal auditors can be used to provide direct assistance?

12. What are the audit considerations that the external auditors need to consider in using the internal auditors to provide direct assistance?

MULTIPLE CHOICE QUESTIONS

1. When issuing an unmodified auditor's report, the auditor
   a. May refer to the work of an expert.
   b. Should include in the auditor's report the identity of the expert and the extent of the expert's involvement.
   c. Should not refer to the expert's work.
   d. Should refer to the work of an expert to indicate a division of responsibility.

2. If the results of the expert's work do not provide sufficient appropriate audit evidence or are not consistent with other audit evidence, the auditor should
   a. Express an unqualified opinion with reference to the work of the expert.
   b. Report the matter to the appropriate regulatory agency or the government.
   c. Resolve the matter.
   d. Withdraw from the engagement.

3. In using the work of a specialist, an auditor may refer to the specialist in the auditor's report if, as a result of the specialist's findings, the auditor
   a. Becomes aware of conditions causing substantial doubt about the entity's ability to continue as a going concern.
   b. Desires to disclose the specialist's findings, which imply that a more thorough audit was performed.
   c. Discovers significant deficiencies in the design of the entity's internal control that management does not correct.
   d. Is able to corroborate another specialist's earlier findings that were consistent with management's representations.

4. An auditor who uses the work of an expert may refer to and identify the expert in the auditor's report if the
   a. Auditor indicates a division of responsibility related to the work of the expert.
   b. Auditor's expresses a qualified opinion or an adverse opinion related to the work of the expert.
   c. Expert is employed by the entity.
   d. Expert's work provides the auditor greater assurance of reliability.

5. In assessing the objectivity of internal auditors, an independent auditor should
   a. Determine the organizational level to which the internal auditors report.
   b. Evaluate the quality control program in effect for the internal auditors.
   c. Examine documentary evidence of the work performed by the internal auditors.
   d. Test a sample of the transactions and balances that the internal auditors examined.

6. An internal auditor's work would most likely affect the nature, timing, and extent of an independent CPA's auditing procedures when the internal auditor's work relates to assertions about the
   a. Existence of contingencies.
   b. Existence of fixed asset additions.
   c. Valuation of intangible assets.
   d. Valuation of related-party transactions.

7. An external auditor will use internal auditors to assist in the audit of accounts receivable. Of the following procedures, the one that would be most appropriate for the internal auditors to perform is the
   a. Assessment of control risk for accounts receivable.
   b. Determination of the number of positive confirmation requests to be mailed to substantiate the existence of accounts receivable.
   c. Establishment of the amount of accounts receivable that is considered material.
   d. Preparation of an aged trial balance of accounts receivable.

8. The effect of satisfactory internal audit function upon the work of the independent auditor will most likely be

a. An acceptance of the financial statements as a fair representation of financial position and results of operations.
b. A substitution of the work of the internal auditor for the work of the independent auditor.
c. A substitution of the internal auditor's opinion of the financial statements in place of the independent auditor's opinion.
d. A reduction in the scope of audit procedures necessary by the independent auditor.

9. Which of the following factors most likely would assist an independent auditor in assessing the objectivity of the internal auditor?
   a. The professional certifications of the internal audit staff.
   b. The organizational status of the director of internal audit.
   c. The consistency of the internal audit reports with the results of work performed.
   d. The appropriateness of internal audit conclusions in the circumstances.

10. The introductory paragraph of an auditor's report contains the following sentences:
    We did not audit the financial statements of EZ Inc., a wholly owned subsidiary, which statements reflect total assets and revenues constituting 27% and 29%, respectively, of the related consolidated totals. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for EZ Inc., is based solely on the report of the other auditors.
    These sentences
    a. Require a departure from an unqualified opinion.
    b. Is an improper form of reporting.
    c. Indicate a division of responsibility.
    d. Assume responsibility for the other auditor.

11. In which of the following situations would an auditor ordinarily issue an unqualified audit opinion without an explanatory paragraph?
    a. The entity issues financial statements that present financial position and results of operations, but omits the statement of cash flows.
    b. The auditor wishes to emphasize that the entity had significant related-party transactions.
    c. The auditor has substantial doubt about the entity's ability to continue as a going concern, but the circumstances are fully disclosed in the financial statements.
    d. The auditor decides to make reference to the report of another auditor as a basis, in part, for the auditor's opinion.

12. An auditor may issue the standard audit report when the
    a. Principal auditor assumes responsibility for the work of another auditor.
    b. Financial statements are prepared on the cash receipts and disbursements basis of accounting.
    c. Financial statements are derived and condensed from complete audited financial statements that are filed with a regulatory agency.
    d. Auditor refers to the findings of a specialist.

13. In the auditor's report, the principal auditor decides not to make reference to another CPA who audited a client's subsidiary. The principal auditor could justify this decision if, among other requirements, the principal auditor
    a. Is satisfied as to the independence and professional reputation of the other CPA.
    b. Is unable to review the audit programs and working papers of the other CPA.

c. Issues an unqualified opinion on the consolidated financial statements.
d. Learns that the other CPA issued an unqualified opinion on the subsidiary's financial statements.

14. When two or more auditing firms participate in an audit, one firm should be the principal auditor. If the principal auditor makes reference to another auditor in an audit that would otherwise result in an unqualified opinion, the type of audit report issued should be
a. A disclaimer of opinion.
b. A qualified opinion.
c. An adverse opinion.
d. An unqualified opinion.

15. Mae is auditing the consolidated financial statements of Francisco Co., a publicly held corporation. Edison is the auditor who has audited and reported on the financial statements of a wholly owned subsidiary of Francisco Co.. Mae's first concern with respect to the Francisco financial statements is to decide whether she
a. May refer to the work of Edison in her report on the consolidated financial statements.
b. May serve as the principal auditor and report as such on the consolidated financial statements of Francisco Co.
c. Should resign from the engagement because an unqualified opinion cannot be expressed on the consolidated financial statements.
d. Should review the working papers of Edison with respect to the audit of the subsidiary's financial statements.

16. An auditor's report contains the following: "We did not audit the financial statements of Zara Company, a wholly owned subsidiary, which statements reflect total assets and revenues constituting 17% and 19%, respectively, of the related consolidated totals. Those statements were audited by other auditors whose report has been furnished to us, and our opinion, insofar as it relates to the amounts included for Zara Company, is based solely on the report of the other auditors." These sentences
a. Are an improper form of reporting.
b. Disclaim an opinion.
c. Divide responsibility.
d. Qualify the opinion.

17. If a principal auditor decides that he or she will refer in his report to the audit of another auditor, he or she is required to disclose the
a. Reasons why he or she is unwilling to assume responsibility for the other auditor's work.
b. Portion of the financial statements audited by the other auditor.
c. Nature of his inquiry into the other auditor's professional standing and extent of his review of the other auditor's work.
d. Name of the other auditor.

18. An auditor's expert
a. May be either an auditor's internal expert or an auditor's external expert.
b. Is an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity in preparing its financial statements.

c. An individual or organization possessing expertise in accounting or auditing whose work is used by the auditor in obtaining sufficient appropriate audit evidence.
d. A member of the engagement team with expertise in a specialized area of accounting or auditing.

19. When the auditor has to determine the need to use the work of an expert, he would least likely consider
a. The risk of material misstatement based on the nature and complexity of the matter being considered.
b. The quantity and quality of other audit evidence available.
c. The materiality of the financial statement item being considered.
d. The cost of using the services of an expert.

20. PSA 620 (Revised and Redrafted), Using the Work of an Auditor's Expert, deals with
a. The auditor's use of the work of a management's expert.
b. The auditor's responsibilities regarding the use of an individual or organization's work in a field of expertise other than accounting or auditing, when that work is used to assist the auditor in obtaining sufficient appropriate audit evidence.
c. Situations where the engagement team includes a member with expertise in a specialized area of accounting or auditing.
d. How the auditor's responsibility for the opinion on the entity's financial statements will be divided between the auditor and the auditor's expert.

21. PSA 620 (Using the Work of an Auditor's Expert) provides guidance using the work of an auditor's expert as audit evidence. According to this standard, an auditor's expert may be
a. Contracted or employed by the entity or auditor.
b. Contracted by the entity but never by the auditor.
c. Contracted by the auditor but never by the entity.
d. Contracted but not employed by the entity.

22. Which of the following is not a specialist upon whose work an auditor may rely?
a. Internal auditor.
b. Engineer.
c. Appraiser.
d. Actuary.

23. Which of the following statements is correct concerning an auditor's use of the work of a specialist?
a. An auditor may not use a specialist in the determination of physical characteristics relating to inventories.
b. If an auditor believes that the determinations made by a specialist are unreasonable, only a qualified opinion may be issued.
c. If there is a material difference between a specialist's findings and the assertions in the financial statements, only an adverse opinion may be issued.
d. The work of a specialist who is related to the client may be acceptable under certain circumstances.

24. Which of the following statements is correct about the auditor's use of the work of a specialist?
a. The auditor is required to perform substantive procedures to verify the specialist's assumptions and findings.

b. The auditor should obtain an understanding of the methods and assumptions used by the specialist.
c. The client should not have an understanding of the nature of the work to be performed by the specialist.
d. The specialist should not have an understanding of the auditor's corroborative use of the specialist's findings.

25. Which of the following would an auditor least likely consider in determining whether his/her own participation is sufficient to be able to act as the principal auditor?
a. The degree of knowledge about the business of the components.
b. The materiality of the portion of the financial statements that he/she examines.
c. The risk of material misstatements in the financial statements of the components audited by the other auditor.
d. The type of opinion to be rendered by the auditor of the entity's component.

26. A principal auditor decides not to refer to the audit of another CPA who audited a subsidiary of the principal auditor's client. After making inquiries about the other CPA's professional reputation and independence, the principal auditor most likely would
a. Add an explanatory paragraph to the auditor's report indicating that the subsidiary's financial statements are not material to the consolidated financial statements.
b. Contact the other CPA and review the audit programs and working papers pertaining to the subsidiary.
c. Document in the engagement letter that the principal auditor assumes no responsibility for the other CPA's work and opinion.
d. Obtain written permission from the other CPA to omit the reference in the principal auditor's report.

27. In using the work of an auditor's expert, an understanding should exist among the auditor, the client, and the expert as to the nature, scope, and objective of the expert's work. The documentation of this understanding should cover
a. A statement that the specialist assumes no responsibility to update the specialist's report for future events or circumstances.
b. The auditor's disclaimer as to whether the specialist's findings corroborate the representations in the financial statements.
c. The conditions under which a division of responsibility may be necessary.
d. The intended use by the auditor of the expert's wok, including the possible communication to third parties of the expert's identity and extent of involvement.

28. In using the work of an expert, an auditor referred to the expert's findings in the auditor's report. This is an appropriate reporting practice if the
a. Expert is aware that his/her work will be used to evaluate the assertions in the financial statements.
b. Auditor, as a result of the expert's work, issues a modified auditor's report.
c. Auditor, as a result of the expert's work, decides to indicate a division of responsibility with the expert.
d. Auditor, as a result of the expert's work, adds an emphasis of matter paragraph in his/her unmodified auditor's report.

29. When would the auditor refer to the work of an appraiser in the auditor's report?
a. An unqualified opinion is expressed and an emphasis of matter paragraph is added to disclose the use of the appraiser's work.

b. An adverse opinion is expressed based on the difference of opinion between the client and the outside appraiser as to the value of certain assets.
c. A qualified opinion is expressed because of a matter unrelated to the work of the appraiser.
d. A disclaimer of opinion is expressed because of a scope limitation imposed on the auditor by the appraiser.

30. What is the proper organizational role of internal auditing?
a. To serve as the investigative arm of the audit committee of the board of directors.
b. To serve as an independent, objective assurance and consulting activity that adds value to operations.
c. To perform studies to assist in the attainment of more efficient operations.
d. To assist the external auditor in order to reduce external audit fees.

31. Which of the following is considered a primary reason for creating an internal audit department?
a. To safeguard resources entrusted to the organization.
b. To relieve management of responsibility for establishing effective controls.
c. To evaluate and improve the effectiveness of control processes.
d. To ensure the accuracy, reliability, and timeliness of financial and operating data used in management's decision making.

32. The external auditor should obtain a sufficient understanding of the internal audit function because
a. The work performed by internal auditors may be a factor in determining the nature, timing, and extent of the external auditor's procedures.
b. The understanding of the internal audit function is an important substantive test to be performed by the external auditor.
c. The procedures performed by the internal audit staff may eliminate the external auditor's need for considering internal control.
d. The audit programs, working papers, and reports of internal auditors may often be used as a substitute for the work of the external auditor's staff.

33. Which of the following is an incorrect statement concerning the relationship of the internal auditor and the scope of the external audit of an entity's financial statements?
a. The external auditor is not required to give consideration to the internal audit function beyond obtaining a sufficient understanding to identify and assess the risks of material misstatements of the financial statements and to design and perform further audit procedures.
b. The internal auditors may determine the extent to which audit procedures should be employed by the external auditor.
c. The nature, timing, and extent of the external auditor's substantive tests may be affected by the work of internal auditors.
d. Under certain circumstances, the internal auditors may assist the external auditor in performing substantive tests and tests of controls.

34. If the external auditor decides that it is efficient to consider how the work performed by the internal auditors may affect the nature, timing, and extent of audit procedures, he/she should assess the internal auditors'
a. Competence and objectivity.
b. Efficiency and experience.

c. Independence and review skills.
d. Training and supervisory skills.

35. In assessing the technical competence of an internal auditor, an external auditor most likely would obtain information about the
    a. Entity commitment to integrity and ethical values.
    b. Influence of management on the internal auditor's duties.
    c. Organizational level to which the internal auditor reports.
    d. Quality of working paper documentation, reports, and recommendations.

36. When assessing the internal auditor's competence, the independent CPA should obtain information about the
    a. Educational background and professional certification of the internal auditors.
    b. Internal auditors' access to records and information that is considered sensitive.
    c. Organizational level to which the internal auditors report.
    d. Policies prohibiting the internal auditors from auditing areas where relatives are employed.

37. In assessing the competence and objectivity of an entity's internal auditor, an independent auditor would least likely consider information obtained from
    a. The results of analytical procedures.
    b. Previous experience with the internal auditor.
    c. External quality reviews of the internal auditor's activities.
    d. Discussions with management personnel.

38. Auditors should request that an audit client send a letter of inquiry to those attorneys who have been consulted concerning litigation, claims or assessments. The primary reason for this request is to provide
    a. Information concerning the progress of cases to date.
    b. Corroborative evidential matter.
    c. An estimate of the dollar amount of the probable loss.
    d. An expert opinion as to whether a loss is possible, probable, or remote.

39. If specific information comes to an auditor's attention that implies the existence of possible illegal acts that could have a material, but indirect effect on the financial statements, the auditor should next
    a. Apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.
    b. Seek the advice of an informed expert qualified to practice law as to possible contingent liabilities.
    c. Report the matter to an appropriate level of management at least one level above those involved.
    d. Discuss the evidence with the client's audit committee or others with equivalent authority and responsibility.

40. When using the work of a specialist , an auditor may refer to an and identify the specialist in the auditor's report if the
    a. Auditor wishes to indicate a division of responsibility.
    b. Specialist's work provides the auditor greater assurance of reliability.
    c. Auditors express an adverse opinion as a result of the specialist's findings.
    d. Specialist is not independent of the client.

41. In using the work of a specialist, an understanding should exist among the auditor, the client, and the specialist's as to the nature of the specialists work. The documentation of this understanding should cover
    a. A statement that the specialist assumes **no** responsibility to update the specialist's report for future events or circumstances.
    b. The conditions under which a division of responsibility may be necessary.
    c. The specialist understanding of the auditor's corroborative use of the specialist's findings.
    d. The auditor's disclaimer as to whether the specialist's findings corroborate the representations in the financial statements.

COMPREHENSIVE CASES

CASE 1 – Understanding the Internal Audit Function
Matalas Co sells cars, car parts and petrol from 25 different locations in one country. Each branch has up to 20 staff working there, although most of the accounting systems are designed and implemented from the company's head office. All accounting systems, apart from petty cash, are computerized, with the internal audit department frequently advising and implementing controls within those systems.

Matalas has an internal audit department of six staff, all of whom have been employed at Matalas for a minimum of five years and some for as long as 15 years. In the past, the chief internal auditor appoints staff within the internal audit department, although the chief executive officer (CEO) is responsible for appointing the chief internal auditor. The chief internal auditor reports directly to the finance director. The finance director also assists the chief internal auditor in deciding on the scope of work of the internal audit department.

Required:

1. Explain the issues which limit the independence of the internal audit department in Matalas Co. Recommend a way of overcoming each issue.

CASE 2 – Why Both Internal Auditing and a Financial Statement Audit?
Arnold Yap, a local real estate broker, has been appointed to the board of directors of PanAsia Corporation. At a recent board meeting, Yap discovered two planned expenditures for auditing. The controller's budget included an amount for internal auditing, and the treasurer's budget included an amount for the 2021 financial statement audit by a major public accounting firm.

Yap didn't understand the need for two different expenditures for auditing. Since the fee for the financial statement audit was less than the cost of internal auditing, he proposed eliminating the internal audit function.

Required:

1. Explain to Yap the purposes served by internal auditing and by a financial statement audit.

2. What benefits does the public accounting firm performing an audit derive from internal auditing?

Chapter 13
OTHER AUDIT CONSIDERATIONS

LEARNING OBJECTIVES

Upon completion of this chapter you will

1. **Know the concept of accounting estimate and the appropriate audit procedures relating to such concept.**
2. **To identify the factors affecting the risk assessment procedures and other activities governing auditing accounting estimates.**
3. **To enumerate the factors that should be consider in identifying, assessing and responding to risks if material misstatements for accounting estimates.**
4. **To identify the further substantive procedures to respond to significant risks particularly in estimation uncertainty and recognition and measurement criteria of the accounting estimates.**
5. **Enumerate the applicable audit procedures relevant to opening balances, to determine the consistency of accounting policies and identify the relevant information in the predecessor auditor's report.**

This chapter provides guidance on auditing accounting estimates and fair value measurements and disclosures contained in financial statements.

AUDITING ACCOUNTING ESTIMATES AND RELATED DISCLOSURES

Some financial statement items cannot be precisely measured. These are referred to as accounting estimates. Auditing standards (i.e., PSA 540) defined accounting estimate as an approximation of a monetary amount in the absence of a precise means of measurement. This term is used for amounts measured at fair value when estimation uncertainty exists and other amounts that require estimation. The nature and reliability of information available to management to support the making of an accounting estimate may vary widely. This create a degree of estimation uncertainty, which in turn affects the risks of material misstatement of accounting estimates, including their susceptibility to unintentional or intentional management bias.

Measurement objectives of accounting estimates can vary, depending on the applicable financial reporting framework, or "basis of accounting," and the financial item being reported. They may, for example, have as their objective:

1. Forecasting the outcome of transactions, events, or conditions.
2. Estimating the value of a current transaction or financial statement item based on conditions prevalent at the measurement date, such as a fair value measurement based on an assumed hypothetical current arm's-length transaction.

Accounting estimates are inherently uncertain. This is particularly true for fair value estimates. Thus, differences between the outcome of an accounting estimate and the amount originally recognized or disclosed in the financial statements do not necessarily represent a misstatement.

TABLE 13.1 Definition of Terms

This section defines the following terms:

Auditor's point estimate or auditor's range – The amount, or range of amounts, respectively, derived from audit evidence for use in evaluating management's point estimate.

Estimation uncertainty – The susceptibility of an accounting estimate and related disclosures to an inherent lack of precision in its measurement.

Management bias – A lack of neutrality by management in the preparation and presentation of information.

Management's point estimate – The amount selected by management for recognition or disclosure in the financial statements as an accounting estimate.

Outcome of an accounting estimate –The actual monetary amount which results from the resolution of the underlying transaction(s), event(s) or condition(s) addressed by the accounting estimate.

Risk Assessment Procedures and Related Activities

In performing risk assessment procedures and related activities to gain an understanding of the entity and its environment, including its internal control, the auditor should obtain an understanding of the following in order to provide a basis for identifying and assessing the risks of material misstatement for accounting estimates:

1. The requirements of the applicable financial reporting framework relevant to accounting estimates, including the related disclosures.

2. How management identifies those transactions, events and conditions that may give rise to the need for accounting estimates to be recognized or disclosed in the financial statements.

   In obtaining this understanding, the auditor should inquire of management concerning changes in circumstances that may give rise to new, or the need to revise existing, accounting estimates.

3. How management makes the accounting estimates.

4. Data on which they are based, including:

   - The method or model used in making the accounting estimate.
   - Relevant controls.
   - Management's used of an expert.
   - The assumptions underlying the accounting estimates.
   - Whether there has been or ought to have been a change from the prior period in the methods or assumptions for making the accounting estimates.
   - How management has assessed the effect of estimation uncertainty.

Auditors should perform a retrospective review of management judgments and assumptions related to significant accounting estimates included in the prior period financial statements. When applicable, they should review their re-estimation for the purpose of the current period. This review takes into consideration the nature of the accounting estimates, and whether the

information obtained from the review would be relevant to identifying and assessing risks of material misstatement of accounting estimates made in the current period financial statements. However, it is not intended to question professional judgments that the auditor made in the prior periods that were based on information available at the time.

Identifying and Assessing the Risks of Material Misstatement

When identifying and assessing the risks of material misstatement, auditor should evaluate the degree of estimation uncertainty associated with an accounting estimate and determine whether, in their judgment, any of those accounting estimates that have been identified as having high estimation uncertainty give rise to significant risks.

The degree of estimation uncertainty associated with an accounting estimate may be influenced by factors such as:

1. The extent to which the accounting estimate depends on judgment.
2. The sensitivity of the accounting estimate to changes in assumptions.
3. The existence of recognized measurement techniques that may mitigate the estimation uncertainty.
4. The length of the forecast period, and the relevance of data drawn from past events to forecast future events.
5. The availability of reliable data from external sources.
6. The extent to which the accounting estimate is based on observable or unobservable inputs.
7. The actual or expected magnitude of an accounting estimate.
8. The recorded amount of the accounting estimate (i.e., management's point estimate) in relation to the amount you expected to be recorded).
9. Whether management has used an expert in making the accounting estimates.
10. The outcome of the review of prior period accounting estimates.

In this regard, a seemingly immaterial accounting estimate can potentially result in a material misstatement because the size of the amount of an accounting estimate recognized or disclosed in the financial statements may not indicate uncertainties. In some circumstances, such as the outcome of litigation, the estimation uncertainty may be so high that a reasonable accounting estimate cannot be made.

Depending upon the requirements of the applicable financial reporting framework, there can be audit concerns not only whether an accounting estimate should be recognized, or whether it should be measured at fair value, but also to the adequacy of the disclosures. With respect to such accounting estimates, the applicable financial reporting framework may require disclosure of the accounting estimates and the high estimation uncertainty associated with them.

Responses to the Assessed Risks of Material Misstatement

If the auditor concludes that an accounting estimate has a high degree of estimation uncertainty, the auditor should determine whether, in their judgment, any of the accounting estimates identified as having high estimation uncertainty give rise to significant risks.

Auditors should determine, based on their assessed risks of material misstatement, whether the:

1. Management has appropriately applied the requirements of the applicable financial reporting framework relevant to the accounting estimate.
2. Methods for making the accounting estimates are appropriate and have been applied consistently.
3. Changes, if any, in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances.

In responding to the assessed risks of material misstatement, the auditor should undertake one or more of the following, taking account of the nature of the accounting estimate:

1. Determine whether subsequent events (occurring up to the date of the auditor's report) provide audit evidence about the accounting estimate.

2. Test how management made the accounting estimate and the data on which it is based and evaluates whether the method of measurement used is appropriate in the circumstances and assumptions used by management are reasonable.

3. Test the operating effectiveness of the controls over how management made the accounting estimate, together with appropriate substantive procedures.

4. Develop a point estimate or a range to evaluate management's point estimate.

   If the auditor uses assumptions or methods that differ from management, the auditor should obtain an understanding of management's assumptions or methods in order to establish that the auditor's point estimate or range takes into account relevant variables and to evaluate any significant differences from management's point estimate. When using a range, the auditor should narrow the range, based on available audit evidence, until all outcomes within the range are considered reasonable.

   The auditor should likewise consider whether specialized skills or knowledge in relation to one or more aspects of the accounting estimates are required in order to obtain sufficient appropriate audit evidence.

Testing how management made the accounting estimate and the data on which it is based may be an appropriate response when the accounting estimate is a fair value accounting estimate developed on a model that uses observable and unobservable inputs. Such testing involve the following:

1. Testing the extent to which data on which the accounting estimate is based is accurate, complete and relevant.
2. Testing whether the accounting estimate has been properly determined using such data and management assumptions.
3. Considering the source, relevance and reliability of external data or information, including that received from external experts engaged by management to assist in making an accounting estimate.
4. Recalculating the accounting estimate, and reviewing information about an accounting estimate for internal consistency.
5. Considering management's review and approval processes.

In smaller entities, the process for making accounting estimates is likely to be less structured than in larger entities. Even if the entity has no formal established process, it does not mean that management is not able to provide a basis upon which the auditor can test the accounting estimate.

Further Substantive Procedures to Respond to Significant Risks: Estimation Uncertainty

If the auditor concludes that an accounting estimate gives rise to a significant risk, the auditor should obtain an understanding of the entity's controls, including control activities relevant to that risk.

For accounting estimates that give rise to significant risks, in addition to designing and performing substantive procedures for each material class of transactions, account balance and disclosure, the auditor should evaluate the following:

1. How management has considered alternative assumptions or outcomes, and why it has rejected them, or how management has otherwise addressed estimation uncertainty in making the accounting estimate.
2. Whether the significant assumptions used by management are reasonable.
3. When relevant to the reasonableness of the significant assumptions used by management or the appropriate application of the applicable financial reporting framework, management's intent to carry out specific courses of action and its ability to do so.

If, in the auditor's judgment, management has not adequately addressed the effects of estimation uncertainty on the accounting estimates that give rise to significant risks, auditors should, if considered necessary, develop a range with which to evaluate the reasonableness of the accounting estimate.

Smaller entities may use simple means to assess the estimation uncertainty and management may not have the expertise to consider alternative outcomes or otherwise address the estimation uncertainty of the accounting estimate. Auditors may address this through the review of available documentation and inquiries of management concerning how they considered alternative outcomes or assumptions. Auditors may also explain to management the process or the different methods available for doing so, and the documentation thereof. However, this would not change the responsibilities of management for the preparation and presentation of the financial statements.

Further Substantive Procedures to Respond to Significant Risks: Recognition and Measurement Criteria

For accounting estimates that give rise to significant risks, auditors should obtain sufficient appropriate audit evidence about whether:

1. Management's decision to recognize (or not) the accounting estimates in the financial statements is in accordance with the requirements of the applicable financial reporting framework.
2. The selected measurement basis for the accounting estimates is in such accordance.

The auditor's focus, when management has recognized an accounting estimate in the financial statements, is on evaluating whether the measurement of the accounting estimate is sufficiently reliable to meet the recognition criteria of the applicable financial reporting framework. When

management has decided not to recognize an accounting estimate, the focus of the auditor's evaluation is on whether the recognition criteria of the applicable financial reporting framework have in fact been met. This is important because even when it is appropriate not to recognize an accounting estimate, a disclosure in the notes to the financial statements may be necessary. In some cases, the auditor may also determine that there is a need to draw the reader's attention to a significant uncertainty by adding an Emphasis of Matter paragraph to the auditor's report.

Some financial reporting frameworks presume that fair value measurements can be measured reliably as a prerequisite to either requiring or permitting fair value measurements or disclosures. This presumption may be overcome when, for example, there is no appropriate method or basis for measurement. When this is the case, the auditor's focus is on evaluating whether management's basis for overcoming the presumption relating to the use of fair value set forth under the applicable financial reporting framework is appropriate.

Evaluating the Reasonableness of the Accounting Estimates and Disclosures

At the end of the estimation process, the auditors should evaluate, in the context of the applicable financial reporting framework, and based on the audit evidence:

1. Whether the accounting estimates in the financial statements are either reasonable or are misstated.

   Auditors may conclude that evidence points to an accounting estimate that differs from management's point estimate. When the audit evidence supports a point estimate, the difference between the auditor's point estimate and management's point estimate constitutes a misstatement. Similarly, when the audit evidence indicates a range and management's point estimate lies outside of the auditor's range, the difference between management's point estimate and the nearest point of the auditor's range is a misstatement.

2. Whether the financial statements disclosures related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework.

3. For accounting estimates that give rise to significant risks, the adequacy of the disclosure of their estimation uncertainty in the financial statements.

   These disclosures may include, for example, the assumptions used, method of estimation and model used, basis for the selection of the method of estimation, effect of any changes to the method of estimation from the prior period, and sources and implications of estimation uncertainty.

Indicators of Possible Management Bias

The auditor should performs the review of management's judgments and decisions in the making of accounting estimates to identify if there are indicators of possible management bias. Management bias may be difficult to detect at an account level. It may be identifiable only when considered in the aggregate of groups of accounting estimates or all accounting estimates. Auditors, in applying professional skepticism to their audit of accounting estimates, will exercise an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to error or fraud, including audit evidence that contradicts other audit evidence obtained, and a critical assessment of audit evidence.

However, indicators of possible management bias do not, by themselves, constitute misstatements for the purposes of drawing conclusions about whether individual accounting estimates are reasonable.

Examples of indicators of possible management bias with respect to accounting estimates include:

1. Changes in an accounting estimate, or the method for making it, where management has made a subjective assessment that there has been a change in circumstances.
2. Use of an entity's own assumptions for fair value accounting estimates when they are inconsistent with observable marketplace assumptions.
3. Selection or construction of significant assumptions that yield a point estimate favorable for management objectives.
4. Selection of a point estimate that may indicate a pattern of optimism or pessimism.

Audit Documentation and Written Representations

The auditors should document the basis for the auditor's conclusions about the reasonableness of accounting estimates and their related disclosures that give rise to significant risks and indications of possible management bias, if any.

The auditor shall obtain written representations from management and, where appropriate, from those charged with governance, whether they believe significant assumptions used in making accounting estimates are reasonable, as near as practicable to, but not after, the date of the auditor's report on the financial statements.

INITIAL AUDIT ENGAGEMENTS – OPENING BALANCES

Auditing standards (i.e., PSA 510) outlines the auditor's responsibility relating to opening balances when conducting an initial audit engagement. In addition to financial statement amounts, opening balances include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.

TABLE 13.2 Definition of Terms

This section defines the following terms:

Initial audit engagement – An engagement in which either:
- The financial statements for the prior period were not audited
- The financial statements for the prior period were audited by a predecessor auditor.

Opening balances – Those account balances that exist at the beginning of the period. These balances:
- Are based upon the closing balances of the prior period
- Reflect the effects of transactions and events of prior periods
- Reflect the accounting policies applied in the prior period
- Include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments

Predecessor auditor – The auditor from a different audit firm, who audited the financial statements of an entity in the prior period and who has been replaced by the current auditor.

In conducting an initial audit engagement, the objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether:

1. Opening balances contain misstatements that materially affect the current period's financial statements.

2. Appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements, or changes thereto are properly accounted for and adequately presented and disclosed in accordance with the applicable financial reporting framework.

Audit Procedures: Opening Balances

Auditors should read the most recent financial statements, and the predecessor auditor's report on them, if any, for any information relevant to opening balances, including disclosures.

Auditors should obtain sufficient appropriate audit evidence about whether the opening balances contain material misstatements that could be material to the current period's financial statements by performing all of the following:

1. Determining whether prior period closing balances are brought forward correctly to the current period or, when appropriate, have been restated.
2. Determining whether opening balances reflect appropriate application of accounting policies.
3. Evaluating whether current period audit procedures provide evidence about opening balances by means of performing one or both of the following:
   - When the prior year financial statements were audited, reviewing the predecessor auditor's working papers.
   - Performing specific audit procedures to obtain evidence regarding the opening balances.

If the opening balances contain misstatements that could materially affect the current period's financial statements, the auditor should perform additional audit procedures as appropriate in the circumstances to determine the effect on the current period's financial statements. If the auditor concludes that such misstatements exist in the current period's financial statements, the auditor should communicate the misstatements with the appropriate level of management and those charged with governance.

Audit Procedures: Consistency of Accounting Policies

Auditor should obtain sufficient appropriate audit evidence about whether:

1. The accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements.
2. Changes in the accounting policies have been (a) properly accounted for and (b) adequately presented and disclosed in accordance with the applicable financial reporting framework.

EVALUATE WHETHER ISSUES THAT CAUSED LAST YEAR'S MODIFICATION COULD STILL AFFECT CURRENT YEAR FS
① UNDERSTAND WHAT CAUSED IT ③ ASSESS IMPACT ON CURRENT PERIOD
② DETERMINE IF THE ISSUE STILL EXISTS ④ MODIFY AUDIT APPROACH IF NECESSARY

Audit Procedures: Relevant Information in the Predecessor Auditor's Report

If the prior period's financial statements were audited by a predecessor auditor and there was a modification to the opinion, the successor auditor should evaluate the effects of the matter giving

rise to the modification in assessing the risks of material misstatement in the current period's financial statements.

Audit Conclusions and Reporting

Auditors should not refer to the report or work of a predecessor auditor as the basis, in part, for their own opinions. Certain conditions related to opening balances may require an auditor to express a modified opinion. Those conditions are summarized in Table 13.3, below.

TABLE 13.3 Modifications to Opinions – Opening Balances

Conditions	Modifications to Opinion
Inability to obtain sufficient appropriate audit evidence regarding opening balances	Qualified or disclaimer
Opening balances materially misstated	Qualified or adverse
Current period's accounting policies not consistently applied with respect to the opening balances	Qualified or adverse
Change in accounting policies not appropriately accounted for	Qualified or adverse
Change in accounting policies not adequately presented	Qualified or adverse
Change in accounting policies not adequately disclosed	Qualified or adverse
Predecessor's opinion modified for a matter that remains material and relevant to current statements	Qualified, adverse or disclaimer

The decision to express a qualified opinion, as opposed to an adverse opinion or disclaimer, is based on the auditor's judgment about the materiality and pervasiveness of the condition.

REVIEW QUESTIONS

1. What is an accounting estimate and what are the appropriate audit procedures relating to such concept? Enumerate at least five examples on accounting estimates.

2. What are the factors affecting the risk assessment procedures and other activities governing auditing accounting estimates?

3. What are the factors that should be consider in identifying, assessing and responding to risks if there are material misstatements relating to accounting estimates?

4. What are the further substantive procedures to respond to significant risks particularly in estimation uncertainty and recognition and measurement criteria of the accounting estimates?

5. What are the applicable audit procedures relevant to opening balances, to determine the consistency of accounting policies and identify the relevant information in the predecessor auditor's report?

MULTIPLE CHOICE QUESTIONS

1. It means an approximation of the amount of an item in the absence of a precise means of measurement
   a. Accounting change.
   b. Accounting error.
   c. Accounting estimates.
   d. Accounting policy.

2. In evaluating the reasonableness of an entity's accounting estimates, an auditor normally would be concerned about assumptions that are
   a. Consistent with prior periods.
   b. Insensitive to variations.
   c. Similar to industry guidelines.
   d. Susceptible to bias.

3. Which of the following is not one of the primary approaches that the auditors may use when evaluating the reasonableness of accounting estimates?
   a. Confirm estimates directly with outsiders.
   b. Independently develop an estimate of the amount to be compared to management's estimate.
   c. Review and test management's process of developing estimates.
   d. Review subsequent events or transactions that have bearing on the estimate.

4. In evaluating the assumptions on which the estimate is based, the auditor would need to pay particular attention to assumptions which are
   a. Consistent with management's plans which appear appropriate.
   b. Consistent with those used for other accounting estimates.
   c. Reasonable in light of actual results in prior years.
   d. Subjective or susceptible to material misstatement.

5. In evaluating the reasonableness of an accounting estimate, an auditor most likely would concentrate on key factors and assumptions that are
   a. Consistent with prior periods.
   b. Deviations from historical patterns.
   c. Objective and not susceptible to bias.
   d. Similar to industry guidelines.

6. Which of the following statements concerning accounting estimates is incorrect?
   a. Accounting estimates are often made in conditions of uncertainty regarding the outcome of events that have occurred or are likely to occur and involve the use of judgment.
   b. The auditor is responsible for making accounting estimates included in financial statements.
   c. The auditor should obtain sufficient appropriate audit evidence regarding accounting estimates.
   d. The risk of material misstatement is greater when accounting estimates are involved and in some cases the auditor may determine that it is a significant risk that requires special audit consideration.

7. Which of the following is least likely to be an approach followed when auditing the fair values of assets and liabilities?
   a. Confirm valuations with audit committee members.
   b. Independently develop an estimate of the value of the account.
   c. Review and test management's process of valuation.
   d. Review subsequent events relating to the account.

8. Which statement is correct regarding auditing fair value measurements and disclosures?
   a. Assumptions used in fair value measurements are similar in nature to those required when developing other accounting estimates.
   b. Many measurements based on estimates, including fair value measurements, are inherently precise.
   c. The measurement of fair value may be relatively complex for assets that are bought and sold in active and open markets.
   d. Underlying the concept of fair value measurements is a presumption that the entity will be liquidated.

9. As defined in PSA 540 (Audit of Accounting Estimates), "accounting estimates" means an approximation of the amount of an item in the absence of a precise means of measurement. Which of the following are examples of accounting estimates?

	a	b	c	d
Allowance to reduce accounts receivable to net realizable value	No	Yes	Yes	Yes
Cost of inventory purchased	Yes	Yes	No	No
Provision for a loss from lawsuit	Yes	No	Yes	No
Provision to meet warranty claims	No	Yes	Yes	Yes
Accrued revenue	Yes	No	Yes	No
Deferred tax	No	No	Yes	Yes

10. Who is responsible for establishing the process and controls for preparing accounting estimates?
    a. The controller.

b. The independent auditor.
c. The internal auditor.
d. The management.

11. In evaluating an entity's accounting estimates, one of an auditor's objectives is to determine whether the estimates are
    a. Reasonable in the circumstances.
    b. Not subject to bias.
    c. Consistent with industry guidelines.
    d. Based on objective assumptions.

12. The auditor should normally concentrate on the key factors and assumptions used by management including all of the following except those that are
    a. Susceptible to misstatement and bias.
    b. Sensitive to variations.
    c. Insignificant to the accounting estimates.
    d. Deviations from historical patterns.

13. Which of the following procedures would an auditor ordinarily perform first in evaluating management's accounting estimates for reasonableness?
    a. Test the calculations used by management in developing the estimates.
    b. Obtain an understanding of how management developed its estimates.
    c. Develop independent expectations of management's estimates.
    d. Consider the appropriateness of the key factors or assumptions used in preparing the estimates.

14. The audit evidence available to detect a material misstatement in an accounting estimate will often be
    a. More difficult to obtain and more persuasive than audit evidence available to detect a material misstatement in other items in the financial statements.
    b. More difficult to obtain and less persuasive than audit evidence available to detect a material misstatements in other items in the financial statements.
    c. Less difficult to obtain and more persuasive than audit evidence available to detect a material misstatement in other items in the financial statements.
    d. Less difficult to obtain and less persuasive than audit evidence available to detect a material misstatement in other items in the financial statements.

15. Karen, an auditor with extensive experience in the retail industry, is assigned to audit the reasonableness of accounting estimates in the Year 1 financial statements of Hardy Company. Hardy Company, which was formed in Year 1, markets fishing nets. Which of the following is the least important consideration for consideration for Karen in her audit of the reasonableness of accounting estimates?
    a. The accounting estimates in the financial statements of Hardy Company are based on numerous significant assumptions.
    b. The accounting estimates in the financial statements are susceptible to bias.
    c. Karen has never been involved in an audit of a company that sells fishing nets.
    d. An inexperienced employee at Hardy prepared the financial statements and was entirely responsible for the accounting estimates.

16. When auditing the fair value of an asset or liability, valuation issues ordinarily arise at the point of

	a	b	c	d
Subsequent to initial recording	Yes	No	Yes	No
Initial recording	Yes	Yes	No	No

17. An auditor should obtain sufficient knowledge to an entity's accounting system to understand the
    a. Safeguards used to limit access to computer facilities.
    b. Process used to prepare significant accounting estimates.
    c. Procedures used to assure proper authorization of transactions.
    d. Policies used to detect the concealment of irregularities.

18. Which of the following procedures would an auditor most likely include in the initial planning of financial statement audit?
    a. Obtaining a written representation letter from the client's management.
    b. Examining documents to detect illegal acts having a material effect on the financial statements.
    c. Considering whether the client's accounting estimates are reasonable in the circumstances.
    d. Determining the extent of involvement of the client's internal auditors.

19. In evaluating an entity's accounting estimates, one of an auditor's objectives is to determine whether the estimate are
    a. Not subject to bias.
    b. Consistent with industry guidelines.
    c. Based on objective assumptions.
    d. Reasonable in the circumstances.

20. Which of the following matters is an auditor required to communicate to an entity's audit committee?
    a. The basis or assessing control risk below the maximum.
    b. The process used by management in formulating sensitive accounting estimates.
    c. The auditor's preliminary judgments about materiality levels.
    d. The justification for performing substantive procedures at interim dates.

21. Which of the following procedures would an auditor ordinarily perform first in evaluating managements accounting estimates for reasonableness'?
    a. Develop independent expectations of management's estimates.
    b. Consider the appropriateness of the key factors or assumptions used in preparing the estimates.
    c. Test the calculations used by management in developing the estimates.
    d. Obtain an understanding of how managements develop its estimates.

22. There are many kinds of statistical estimates that an auditor may find useful, but basically every accounting estimate is either of a quantity or of an error rate. The statistical terms that roughly correspond to "quantities" and "error rate," respectively, are
    a. Attributes and variables.
    b. Variables and attributes.
    c. Constants and attributes.
    d. Constants and variables.

23. A lack of neutrality by management in the preparation and presentation of information.
    a. Management override.
    b. Management bias.
    c. Management concern.
    d. Management impartiality.

24. Which of the following statements about accounting estimate is true?
    a. For accounting estimates that give rise to significant risks, the auditor need not to evaluate the adequacy of the disclosure of their estimation uncertainty in the financial statements in the context of the applicable financial reporting framework.
    b. Indicators of possible management bias constitute misstatements for the purposes of drawing conclusions on the reasonableness of individual accounting estimates.
    c. The auditor shall obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates are in accordance with the requirements of the applicable financial reporting framework.
    d. The auditor shall not obtain written representations from management whether management believes significant assumptions used by it in making accounting estimates are reasonable.

25. Some accounting estimates involve relatively low estimation uncertainty and may give rise to lower risks of material misstatements, which of the following is an example of this?
    a. Accounting estimates arising in entities that engage in business activities that are complex.
    b. Accounting estimates that are not frequently made because they relate to routine transactions.
    c. Accounting estimates derived from data that is readily available, such as published interest rate data or exchange-traded prices of securities. Such data may be referred to as "observable" not in the context of a fair value accounting estimate.
    d. Accounting estimates derived from data that is readily available, such as published interest rate data or exchange-traded prices of securities. Such data may be referred to as "observable" in the context of a fair value accounting estimate.

26. Some accounting estimates, however, there may be relatively high estimation uncertainty, particularly where they are based on significant assumptions, which of the following is an example of this?
    a. Accounting estimates relating to the outcome of litigation.
    b. Fair value accounting estimates for derivative financial instruments not publicly traded.
    c. Fair value accounting estimates for which a highly specialized entity developed model is used or for which there are assumptions or inputs that cannot be observed in the marketplace.
    d. All of the above.

Chapter 14
COMPLETING THE AUDIT AND OTHER POST-AUDIT RESPONSIBILITIES

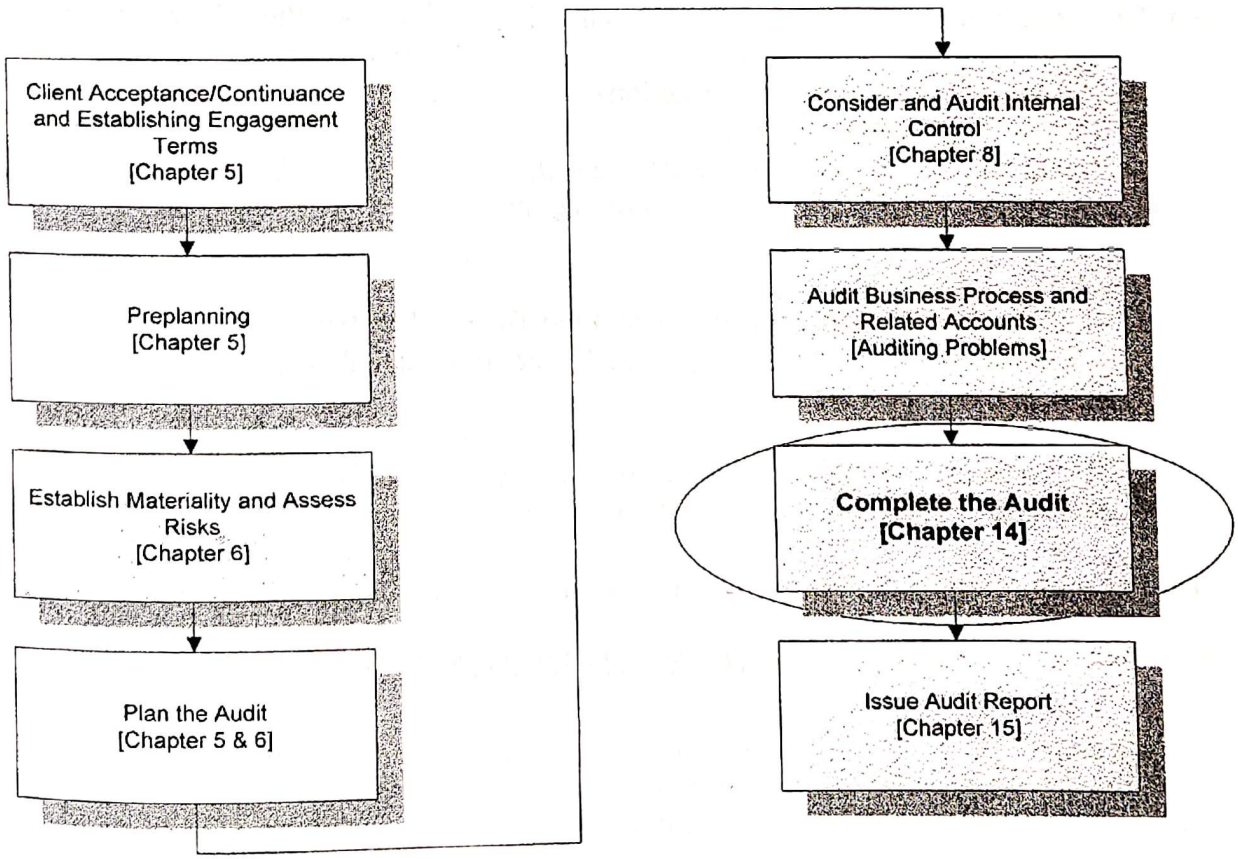
LEARNING OBJECTIVES

Upon completion of this chapter you will

1. **Identify the different procedures performed to complete an audit engagement.**
2. **Know the types of subsequent events.**
3. **Understand the auditor's responsibility regarding subsequent events.**
4. **Know the audit procedures used to identify subsequent events.**
5. **Understand how to identify and assess entities with going-concern problems.**
6. **Know the requirements of PSAs for the other different completion procedures.**
7. **Describe the purpose and content of management representation letters, management letters, and communications with management and those charged with governance.**

This chapter covers the seventh phase of the audit process identified in Chapter 5 (Figure 5.1), ***completing the audit.***

Major Phases of an Audit



The adage, "last but not the least," applies to completing the audit. Indeed, the decisions made by the auditor in this part of the audit are usually crucial to the ultimate outcome of the audit. This is the last opportunity for the auditor to step above the transaction level and take a holistic look at the financial statements and determine that they represent the underlying business dynamics. For example, in determining the procedures to be used and in evaluating the evidence obtained, the auditor must be fully aware of the audit risks associated with the engagement. Moreover, the conclusions reached by the auditor in completing the audit often have a direct impact on the opinion to be expressed on the client's financial statements.

In completing the audit, the auditor frequently works under tight time constraints, particularly as clients seek the earliest possible date for the issuance of the audit report. Although time may not be an ally of the auditor, the auditor must take time to make sound professional judgments and to express the opinion appropriate in the circumstances. For purposes of discussion, the auditor's responsibilities in completing the audit are divided into the following three categories: (1) completing the fieldwork, (2) evaluating the findings, and (3) communicating with the client.

After explaining the activities involved in completing the audit, consideration is then given to the auditor's post-audit responsibilities. These responsibilities pertain to events occurring after the date of the auditor's report.

COMPLETING THE AUDIT

After the auditor has completed auditing the various business processes and their related financial statement accounts, the evidence is summarized and evaluated. In addition, before choosing the appropriate audit report an auditor performs additional procedures designed to "wrap-up" the engagement and to generate additional evidence that may affect either the conclusions reached for individual accounts or the auditor's report. This chapter discusses the following procedures:

1. Review for related party transactions.
2. Review for subsequent events.
3. Make inquiries of a client's legal counsel.
4. Obtain a management representation letter.
5. Form an opinion.

However, an auditor's responsibility for audited financial statements does not end either on the report date or when audit report is physically communicated to the client. Rather, an auditor continues to be responsible to:

1. Communicate with those charged with governance and management.
2. Discover facts existing at the date of the auditor's report.

These procedures and responsibilities are explained in the following section.

REVIEW FOR RELATED PARTY TRANSACTIONS

In most cases, parties to a transaction are unrelated and independent, thereby increasing the likelihood that the transaction is a bargained exchange negotiated at "arm's length." Occasionally, however, parties to a transaction are not independent. Rather, they are related and may include, for example, subsidiaries, affiliates, directors, principal stockholders, officers and their immediate family members, and others in a position to influence or to be influenced. A relationship between or among related parties does not necessarily mean a transaction is not at arm's length. However,

the auditor should be aware that the nature of related party relationships and transactions may, in some circumstances, give rise to higher risks of material misstatement of the financial statements than transactions with unrelated parties.

Auditing standards (i.e., PSA 550) require the auditor to (1) obtain sufficient appropriate audit evidence about whether related party relationships and transactions have been appropriately accounted for and disclosed in the financial statements, (2) obtain an understanding of related party relationships and transactions sufficient to be able to conclude whether the financial statements, insofar as they are affected by those relationships and transactions, achieve fair presentation or are not misleading, and (3) identify fraud risk factors arising from related party relationships and transactions that are relevant to the identification and assessment of the risks of material misstatement due to fraud.

The auditor should obtain from management the names of the related parties and inquire regarding the nature of the relationships between the entity and these related parties and whether the entity entered into any transactions with these related parties during the period, and if so, the general nature of the transactions. The auditor, during the audit, should also be alert for arrangements or other information that may indicate the existence of related party relationships or transactions that management has not previously identified or disclosed to the auditor. In addition, the auditor should inspect bank and legal confirmations obtained as part of the auditor's procedures and minutes of meetings of shareholders and of those charged with governance for information that may indicate the existence of such relationships or transactions.

After identifying related party transactions, an auditor should apply the audit procedures necessary to assess the purpose, nature, and extent of the transactions and their effect on the financial statements. In general, the procedures should extend beyond simply making inquiries of management and might include obtaining an understanding of the business purpose of the transactions, examining documentation such as invoices or contracts, and determining whether the transactions were approved by the board of directors. The accounting considerations and required disclosures for related party transactions are discussed in Philippine Accounting Standards 24, "*Related Party Disclosures.*"

REVIEW FOR SUBSEQUENT EVENTS FOR AUDIT OF FINANCIAL STATEMENTS

The auditor should consider the effect of subsequent events on the financial statements and on the auditor's report. Subsequent events refer to both events occurring between the date of the financial statements and the date of the auditor's report, and facts discovered after the date of the auditor's report.

Types of Events

Two types of subsequent events require consideration by management and evaluation by the auditor:

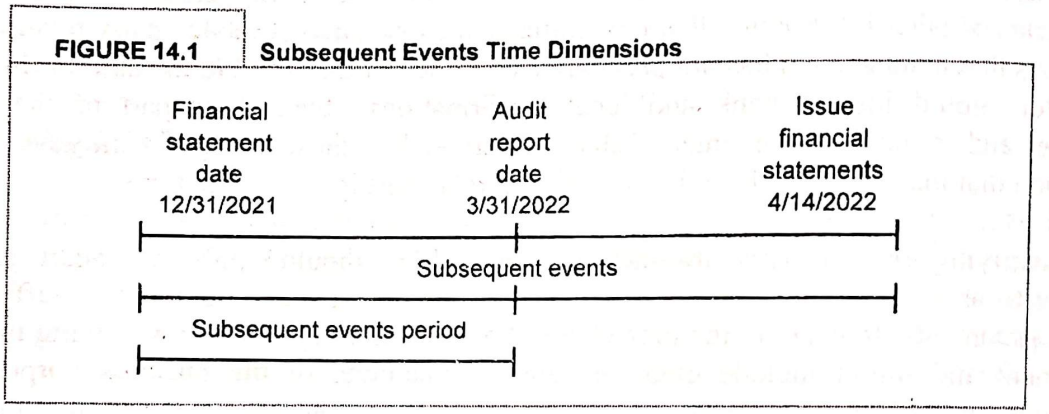
1. Type I subsequent events provide additional evidence about conditions that existed at the date of the balance sheet and affect the estimates that are part of the financial statement preparation process. Type I events require adjustment of the financial statements.

2. Type II subsequent events provide evidence about conditions that did not exist at the date of the balance sheet but arose subsequent to that date. Type II events usually require financial statement disclosure.

Auditor's Responsibility Regarding Subsequent Events

Figure 14.1 presents a diagram of the time frame for subsequent-events. The period from the date of the financial statements (i.e., December 31, 2021) to the date of the auditor's report (i.e., March 31, 2022) is sometimes referred to as the formal subsequent-events period. During this period, the auditor performs routine audit procedures related to the current-year audit. The period from the date of the auditor's report to the issuance of the financial statements (i.e., April 15, 2022) is also part of the subsequent events period, but the auditor does not have any responsibility to perform audit procedures or make any inquiries regarding the financial statements after the date of the auditor's report. During this period, the responsibility to inform the auditor of facts which may affect the financial statements rests with management.

FIGURE 14.1 Subsequent Events Time Dimensions



However, when the auditor becomes aware of a fact which may materially affect the financial statements, the auditor should consider whether the financial statements need amendment, discuss the matter with management, and take the action appropriate in the circumstances.

When management amends the financial statements, the auditor would carry out the procedures necessary in the circumstances and would provide management with a new report on the amended financial statements. The new auditor's report would be dated not earlier than the date of approval of the amended financial statements and, accordingly, the auditor's responsibility would be extended to the date of the new auditor's report. On the other hand, if management does not amend the financial statements, the auditor should express a qualified opinion or an adverse opinion.

However, when the auditor's report has been released to the entity, the auditor would notify those persons ultimately responsible for the overall direction of the entity not to issue the financial statements and the auditor's report thereon to third parties. If the financial statements are subsequently released, the auditor needs to take action to prevent reliance on the auditor's report. The action taken will depend on the auditor's legal rights and obligations and the recommendations of the auditor's lawyer.

Figure 14.1 also includes the time period after the financial statements have been issued. This time period is discussed later in this chapter.

Audit Procedures for Subsequent Events

Auditing standards (PSA 560) require that the auditor performs procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified. Some audit procedures for business processes and their related financial statement accounts are conducted before year-end, while others may be conducted during the subsequent-events period. Some of these procedures, such as testing of inventory cutoff and payments to creditors, are applied to specific transactions occurring after the date of the financial statements to obtain audit evidence as to account balances as at the date of the financial statements. Such audit procedures may detect subsequent events. In addition, the auditor should also perform specific audit procedures for the period from the date of the financial statements to the date of the auditor's report.

Examples of these audit procedures include the following:

1. Reviewing procedures management has established to ensure that subsequent events are identified.

2. Reading minutes of the meetings of shareholders, the board of directors and audit and executive committees held after the date of the financial statements and inquiring about matters discussed at meetings for which minutes are not yet available.

3. Reading the entity's latest available interim financial statements and, as considered necessary and appropriate, budgets, cash flow forecasts and other related management reports.

4. Inquiring, or extending previous oral or written inquiries, of the entity's lawyers concerning litigation and claims.

5. Inquiring of management about the following matters: (a) the current status of items that were accounted for on the basis of preliminary or inconclusive data; (b) whether new commitments, borrowings or guarantees have been entered into; (c) whether sales of assets have occurred or are planned; (d) whether the issue of new shares or debentures or an agreement to merge or liquidate has been made or is planned; (e) whether any assets have been appropriated by government or destroyed, for example, by fire or flood; (f) whether there have been any developments regarding risk areas and contingencies; (g) whether any unusual accounting adjustments have been made or are contemplated; and (h) whether any events have occurred or are likely to occur which will bring into question the appropriateness of accounting policies used in the financial statements.

INQUIRY REGARDING LITIGATION AND CLAIMS

Litigation and claims involving an entity may have a material effect on the financial statements and thus may be required to be disclosed and/or provided for in the financial statements. Auditing standards (PSA 501) require the auditor to carry out procedures in order to become aware of any litigation and claims involving the entity which may have a material effect on the financial statements. Such procedures would include the following:

1. Make appropriate inquiries of management including obtaining representations.
2. Review board minutes and correspondence with the entity's lawyers.
3. Examine legal expense accounts.

4. Use any information obtained regarding the entity's business including information obtained from discussions with any in-house legal department.

When litigation or claims have been identified or when the auditor believes they may exist, the auditor should seek direct communication with the entity's lawyers. Such communication will assist in obtaining sufficient appropriate audit evidence as to whether potentially material litigation and claims are known and management's estimates of the financial implications, including costs, are reliable. A letter of audit inquiry (referred to as a legal letter) sent to the client's lawyers is the primary means of obtaining or corroborating information about litigation, claims and assessments. The letter, which should be prepared by management and sent by the auditor, should request the lawyer to communicate directly with the auditor.

When it is considered unlikely that the lawyer will respond to a general inquiry, the letter would ordinarily specify the following:

1. A list of litigation and claims.
2. Management's assessment of the outcome of the litigation or claim and its estimate of the financial implications, including costs involved.
3. A request that the lawyer confirms the reasonableness of management's assessments and provides the auditor with further information if the list is considered by the lawyer to be incomplete or incorrect.

In certain circumstances, for example, where the matter is complex or there is disagreement between management and the lawyer, it may be necessary for the auditor to meet with the lawyer to discuss the likely outcome of litigation and claims. Such meetings should take place with management's permission and, preferably, with a representative of management in attendance. If management refuses to give the auditor permission to communicate with the entity's lawyers or where a lawyer refuses to respond in an appropriate manner and the auditor is unable to obtain sufficient appropriate audit evidence by applying alternative procedures, the auditor should consider whether there is a scope limitation which may lead to a qualified opinion or a disclaimer of opinion.

REPRESENTATION LETTER

During the course of the financial statement audit, management makes a number of representations to the auditor as part of the inquiries made to obtain sufficient appropriate evidence. PSA 580 (Revised and Redrafted) *Written Representations* provides guidance on the use of management representations as audit evidence. A written representation is ordinarily more reliable audit evidence than an oral representation. Auditing standards, including PSA 580, require that the audit obtains written representation from management on specific matters. Thus, auditors ordinarily obtain a representation letter from management. The purpose of this letter is to confirm oral representations given to the auditor and to document the continuing appropriateness of such representations. The representation letter also reduces the possibility of misunderstanding concerning management's representations.

The representations included in the management's representation letter will vary depending on the circumstances, but ordinarily includes the following: (1) management's fulfillment of its responsibility for the preparation and presentation of the financial statements as set out in the terms of the audit engagement and, in particular, whether the financial statements are prepared and presented in accordance with the applicable financial reporting framework, and, (2) management has provided the auditor with all relevant information agreed in the terms of the

audit engagement, and that all transactions have been recorded and are reflected in the financial statements.

A representation letter may complement other auditing procedures but cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available. For example, a representation by management as to the cost of an asset is not a substitute for the audit evidence of such cost that an auditor would ordinarily expect to obtain. In some cases, however, a representation by management may be the only audit evidence which can reasonably be expected to be available. For example, the auditor would not necessarily expect that other audit evidence would be available to corroborate management's intention to hold a specific investment for long-term appreciation.

If a representation by management is contradicted by other audit evidence, the auditor should investigate the circumstances and consider the reliability of other representations made by management. In addition, based on the circumstances, the auditor should consider whether his or her reliance on management's representations relating to other aspects of financial statements is appropriate and justified. Repeated, intentional misrepresentations could drive an auditor to withdraw from an engagement, since he or she could not assess reliably the risk that the financial statements may be materially misstated.

Basic Elements of a Management Representation Letter

The representation letter should be addressed to the auditor, contain specified information and be appropriately dated and signed. A management representation letter is generally given the same date as the auditor's report (i.e., as near as practicable to, but not after, the date of the auditor's report on the financial statements) and signed by the members of management who have primary responsibility for the entity and its financial aspects (ordinarily the chief executive officer and the chief financial officer) based on the best of their knowledge and belief.

Exhibit 14.1 presents an example of a representation letter. Note the important types of information that management is asked to represent.

EXHIBIT 14.1 Sample Management Representation Letter

(Entity Letterhead)

(To Auditor) (Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended December 31, 20XX for the purpose of expressing an opinion as to whether the financial statements are presented fairly, in all material respects, in accordance with Philippine Financial Reporting Standards.

We confirm that *(to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves)*:

Financial Statements

- We have fulfilled our responsibilities for the preparation and presentation of the financial statements as set out in the terms of the audit engagement dated [insert date] and, in particular, the financial statements are fairly presented in accordance with Philippine Financial Reporting Standards.
- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable. (PSA 540 (Revised and Redrafted)
- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of Philippine Financial Reporting Standards. (PSA 550 (Revised and Redrafted))
- All events subsequent to the date of the financial statements and for which Philippine

Financial Reporting Standards require adjustment or disclosures have been adjusted or disclosed. (PSA 560 (Redrafted))
- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter. (PSA 450 (Revised and Redrafted))
- [Any other matters that the auditor may consider appropriate]

Information Provided
- We have provided you with:
  - All information, such as records and documentation, and other matters that are relevant to the preparation and presentation of the financial statements;
  - Additional information that you have requested from us; and
  - Unrestricted access to those within the entity.
- All transactions have been recorded in the accounting records and are reflected in the financial statements.
- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud. (PSA 240 (Redrafted))
- We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:
  - Management;
  - Employees who have significant roles in internal control; or
  - Others where the fraud could have a material effect on the financial statements. (PSA 240 (Redrafted))
- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others. (PSA 240 (Redrafted))
- We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements. (PSA 250 (Redrafted))
- We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware. (PSA 550 (Revised and Redrafted))
- [Any other matters that the auditor may consider necessary]

Management Management

Doubt as to the Reliability of Written Representations

If the auditor has concerns about the competence, integrity, ethical values or diligence of management, or about its commitment to or enforcement of these, the auditor shall determine the effect that such concerns may have on the reliability of representations (oral or written) and audit evidence in general.

In particular, if written representations are inconsistent with other audit evidence, the auditor shall perform audit procedures to attempt to resolve the matter. If the matter remains unresolved, the auditor shall reconsider the assessment of the competence, integrity, ethical values or diligence of management, or of its commitment to or enforcement of these, and shall determine the effect that this may have on the reliability of representations (oral or written) and audit evidence in general.

If the auditor concludes that the written representations are not reliable, the auditor shall take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

Requested Written Representations Not Provided

If management does not provide one or more of the requested written representations, the auditor shall:

1. Discuss the matter with management.
2. Reevaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general.
3. Take appropriate actions, including determining the possible effect on the opinion in the auditor's report.

Written Representations about Management's Responsibilities

When the auditor obtains a representation letter and he or she is able to corroborate management's representations, an unmodified opinion can be issued. However, if the auditor concludes that there is sufficient doubt about integrity of management such that the written representations are not reliable or if management refuses to provide a representation that the auditor considers necessary, the auditor should disclaim an opinion on the financial statements.

EVALUATING FINDINGS, FORMULATING AN OPINION AND DRAFTING THE AUDIT REPORT

The auditor conducts a number of audit steps before deciding on the appropriate audit report to issue for the entity. These include the following:

1. Performance of analytical procedures in the overall or final review stage.
2. Evaluation of the entity's ability to continue as a going concern.
3. Review of working papers.
4. Final assessment of audit results.
5. Evaluation of financial statement presentation and disclosure.
6. Obtaining an independent review of the engagement.

Each is discussed next.

ANALYTICAL PROCEDURES IN THE OVERALL OR FINAL REVIEW STAGE

Auditing standards (PSA 520) require that the auditor performs analytical procedures at or near the end of the audit. The objective of the overall review is to assist the auditor in forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's knowledge of the business. The conclusions drawn from the results of such procedures are intended to corroborate conclusions formed during the audit of individual components or elements of the financial statements and assist in arriving at the overall conclusion as to the reasonableness of the financial statements. However, they may also identify areas requiring further procedures.

In making an overall review, the auditor reads the financial statements and accompanying notes and considers the adequacy of the evidence gathered in response to unusual or unexpected balances and relationships (1) anticipated in planning the audit or (2) identified during the audit in substantive testing. Analytical procedures are then applied to the financial statements to

determine if any additional unusual or unexpected relationships exist. If such relationships exist, additional auditing procedures should be performed in completing the audit.

GOING CONCERN CONSIDERATIONS

The going concern assumption is a fundamental principle in the preparation of financial statements. Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing operations or seeking protection from creditors. Accordingly, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business. When financial statements are not prepared on a going concern basis, PAS 1, *"Presentation of Financial Statements,"* requires that fact is disclosed, together with the basis on which the financial statements are prepared and the reason why the entity is not regarded as a going concern.

Auditing standards (PSA 570) require the auditor to consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements, and consider whether there are material uncertainties about the entity's ability to continue as a going concern that need to be disclosed in the financial statements. When the entity has a history of profitable operations and ready access to financial resources, the auditor's conclusion about the appropriateness of management's assessment normally is made without the need of performing detailed analysis. While the auditor's going concern considerations are made during the planning of the engagement, the auditor must also consider the going concern issue near the end of the engagement.

The auditor normally identifies whether there is substantial doubt about the client's ability to continue as a going concern based on the results of normal audit procedures performed in planning, in gathering evidence to support various audit objectives, and in completing the audit. In performing audit procedures throughout the audit, the auditor, however, should remain alert for evidence of events or conditions which may cast significant doubt on the entity's ability to continue as a going concern. Additionally, auditing standards require that the auditor inquires management as to its knowledge of such events or conditions beyond the period of going concern assessments used.

Examples of events or conditions which may cast significant doubt about the going concern assumption are set out in Table 14.1. This listing is not all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty exists.

TABLE 14.1 Conditions and Events Indicating a Problem with the Going Concern Assumption

Financial
Net liability or net current liability position.
Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
Indications of withdrawal of financial support by debtors and other creditors.
Negative operating cash flows indicated by historical or prospective financial statements.
Adverse key financial ratios.
Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
Arrears or discontinuance of dividends.
Inability to pay creditors on due dates.
Inability to comply with the terms of loan agreements.
Change from credit to cash-on-delivery transactions with suppliers.
Inability to obtain financing for essential new product development or other essential

investments.

Operating

Loss of key management without replacement.
Loss of a major market, franchise, license, or principal supplier.
Labor difficulties or shortages of important supplies.

Other

Non-compliance with capital or other statutory requirements.
Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that are unlikely to be satisfied.
Changes in legislation or government policy expected to adversely affect the entity.

When events or conditions have been identified which may cast significant doubt on the entity's ability to continue as a going concern, the auditor should (1) review management's plans for future actions based on its going concern assessment, (2) gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists through carrying out procedures considered necessary, including considering the effect of any plans of management and other mitigating factors and (3) seek written representations from management regarding its plans for future action. The auditor inquires of management as to its plans for future action, including its plans to liquidate assets, borrow money or restructure debt, reduce or delay expenditures, or increase capital. When evaluating management's plans, the auditor should obtain sufficient appropriate audit evidence that management's plans are feasible and that the outcome of these plans will improve the situation. This will require examining the assumptions used by management in developing such plans.

If after obtaining and evaluating audit evidence regarding management's plans, the auditor concludes that there is a material uncertainty related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern, the auditor will, when the disclosure made in the financial statements is adequate, issue an unmodified opinion with an emphasis of matter paragraph that highlights the existence of a material uncertainty relating to the event or condition that may cast significant doubt on the entity's ability to continue as a going concern and draws attention to the note in the financial statements that discloses the matter. However, if the disclosure is inadequate, the auditor should express a qualified or adverse opinion, as appropriate. The report should include specific reference to the fact that there is a material uncertainty that may cast significant doubt about the entity's ability to continue as a going concern.

REVIEW OF WORKING PAPERS

All audit work should be reviewed by an audit team member senior to the person preparing the working papers. Thus, senior-in-charge should conduct a detailed review of the working papers prepared by the staff and follow up on any unresolved problems or issues. In turn, the manager should review all working papers, although the extent of the manager's review may vary with how much the manager relies on the senior-in-charge. The engagement partner normally reviews working papers related to critical audit areas as well as working papers prepared by the manager. In reviewing the working papers, the reviewers must ensure that the working papers document that the audit was properly planned and supervised, that the evidence supports the assertions tested, and that the evidence is sufficient for the type of audit report issued.

FINAL ASSESSMENT OF AUDIT RESULTS

During the course of an audit engagement, a variety of audit tests are performed. These tests often performed by staff personnel whose participation in the audit may be limited to a few areas or accounts. As the tests for each functional area or statement items are completed, the staff auditor is expected to summarize his or her findings. It is necessary in completing the audit for the separate findings to be summarized and evaluated for the purpose of expressing an opinion on the financial statements taken as a whole. The ultimate responsibility for these steps rests with the partner in charge of the engagement. In some cases, the audit manager makes the initial determinations that are then carefully reviewed by the partner.

The evaluation of the results of the financial statement audit is concerned with two issues: (1) the sufficiency of the audit evidence, and (2) the effects of detected misstatements in the financial statements. In evaluating the audit evidence, the auditor determines whether there is sufficient evidence to support each relevant assertion. This evaluation considers evidence obtained to support the assessment of inherent and control risk. If this evaluation indicates that the evidence is not sufficient to meet the planned level of audit risk, the auditor may need to gather additional evidence. Any misstatements detected during the audit process must be considered in terms of their effects on the financial statements. In particular, the auditor must compare the amount of uncorrected misstatements to arrive at the amount of materiality allocated to the relevant component of the financial statement. The auditor should also consider the effects of uncorrected misstatements on aggregated components of the financial statements such as assets, liabilities equity, revenues and expenses.

Before reaching a final decision on the opinion, a conference is generally held with the client. At this meeting, the auditor reports the findings orally and attempts to provide a rationale for proposed adjustments and/or additional disclosures. Management, in turn, may attempt to defend its position. In the end, some agreement is generally reached on the changes to be made and the auditor can proceed to issue an unmodified opinion. When such an agreement is not obtained, the auditor may have to issue another type of opinion. Communication of the auditor's opinion is made through an audit report. The various types of auditor's reports are discussed in Chapter 15.

EVALUATING FINANCIAL STATEMENT PRESENTATION AND DISCLOSURES

Either the client or the auditor normally prepares a draft of the financial statements, including notes. The auditor reviews the financial statements to ensure compliance with the applicable financial reporting framework, proper presentation of accounts, and inclusion of all necessary disclosures. Most audit firms use some types of financial statement checklist that is completed by the auditor who performs the initial review of the financial statements. The completed checklist is then reviewed by the manager and partner in charge of the engagement. The checklist includes matters pertaining to the form and content of each of the basic financial statements as well as the required disclosures. The completed checklist and the findings of the reviewers should be included in the working papers.

INDEPENDENT ENGAGEMENT QUALITY REVIEW

Most audit firms have a policy requiring an independent (or second) review by a concurring partner of the financial statements and audit report for listed companies and those financial statements expected to be widely distributed. Auditing standards (PSA 220) require for the audit

of financial statements of listed companies that the engagement partner appoints an engagement quality reviewer. The reviewer is generally not associated with the details of the engagement and is expected to provide an independent review. An engagement quality review should include an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the auditor's report. The extent of the review depends on the complexity of the audit engagement and the risk that the auditor's report might not be appropriate in the circumstances.

COMMUNICATIONS OF AUDIT MATTERS WITH THOSE CHARGE WITH GOVERNANCE

Auditing standards (PSA 260) require that the auditor communicates audit matters of governance interest arising from the audit of financial statements with those charged with governance of an entity. The communication to those charged with governance should address the following matters:

1. The auditor's responsibility.
2. The planned scope and timing of the audit.
3. The conduct of and findings from the audit.
4. Matters required by other PSAs and additional external requirements, and matters agreed with the entity.
5. Other matters of which the auditor is aware that the auditor judges to be serious and relevant to those charged with governance.

In addition, other auditing standards require matters to be communicated to those charged with governance. These include:

1. Fraud that the auditor has identified that involves management, employees who have significant roles in internal control; or others where the fraud results in a material misstatement in the financial statements (PSA 240).

2. Non-compliance with laws and regulations that comes to the auditor's (PSA 250).

3. Material weaknesses in the design or implementation of internal control that could have a material effect on the financial statements that have come to the auditor's attention (PSA 315).

The auditor should issue a written communication to those in charged with governance regarding significant matters arising from the conduct of and findings from the audit. When audit matters of governance interest are communicated orally, the auditor should document in the working papers the matters communicated and any response to those matters. This documentation may also take the form of a copy of the minutes of the auditor's discussion with those charged with the governance. In certain circumstances, it may be advisable for the auditor to confirm in writing with those charged with governance any oral communications on audit matters of governance interest.

Ordinarily, the auditor initially discusses audit matters of governance interest with management, except where those matters relate to questions of management competence or integrity. These initial discussions with management are important in order to clarify facts and issues, and to give management an opportunity to provide further information. If management agrees to communicate a matter of governance interest with those charged with governance, the auditor

may not need to repeat the communications, provided that the auditor is satisfied that such communications have effectively and appropriately been made.

FACTS DISCOVERED AFTER THE FINANCIAL STATEMENTS HAVE BEEN ISSUED

An auditor has no obligation to make any inquiries or perform any audit procedures after the financial statements and audit report have been issued. However, after the issuance of the financial statements, the auditor may become aware of facts, which existed at the date of the auditor's report and if known at that date, may have caused the auditor to modify the auditor's report.

When facts are encountered that may affect the auditor's previously issued report, the auditor should determine whether the facts are reliable and whether they existed at the date of the audit report. The auditor should consider whether the financial statements need revision, discuss the matter with an appropriate level of management, and take the action appropriate in the circumstances.

If the auditor determines that the previously issued financial statements are in error and the audit report is affected, he or she should request that the client issues an immediate revision to the financial statements and auditor's report. When management revises the financial statements, the auditor should carry out the audit procedures necessary in the circumstances, review the steps taken by the management to ensure that anyone in receipt of the previously issued financial statements together with the auditor's report thereon is informed of the situation, and issue a new report on the revised financial statements.

The new auditor's report should include an emphasis of a matter paragraph referring to a note to the financial statements that more extensively discusses the reason for the revision of the previously issued financial statements and to the earlier report issued by the auditor. The new auditor's report should be dated not earlier than the date of approval of the revised financial statements. The auditor is also permitted to restrict the audit procedures regarding the revised financial statements to the effects of the subsequent event that necessitated the revision. In such cases, the new auditor's report would contain a statement to that effect.

If the management refuses to cooperate and does not revise the financial statements, the auditor should notify those persons ultimately responsible for the overall direction of the entity that action will be taken by the auditor to prevent future reliance on the auditor's report. The action taken will depend on the auditor's legal rights and obligations and the recommendations of the auditor's lawyers.

REVIEW QUESTIONS

1. Define related parties and related party transactions. Why it is important to review related party transactions in an audit of financial statements?

2. What are the steps involve in a review for related party transactions?

3. What are the types of subsequent events relevant to financial statement audit? What is the auditor's responsibility regarding events and transactions in the period from the date of the auditor's report to the issuance of the financial statements?

4. What is a letter of audit inquiry? What information does the auditor ask the lawyer to provide on pending or threatened litigation?

5. What is a representation letter? Why does the auditor obtain a representation letter from the management?

6. Are any analytical procedures required as part of the final overall review of the financial statements? What is the purpose of such analytical procedures?

7. What are the overall steps in the going concern evaluation process? What three major categories of events or conditions may indicate going concern problems? Give three examples for each category.

8. Describe the purposes of the engagement quality review (concurring partner review).

9. What items should be included in the auditor's communication with those charged with governance?

10. What types of events would generally require revision of the issued financial statements? What procedures should the auditor follow when the client refuses to cooperate and make the necessary revision of the financial statements?

MULTIPLE CHOICE QUESTIONS

1. Which of the following events most likely indicates the existence of related parties?
   a. Making a loan without scheduled terms for repayment of the funds.
   b. Discussing merger terms with a company that is a major competitor.
   c. Selling real estate at a price that differs significantly from its book value.
   d. Borrowing a large sum of money at a variable rate of interest.

2. Which of the following statements concerning related party transactions is correct?
   a. An auditor should determine whether a particular transaction would have occurred if the parties had not been related.
   b. An auditor should substantiate that related party transactions were consummated on terms equivalent to those prevail in arm's length transactions.
   c. In the absence of evidence to the contrary, related party transactions should be assumed to be outside the ordinary course of business.

d. The audit procedures directed toward identifying related party transactions should include considering whether transactions are occurring but are not being given proper accounting recognition.

3. An auditor searching for related party transactions should obtain an understanding of each subsidiary's relationship to the total entity because
   a. Intercompany transactions may have been consummated on terms equivalent to arm's-length transactions.
   b. The business structure may be deliberately designed to obscure related party transactions.
   c. This may permit the audit of intercompany account balances to be performed as of concurrent dates.
   d. This may reveal whether particular transactions would have taken place if the parties had not been related.

4. Which of the following audit procedures is most likely to assist an auditor in identifying related party transactions?
   a. Inspecting communications with law firms for evidence of unreported contingent liabilities.
   b. Retesting ineffective controls previously reported to the audit committee.
   c. Reviewing accounting records for nonrecurring transactions recognized near the balance sheet date.
   d. Sending second requests for unanswered positive confirmations of accounts receivable.

5. After discovering that a related party transaction exists, the auditor should be aware that the
   a. Adequacy of disclosure of the transaction is secondary to its legal form.
   b. Financial statements should recognize the legal form of the transaction rather than its substance.
   c. Substance of the transaction could be significantly different from its form.
   d. Transaction is assumed to be outside the ordinary course of business.

6. For a reporting entity that has participated in related party transactions that are material, disclosure in the financial statements should include
   a. A reference to deficiencies in the entity's internal control.
   b. A statement to the effect that a transaction was consummated on terms equivalent to those that prevail in arm's length transactions.
   c. Details of the transactions within major classifications.
   d. The nature of the relationship and the terms and manner of settlement.

7. Which of the following statements best describes the "date of the financial statements"?
   a. The date of the end of the latest period covered by the financial statements, which is normally the date of the most recent balance sheet in the financial statements subject to audit.
   b. The date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements.
   c. The date on which those with the recognized authority assert that they have prepared the entity's complete set of financial statements, including the related notes, and that they have taken responsibility for them.
   d. The date that the auditor's report and audited financial statements are made available to third parties.

8. Which of the following procedures would an auditor most likely perform to obtain evidence about the occurrence of subsequent events?
   a. Comparing the financial statements being reported on with those of the prior period.
   b. Confirming a sample of material accounts receivable established after the date of the financial statements.
   c. Inquiring as to whether any unusual adjustments were made after the date of the financial statements.
   d. Investigating personnel changes in the accounting department occurring after the date of the financial statements.

9. Which of the following statements best expresses the auditor's responsibility with respect to facts discovered after the date of the auditor's report but before the date the financial statements are issued?
   a. The auditor should withdraw from the engagement.
   b. The auditor should consider whether the financial statements need amendment, discuss the matter with management, and consider taking actions appropriate in the circumstances.
   c. The auditor should amend the financial statements.
   d. If the facts discovered will materially affect the financial statements, the auditor should issue a new report which contains either a qualified opinion or an adverse opinion.

10. Which of the following procedures should an auditor ordinarily perform regarding subsequent events?
   a. Send second requests to the client's customers who failed to respond to initial accounts receivable confirmation requests.
   b. Review the cutoff bank statements for several months after the year-end.
   c. Compare the latest available interim financial statements with the financial statements being audited.
   d. Communicate material weaknesses in internal control to the client' audit committee.

11. A client acquired 25% of its outstanding capital stock after year-end and prior to completion of the auditor's fieldwork. The auditor should
   a. Advise management to adjust the balance sheet to reflect the acquisition.
   b. Advise management to disclose the acquisition in the notes to the financial statements.
   c. Disclose the acquisition in the opinion paragraph of the auditor's report.
   d. Issue pro forma financial statements giving effect to the acquisition as if it had occurred at year-end.

12. The primary source of information to be reported about litigation, claims, and assessments is the
   a. Independent auditor.
   b. Court records.
   c. Client's management.
   d. Client's lawyer.

13. The primary reason an auditor requests that letters of inquiry to be sent to a client's attorneys is to provide the auditor with
   a. A description and evaluation of litigations, claims, and assessments that existed at the balance sheet date.

b. Corroboration of the information furnished by management about litigation, claims, and assessments.
c. The attorneys' opinions of the client's historical experiences in recent similar litigation.
d. The probable outcome of asserted claims and pending or threatened litigation.

14. The auditor should consider the status of legal matters up to the
a. Balance sheet date.
b. Date of approval of the financial statements.
c. Date of issuance of the financial statements.
d. Date of the auditor's report.

15. Which of the following procedures is least likely to be performed by the auditor to identify litigation and claims involving the entity which may result in a material misstatement of the financial statements?
a. Use any information regarding the entity's business including information obtained from discussions with any in-house legal department.
b. Make appropriate inquiries of management including obtaining representations.
c. Examine legal expense accounts.
d. Confirm directly with the client's lawyer that all claims have been recorded in the financial statements.

16. An auditor should obtain evidence relevant to all of the following factors concerning third-party litigation against a client except the
a. Probability of an unfavorable outcome.
b. Period in which the underlying cause for legal action occurred.
c. Jurisdiction in which the matter will be resolved.
d. Existence of a situation indicating an uncertainty as to the possible losses.

17. The refusal of a client's lawyer to provide a representation on the legality of a particular act committed by the client is ordinarily
a. Sufficient reason to issue a "subject to" opinion.
b. Proper grounds to withdraw from the engagement.
c. Insufficient reason to modify the auditor's report because of the lawyer's obligation of confidentiality.
d. Considered to be a scope limitation.

18. Which of the following statements extracted from a client's lawyer's letter concerning litigation, claims, and assessments most likely would cause the auditor to request clarification?
a. "I believe that the possible liability to the company is nominal in amount."
b. "I believe that the plaintiff's case against the company is without merit."
c. "I believe that the company will be able to defend this action successfully."
d. "I believe that the action can be settled for less than the damages claimed."

19. "There have been no communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices that could have a material effect on the financial statements." The foregoing passage is most likely from a
a. Letter for underwriters.
b. Management representation letter.
c. Report on internal control.

d. Special report.

20. The primary purpose of the representation letter is the
    a. Acceptance of the auditor's engagement letter.
    b. Acknowledgement of management's responsibility for the financial statements.
    c. Agreement by management to engage the auditor for the next annual audit.
    d. Evaluation by management of the auditor's performance.

21. When considering the use of management's written representations as audit evidence about the completeness assertion, an auditor should understand that such representations
    a. Are not part of the audit evidence considered to support the assertion.
    b. Complement, but do not replace, substantive tests designed to support the assertion.
    c. Constitute sufficient appropriate audit evidence to support the assertion when considered in combination with a sufficiently low assessed level of control risk.
    d. Replace a low assessed level of control risk as audit evidence to support the assertion.

22. For which of the following matters should an auditor obtain written management representations?
    a. Management's acknowledgment of its responsibility for employees' violations of laws.
    b. Management's compliance with contractual agreements that may affect the financial statements.
    c. Management's cost-benefit justifications for not correcting internal control weaknesses.
    d. Management's knowledge of future plans that may affect the price of the entity's stock.

23. Which of the following statements ordinarily is included among the written client representations obtained by the auditor?
    a. Sufficient evidential matter has been made available to permit the issuance of an unqualified opinion.
    b. Management acknowledges that there are no material weaknesses in the internal control.
    c. Management acknowledges responsibility for illegal actions committed by employees.
    d. Compensating balances and other arrangements involving restrictions on cash balances have been disclosed.

24. A written representation from a client's management that, among other matters, acknowledges responsibility for the fair presentation of financial statements, should normally be signed by the
    a. Chief financial officer and the chair of the board of directors.
    b. Chief executive officer, the chair of the board of directors, and the client's lawyer.
    c. Chief executive officer and the chief financial officer.
    d. Chair of the audit committee of the board of directors.

25. A written representation letter is most likely to be an auditor's best source of corroborative information of a client's intention to
    a. Terminate an employee pension plan.
    b. Settle an outstanding lawsuit for an amount less than the accrued loss contingency.
    c. Make a public offering of its common stock.

d. Discontinue a line of business.

26. A limitation on the scope of the auditor's examination sufficient to preclude an unqualified opinion will always result when management
    a. Refuses to furnish a management representation letter to the auditor.
    b. Prevents the auditor from reviewing the working papers of the predecessor auditor.
    c. Fails to correct a reportable condition of internal control that had been identified during the prior year's audit.
    d. Engages the auditor after the year-end physical inventory count is completed.

27. Analytical procedures performed in the overall review stage of an audit suggest that several accounts have unexpected relationships. The results of these procedures most likely indicate that
    a. The communication with the audit committee should be revised.
    b. Irregularities exist among the relevant account balances.
    c. Internal control activities are not operating effectively.
    d. Additional substantive tests of details are required.

28. PSA 570 (Going Concern) states that a fundamental principle in the preparation of financial statements is the going concern assumption. Under this assumption, an entity is ordinarily viewed as continuing in business for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws and regulations. The responsibility to make an assessment of an entity's ability to continue as a going concern rests with the
    a. Auditor.
    b. Entity's creditors.
    c. Entity's management.
    d. SEC.

29. Which of the following audit procedures most likely would assist an auditor in identifying conditions and events that may indicate substantial doubt about an entity's ability to continue as a going concern?
    a. Comparing the entity's depreciation and asset capitalization policies to other entities in the industry.
    b. Confirming with third parties the details of arrangements to maintain financial support.
    c. Inspecting title documents to verify whether any assets are pledged as collateral.
    d. Reconciling the cash balance per books with the cutoff bank statement and the bank confirmation.

30. The responsibility for the identification and disclosure of related parties and transactions with such parties rests with the
    a. Securities and Exchange Commission (SEC).
    b. Financial Reposting Standards Council (FRSC).
    c. Entity's management.
    d. Auditor.

31. The auditor is required to perform procedures designed to obtain sufficient appropriate audit evidence to identify all events that may require adjustment of, or disclosure in, the financial statements up to the
    a. Date of the approval of the financial statements.

b. Date of the auditor's report.
c. Date of the financial statements.
d. Date the financial statements are issued.

32. Which of the following procedures would an auditor most likely perform in obtaining evidence about subsequent events?
a. Determine that changes in employee pay rates after year-end were properly authorized.
b. Inquire about payroll checks that were recorded before year-end but cashed after year-end.
c. Investigate changes in long-term debt occurring after year-end.
d. Recompute depreciation charges for plant assets sold after year-end.

33. Which of the following procedures should an auditor generally perform regarding subsequent events?
a. Communicate material weaknesses in internal control to the client's audit committee.
b. Compare the latest available interim financial statements with the financial statements being audited.
c. Review the cutoff bank statements for several months after the year-end.
d. Send second requests to the client's customers who failed to respond to initial accounts receivable confirmation requests.

34. A major customer of an audit client suffers a fire just prior to completion of year end fieldwork. The audit client believes that this event could have a significant effect on the financial statements. The auditor should
a. Advise management to adjust the financial statements.
b. Advise management to disclose the event in notes to the financial statements.
c. Disclose the event in the auditor's report.
d. Withhold submission of the auditor's report until the extent of the direct effect on the financial statements is known.

35. A lawyer's response to an auditor's inquiry concerning litigation, claims, and assessments may be limited to matters that are considered individually or collectively material to the client's financial statements. Which parties should reach an understanding on the limits of materiality for this purpose?
a. The auditor and the client's management.
b. The client's audit committee and the lawyer.
c. The client's management and the lawyer.
d. The lawyer and the auditor.

36. The letter of audit inquiry should be
a. Prepared and sent by the auditor.
b. Prepared by management and sent by the auditor.
c. Prepared and sent by management.
d. Prepared by the auditor and sent by management.

37. Which of the following is an audit procedure that an auditor most likely would perform concerning litigation, claims, and assessments?
a. Confirm directly with the client's lawyer that all litigation, claims, and assessments have been recorded or disclosed in the financial statements.

b. Discuss with management its policies and procedures adopted for evaluating and accounting for litigation, claims, and assessments.
c. Examine the legal documents in the client's lawyer's possession concerning litigation, claims, and assessments to which the lawyer has devoted substantive attention.
d. Request the client's lawyer to evaluate whether the client's pending litigation, claims, and assessments indicate a going concern problem.

38. The audit step most likely to reveal the existence of contingent liabilities is
a. A review of vouchers paid during the month following the year-end.
b. Accounts payable confirmations.
c. An inquiry directed to legal counsel.
d. Mortgage-note confirmation.

39. When obtaining evidence regarding litigation against a client, the CPA would least interested in determining
a. An estimate of the potential loss.
b. An estimate of when the matter will be resolved.
c. The period in which the underlying cause of the litigation occurred.
d. The probability of an unfavorable outcome.

40. The scope of an audit is not restricted when an attorney's response to an auditor as a result of a client's letter of audit inquiry limits the response to
a. An evaluation of the likelihood of an unfavorable outcome of the matters disclosed by the entity.
b. Matters to which the attorney has given substantive attention in the form of legal representation.
c. The attorney's opinion of the entity's historical experience in recent similar litigation.
d. The probable outcome of asserted claims and pending or threatened litigation.

41. After an audit report containing an unqualified opinion on a client's financial statements was issued, the client decided to sell the shares of a subsidiary that accounts for 40% of its revenue and 30% of its net income. The auditor should
a. Take no action because the auditor has no obligation to make any further inquiries.
b. Notify the entity that the auditor's report may no longer be associated with the financial statements.
c. Determine whether the information is reliable and, if determined to be reliable, request that revised financial statements be issued.
d. Describe the effects of this subsequently discovered information in a communication with persons known to be relying on the financial statements.

42. On February 25, a CPA issued an auditor's report expressing an unqualified opinion on financial statements for the year ended January 31. On March 2, the CPA learned that on February 11, the entity incurred a material loss on an uncollectible trade receivable as a result of the deteriorating financial condition of the entity's principal customer that led to the customer's bankruptcy. Management then refused to adjust the financial statements for this subsequent event. The CPA determined that the information is reliable and that there are creditors currently relying on the financial statements. The CPA's next course of action most likely would be to
a. Issue a revised auditor's report and distribute it to each creditor known to be relying on the financial statements.

b. Issue a revised financial statement and distribute it to each creditor known to be relying on the financial statements.
c. Notify each member of the entity's board of directors about management's refusal to adjust the financial statements.
d. Notify the entity's creditors that the financial statements and the related auditor's report should no longer be relied on.

43. Which of the following conditions or events most likely would cause an auditor to have substantial doubt about an entity's ability to continue as a going concern?
a. Arrearages in principal stock dividends are paid.
b. Restrictions on the disposal of principal assets are present.
c. Significant related party transactions are pervasive.
d. Usual trade credit from suppliers is denied.

44. Princess, CPA, believes there is substantial doubt about the ability of Maximo Inc. to continue as a going concern for a reasonable period of time. In evaluating Maximo's plans for dealing with the adverse effects of future conditions and events, Princess most likely would consider, as mitigating factor, Maximo's plans to
a. Discuss with lenders the terms of all debt and loan agreements.
b. Postpone expenditures for research and development projects.
c. Purchase production facilities currently being leased from a related party.
d. Strengthen internal controls over cash disbursements.

45. When an auditor concludes that there is substantial doubt about a continuing audit client's ability to continue as a going concern.
a. Report to the client's audit committee that management's accounting estimates may need to be adjusted.
b. Reissue the prior year's auditor's report and add an emphasis of matter paragraph that specifically refers to "substantial doubt" and "going concern".
c. Issue a qualified or adverse opinion, depending upon materiality, due to the possible effects on the financial statements.
d. Consider the adequacy of disclosure about the client's possible inability to continue as a going concern.

46. The following statements relate to the engagement partner's responsibility to conduct timely reviews of the audit documentation to be satisfied that sufficient appropriate evidence has been obtained to support the conclusions reached and for the auditor's report to be issued. Which is false?
a. The reviews cover critical areas of judgment, especially those relating to difficult or contentious matters identified during the course of the engagement, significant risks, and other areas the engagement partner considers important.
b. The engagement partner's review of the audit documentation allows significant matters to be resolved on a timely basis to his/her satisfaction before the auditor's report is issued.
c. The engagement partner should review all audit documentation.
d. The engagement partner should document the extent and timing of the reviews.

47. Which of the following procedures would an auditor most likely perform during an audit engagement's overall review stage in formulating an opinion on an entity's financial statements?

a. Consider whether the results of audit procedures affect the assessment of the risk of material misstatement due to fraud.
b. Determine whether inadequate provisions for the safeguarding of assets have been corrected.
c. Verify the clerical accuracy of the entity's proof of cash and its bank cutoff statement.
d. Obtain assurance from the entity's attorney that all material litigation has been disclosed in the financial statements.

48. Which of the following events occurring after the issuance of an auditor's report most likely would cause the auditor to make further inquiries about the previously issued financial statements?
a. A technological development that could affect the entity's future ability to continue as a going concern.
b. The discovery of information regarding a contingency that existed before the financial statements were issued.
c. The entity's sale of a subsidiary that accounts for 30% of the entity's consolidated sales.
d. The final resolution of a lawsuit disclosed in the notes to the financial statements.

49. Which of the following events occurring after the issuance of an auditor's report most likely would cause the auditor to make further inquiries about the previously issued financial statements?
a. A contingency is resolved that had been disclosed in the audited financial statements.
b. A subsidiary is sold that accounts for 25% of the entity's consolidated net income.
c. An uninsured natural disaster occurs that may affect the entity's ability to continue as a going concern.
d. New information is discovered concerning undisclosed lease transactions of the audited period.

50. Which of the following statements concerning management representations is incorrect?
a. If a representation by management is contradicted by other audit evidence, the auditor should investigate the circumstances and, when necessary, reconsider the reliability of other representations by management.
b. If the auditor is unable to obtain sufficient appropriate audit evidence regarding a matter, which has, or may have, a material effect on the financial statements and such audit evidence is expected to be available, this will constitute a limitation in the scope of the audit, even if a representation from management has been received on the matter.
c. Representations by management can be a substitute for other audit evidence that the auditor could reasonably expect to be available.
d. The auditor's working papers would ordinarily include a summary by oral discussions with management or written representations from management.

COMPREHENSIVE CASES

CASE 1 – Review for Subsequent Events for Audit of Financial Statements

EastVale Co manufactures a range of dairy products (for example, milk, yoghurt and cheese) in one factory. Products are stored in a nearby warehouse (which is rented by EastVale) before being sold to 350 supermarkets located within 200 kilometers of EastVale's factory. The products are perishable with an average shelf life of eight days. EastVale's financial statements year-end is 31 July. It is four months since the year-end at your audit client of EastVale and the annual audit of EastVale is almost complete, but the auditor's report has not been signed.

The following events have just come to your attention. Both events occurred in late November.

a. A fire in the warehouse rented by the company has destroyed 60% of the inventory held for resale.

b. A batch of cheese produced by EastVale was found to contain some chemical impurities. Over 300 consumers have complained about food poisoning after eating the cheese. 115 supermarkets have stopped purchasing EastVale's products and another 85 are considering whether to stop purchasing from EastVale. Lawyers acting on behalf of the consumers are now presenting a substantial claim for damages against EastVale.

Required:

In respect of each of the events at EastVale Co mentioned above:

1. Describe the additional audit procedures you will carry out.

2. State, with reasons, whether or not the financial statements for the year-end require amendment.

3. Discuss whether or not the audit report should be modified.

CASE 2 – Going Concern Considerations

Smithson Co provides scientific services to a wide range of clients. Typical assignments range from testing food for illegal additives to providing forensic analysis on items used to commit crimes to assist law enforcement officers.

The annual audit is nearly complete. As audit senior you have reported to the engagement partner that Smithson is having some financial difficulties. Income has fallen due to the adverse effect of two high-profile court cases, where Smithson's services to assist the prosecution were found to be in error. Not only did this provide adverse publicity for Smithson, but a number of clients withdrew their contracts. A senior employee then left Smithson, stating lack of investment in new analysis machines was increasing the risk of incorrect information being provided by the company.

A cash flow forecast prepared internally shows Smithson requiring significant additional cash within the next 12 months to maintain even the current level of services. Smithson's auditors have been asked to provide a negative assurance report on this forecast.

Required:

1. Define 'going concern' and discuss the auditor's responsibilities in respect of going concern.

2. State the audit procedures that may be carried out to try to determine whether or not Smithson Co is a going concern.

3. Explain the audit procedures the auditor may take where the auditor has decided that Smithson Co is unlikely to be a going concern.

4. In the context of the cash flow forecast, define the term 'negative assurance' and explain how this differs from the assurance provided by an audit report on statutory financial statements.

Chapter 15
REPORTS ON AUDITED FINANCIAL STATEMENTS

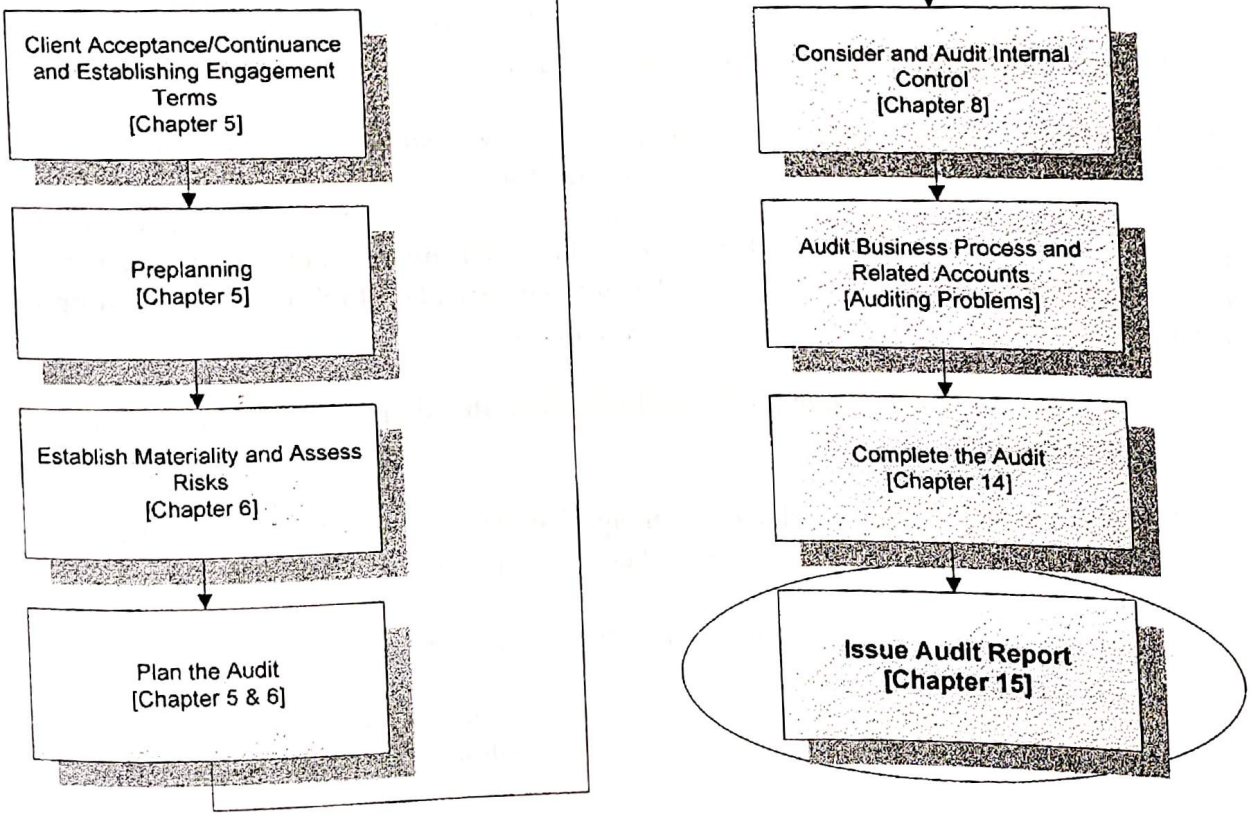
LEARNING OBJECTIVES

Upon completion of this chapter you will

1. **Understand the standard financial statement audit report with an unmodified opinion.**
2. **Know the situations to include an emphasis of matter paragraph and other matters paragraph in a financial statement audit report with an unmodified opinion.**
3. **Know the conditions that lead to modification of the auditor's opinion.**
4. **Know the other types of financial statement audit reports.**
5. **Understand the effect of materiality on the auditor's choice of financial statement audit reports.**
6. **Understand the auditor's reporting on comparatives.**
7. **Know the auditor's responsibility for other information in documents containing audited financial statements.**

This chapter covers the last phase of the audit process identified in Chapter 5 (Figure 5.1), ***the issuance of audit report.***

Major Phases of an Audit



The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Audit reports are highly visible and often the auditor's only means of communication to users of the financial statements. Thus, the form and content of the audit report is important. For the purposes of this chapter only audit-related engagements are considered.

To rely on the financial statements the users must understand the scope of the audit and the degree of responsibility taken by the auditor. To assist in accomplishing this goal, the auditing profession has adopted conventional wording for audit reports. This approach helps to prevent misunderstanding in the message being communicated by the auditor to the users of the financial statements. You are reminded that the financial statements are the representations of management and that the conformance of their presentation with the financial reporting framework is management's responsibility.

In addition to ensure consistent content, layout, and wording in the audit report, auditing standards state when: (1) an Emphasis of Matter paragraph or an Other Matter paragraph is included in the audit report with an unmodified opinion; and (2) when modification of the auditor's opinion is necessary.

Finally, the auditors encounter a number of special reporting issues that affect the financial statement audit report. This chapter covers two special reporting issues: reports on comparatives and other information in documents containing audited financial statements.

STANDARD AUDIT REPORT WITH AN UNMODIFIED OPINION

Auditor's standard financial statement report with an unmodified opinion is the most common and issued when the auditor has gathered sufficient appropriate evidence, the audit was performed in accordance with the applicable auditing standards and regulations and the financial statements conform to the applicable financial reporting framework.

Forming an Opinion on the Financial Statements

Auditing standards (i.e., PSA 700 *Revised*) require the auditor to evaluate the conclusions drawn from the audit evidence obtained as the basis for forming an opinion on the financial statements. This involves concluding whether sufficient appropriate audit evidence has been obtained to reduce to an acceptably low level the risks of material misstatement of the financial statements and evaluating the effects of uncorrected misstatements identified. In forming an opinion on the financial statements, the auditor evaluates whether the:

1. The financial statements adequately disclose the significant accounting policies selected and applied.
2. Accounting policies selected and applied are consistent with the financial reporting framework and are appropriate in the circumstances.
3. Accounting estimates made by management are reasonable in the circumstances.
4. Information presented in the financial statements, including accounting policies, is relevant, reliable, comparable and understandable.

5. Financial statements provide sufficient disclosures to enable users to understand the effect of material transactions and events on the information conveyed in the financial statements.

6. The terminology used in the financial statements, including the title of each financial statement, is appropriate.

Forming an opinion on the financial statements also involves evaluating the fair presentation of the financial statements. The auditor considers whether the financial statements, after any adjustments made by management as a result of the audit process, are consistent with the auditor's understanding of the entity and its environment. The auditor considers the overall presentation, structure and content of the financial statements. The auditor also considers whether the financial statements, including the note disclosures, faithfully represent the underlying transactions and events in a manner that presents fairly, in all material respects, the information conveyed in the financial statements in the context of the financial reporting framework.

Applicable Financial Reporting Framework

The auditor's judgment regarding whether the financial statements are presented fairly, in all material respects, is made in the context of the applicable financial reporting framework. As discussed in PSA 210, *"Terms of Audit Engagements,"* without an acceptable financial reporting framework, the auditor does not have suitable criteria for evaluating the entity's financial statements. PSA 200, *"Objective and General Principles Governing an Audit of Financial Statements,"* also describes the auditor's responsibility to determine whether the financial reporting framework adopted by management in preparing the financial statements is acceptable.

Extremely Rare Circumstances when Applying the Financial Reporting Framework Results in Misleading Financial Statements

When forming the opinion on the financial statements, the auditor should recognize that in extremely rare circumstances the application of the financial reporting framework may result in a misleading financial statement. The auditor's response to such circumstances will depend on how management has addresses the matter in the financial statements (e.g., include additional disclosures beyond those specifically required by the framework or, in extremely rare circumstances, to depart from a requirement in the framework in order to achieve fair presentation of the financial statements) and how the financial reporting framework applied deals with these rare circumstances. If the auditor concludes that compliance with a specific requirement results in financial statements that are misleading, the auditor should consider the need to modify the auditor's report.

Auditor's Report for Audits Conducted in Accordance with Both Auditing Standards of a Specific Jurisdictions and PSAs

An auditor may be required to conduct an audit in accordance with the auditing standards of a specific jurisdiction (the national standards), and has additionally complied with the PSAs in the conduct of the audit. If this is the case, the auditor's report may refer to Philippine Standards on Auditing in addition to the national auditing standards, but the auditor shall do so only if:

1. There is no conflict between the requirements in the national auditing standards and those in PSAs that would lead the auditor (a) to form a different opinion, or (b) not to include

an Emphasis of Matter paragraph or Other Matter paragraph that, in the particular circumstances, is required by PSAs.

2. The auditor's report includes, at a minimum, each of the elements set out in PSA 700 (Revised), when the auditor uses the layout or wording specified by the national auditing standards. However, reference to "law or regulation" in the said auditor's report shall be read as reference to the national auditing standards and shall identify the jurisdiction of origin of the national auditing standards.

Unaudited Supplementary Information Presented with the Financial Statements

In some circumstances, the entity may be required by law, regulation or standards, or management may voluntary choose, to present supplementary information together with the financial statements. The auditor should evaluate whether, in the auditor's professional judgment, supplementary information is nevertheless an integral part of the financial statements due to its nature or how it is presented. When it is an integral part of the financial statements, the supplementary information shall be covered by the auditor's opinion.

If the supplementary information is not considered an integral part of the audited financial statements, the auditor shall evaluate whether such supplementary information is presented in a way that sufficiently and clearly differentiates it from the audited financial statements. If this is not the case, then the auditor should ask management to change how the unaudited supplementary information is presented. If management refuses to do so, the auditor shall identify the unaudited supplementary information and explain in the auditor's report that such supplementary information has not been audited.

However, the fact that supplementary information is unaudited does not relieve the auditor of the responsibility to read and consider other information to identify material inconsistencies with the audited financial statements or auditor's knowledge obtained in the audit.

BASIC ELEMENTS OF A STANDARD AUDIT REPORT WITH AN UNMODIFIED OPINION

PSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*, set out the following elements of the auditor's report with an unmodified opinion:

Title

The auditor's report should have a title that clearly indicates that it is the report of an independent auditor. A title indicating the report is the report of an independent auditor, for example, "Independent Auditor's Report," affirms that the auditor has met all of the relevant ethical requirements regarding independence and, therefore, distinguishes the independent auditor's report from reports issued by others.

Addressee

The auditor's report should be addressed as required by the circumstances of the engagement. Ordinarily, the auditor's report is addressed to those for whom the report is prepared, often either to the shareholders or to those charged with governance of the entity whose financial statements are being audited.

Auditor's Opinion

The first section of the auditor's report shall include the auditor's opinion and shall have the heading "Opinion". The Opinion section of the auditor's report should also disclose the entity whose financial statements have been audited, that the financial statements have been audited, the title of each of the financial statements that comprise the complete set of financial statements, a reference to the summary of significant accounting policies and other explanatory notes, and the date and period covered by the financial statements.

In an unmodified opinion, the Opinion section of the auditor's report should state the auditor's opinion that the accompanying financial statements present fairly, in all material respects, in accordance with the applicable financial reporting framework. When Philippine Financial Reporting Standards is not used as the financial reporting framework, the Opinion section should identify the jurisdiction or country of origin of the financial reporting framework.

Basis for Opinion

The auditor's report should include a section with the heading "Basis for Opinion" that provides important context about the auditor's opinion. Accordingly, the Basis for Opinion section should directly follow the Opinion section in the auditor's report. The Basis for Opinion:

1. States that the audit was conducted in accordance with Philippine Standards on Auditing. The reference to the standards used conveys to the users of the auditor's report that the audit has been conducted in accordance with established standards.

2. Refers to the section of the auditor's report that describes the auditor's responsibilities under the PSAs.

3. Includes a statement that the auditor is independent of the entity in accordance with the relevant ethical requirements relating to the audit, and has fulfilled the auditor's other ethical responsibilities in accordance with these requirements. The statement shall identify the jurisdiction of origin of the relevant ethical requirements (i.e., Code of Ethics for Professional Accountants in the Philippines). The identification of the jurisdiction of origin of relevant ethical requirements increases transparency about those requirements relating to the particular audit engagement.

4. States whether the auditor believes that the audit evidence the auditor has obtained is sufficient and appropriate to provide a basis for the auditor's opinion.

Responsibilities of Management for the Financial Statements

The auditor's report should state that management is responsible for the preparation and the fair presentation of the financial statements in accordance with the applicable financial reporting framework and that this responsibility includes the following:

1. Preparing the financial statements in accordance with the applicable financial reporting framework and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

2. Assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern. The explanation of management's responsibility for this assessment shall include a description of when the use of the going concern basis of accounting is appropriate.

This section of the auditor's report shall also identify those responsible for the oversight of the financial reporting process, when those responsible for such oversight are different from those who fulfill the responsibilities described above. In this case, the heading of this section shall also refer to "Those Charged with Governance" or such term that is appropriate in the context of the legal framework in the particular jurisdiction.

Auditor's Responsibilities for the Audit of the Financial Statements

The auditor's report shall include a section with the heading "Auditor's Responsibilities for the Audit of the Financial Statements." This section of the auditor's report shall state that:

1. The objectives of the auditor are to: (a) obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and (b) issue an auditor's report that includes the auditor's opinion.

2. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with PSAs will always detect a material misstatement when it exists.

3. Misstatements can arise from fraud or error, and either:

   - Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

   - Provide a definition or description of materiality in accordance with the applicable financial reporting framework.

The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report shall further:

1. State that, as part of an audit in accordance with PSAs, the auditor exercises professional judgment and maintains professional skepticism throughout the audit.

2. Describe an audit by stating that the auditor's responsibilities are:

   - To identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error; to design and perform audit procedures responsive to those risks; and to obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

- To obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor shall omit the phrase that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.

- To evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

- To conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. If the auditor concludes that a material uncertainty exists, the auditor is required to draw attention in the auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify the opinion. The auditor's conclusions are based on the audit evidence obtained up to the date of the auditor's report. However, future events or conditions may cause an entity to cease to continue as a going concern.

- When the financial statements are prepared in accordance with a fair presentation framework, to evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

The Auditor's Responsibilities for the Audit of the Financial Statements section of the auditor's report also shall:

1. State that the auditor communicates with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that the auditor identifies during the audit.

2. For audits of financial statements of listed entities, state that the auditor provides those charged with governance with a statement that the auditor has complied with relevant ethical requirements regarding independence and communicate with them all relationships and other matters that may reasonably be thought to bear on the auditor's independence, and where applicable, related safeguards.

3. For audits of financial statements of listed entities and any other entities for which key audit matters are communicated, state that from the matters communicated with those charged with governance, the auditor determines those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. The auditor describes these matters in the auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, the auditor determines that a matter should not be communicated in the auditor's report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Other Reporting Responsibilities

The auditor may have additional responsibilities to report on other matters that are supplementary to the auditor's responsibility to express an opinion on the financial statements. Such matters should be addressed in a separate section in the auditor's report with a heading titled "Report on Other Legal and Regulatory Requirements" or otherwise as appropriate to the context of the section.

Name of the Engagement Partner

The name of the engagement partner shall be included in the auditor's report for audits of complete sets of general purpose financial statements of listed entities unless, in rare circumstances, such disclosure is reasonably expected to lead to a significant personal security threat. In such rare circumstances, the auditor shall discuss this intention with those charged with governance to inform the auditor's assessment of the likelihood and severity of a significant personal security threat.

Auditor's Signature

The auditor's report should be signed, either in the name of the audit firm, the personal name of the auditor or both. In addition to the auditor's signature, the auditor may be required to declare the auditor's professional accountancy designation or the fact that the auditor or firm, as appropriate, has been recognized by the appropriate licensing authority.

Date of the Auditor's Report

The date of the auditor's report informs the reader that the auditor has considered the effect of events and transactions of which the auditor became aware and that occurred up to that date. The auditor should date the report on the financial statements no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the opinion on the financial statements. Frequently, this is the same date as the approval of the financial statements, but it could be later. The date of the approval of the financial statements is the date on which those recognized authority conclude that they have prepared the financial statements and that they have taken responsibility for them.

Auditor's Address

The auditor's report should name the location in the country where the auditor practices.

Exhibit 15.1 contains a sample standard audit report on financial statements of a listed entity with an unmodified opinion. This audit report includes the standard elements in line with PSA 700 (Revised), *Forming an Opinion and Reporting on Financial Statements*.

EXHIBIT 15.1 **Auditor's Report on Financial Statements of a Listed Entity Prepared in Accordance with a Fair Presentation Framework**

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements

Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 20X1, and its financial performance and its cash flows for the year then ended in accordance with Philippine Financial Reporting Standards (PFRSs).

Basis for Opinion

We conducted our audit in accordance with Philippine Standards on Auditing (PSAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the International Ethics Standards Board for Accountants' *Code of Ethics for Professional Accountants (IESBA Code)* together with the ethical requirements that are relevant to our audit of the financial statements in the Philippines, the *Code of Ethics for Professional Accountants in the Philippines (Philippine Code of Ethics)*, and we have fulfilled our other ethical responsibilities in accordance with these requirements and the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Material Uncertainty Related to Going Concern

We draw attention to Note X in the financial statements, which indicates that the Company incurred a net loss of Php X during the year ended December 31, 20X1 and, as of that date, the Company's current liabilities exceeded its total assets by Php X. As stated in Note X, these events or conditions, along with other matters as set forth in Note X, indicate that a material uncertainty exists that may cast significant doubt on the Company's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

(For listed entities) Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each KAM in accordance with PSA 701, Communication Key Audit Matters in the Independent Auditor's Report.]

Other Information [or another title if appropriate such as "Information Other than the Financial Statements and Auditor's Report Thereon]

Management is responsible for the other information. The other information comprises the [information included in the X Report], but does not include the financial statements and our auditor's report thereon.

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information; we are required to report that fact. We have

Opinion first. The auditor's opinion – the "pass/fail" statement – is required to be positioned at the beginning of the report, followed by the Basis for Opinion.

Basis for Opinion is required. Before, it is only required when the auditor's opinion was modified.

New affirmative statement about the auditor's fulfillment of independence and other relevant ethical responsibilities requirement.

Separate section when a material uncertainty exists related to an entity's ability to continue as a going concern, and is adequately disclosed in the financial statements.

Description of each KAM for listed entities, including WHY and HOW for each KAM.

A separate section relating to other information to explain responsibilities of management and auditor's and whether the latter have any findings.

nothing to report in this regard [or a statement that describes any material misstatement of the other information].

Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with PFRSs, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or have no realistic alternative but to do so.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with PSAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

(Because of the increased length of this section, ISA 700 includes a provision that certain components of the following description in the auditors' responsibilities section may be presented in an appendix to the auditor's report or, where law, regulation or national auditing standards expressly permit, by reference to a website of an appropriate authority.)

As part of an audit in accordance with PSAs, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

Descriptions of management's responsibilities relating to going concern. Intended to reflect the requirements of the applicable reporting framework.

Identification of TCWG is required when a separate body exists that is responsible for the oversight of the financial reporting process (in many cases, the audit committee). When individuals responsible for such oversight are also responsible for the preparation of the financial statements, no reference to oversight responsibilities is required.

Expanded description of the auditor's responsibilities, including key features of the audit. The auditor's responsibility section is intended to explain more fully the concept of a risk based audit, as well as to clarify the meaning of certain audit-technical terms. This approach results in a more lengthy description of the auditor's responsibilities in relation to specific matters, including fraud; internal control, accounting policies and estimates, evaluation the overall presentation, structure and content of the financial statements and disclosures, group audits, and communications with TCWG.

New description of responsibilities relating to going concern. Reflects responsibilities under PSA 570, which are required regardless of the applicable framework.

- *(For group audit)* Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

(For listed entities) We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

(For listed entities) From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Report on Other Legal and Regulatory Requirements

[The form and content of this section of the auditor's report would vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law, regulation, or national auditing standards. The matters addressed by other law, regulation or national auditing standards (referred to as "other reporting responsibilities") shall be addressed within this section unless the other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the PSAs as part of the Report on the Audit of the Financial Statements section. The reporting of other reporting responsibilities that address the same topics as those required by the PSAs may be combined (i.e., included in the Report on the Audit of the Financial Statements section under the appropriate subheadings) provided that the wording in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the PSAs where such a difference exists.

The engagement partner on the audit resulting in this independent auditor's report is [name].
[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]
[Auditor Address]
[Date]

New description of the auditor's responsibilities in an audit of group financial statements.

New description of the auditor's responsibilities regarding communications with TCWG

New description of the auditor's responsibilities to provide a statement to TCWG that the auditor has complied with relevant ethical requirements regarding independence for listed entities.

New description of the auditor's responsibilities with respect to communicating key audit matters when PAS 701 is applied

Disclosure of the name of the engagement partner for listed entities.

Although this is a new requirement under PSA 700 (Revised), it would not be a new requirement for auditor's report issued in the Philippines as disclosure of the name of signing partner is already required.

COMMUNICATING KEY AUDIT MATTERS IN THE INDEPENDENT AUDITOR'S REPORT

One of the challenges with the financial statements is that they are fairly complicated. As a result, the audit is also quite complex and requires the auditor's assessment of risks of material misstatement to those financial statements to drive the performance of the audit. In today's "boilerplate" auditor's report, it is not possible for financial statements users to understand where the greatest of those risks lie in the eyes of the auditor.

For this reason, a particular area of focus within the new standards is the requirements as set out in the new PSA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*.

For audits of listed entities, a new section in the auditor's report called Key Audit Matters (KAM) will highlight those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period – i.e., the areas where the auditor focused the most during the audit.

KAM are included in a separate section of the auditor's report explaining the nature and intent of KAM. However, KAM is not:

1. A substitute for disclosures in the financial statements that the applicable financial reporting framework requires management to make, or that are otherwise necessary to achieve fair presentation.

2. A substitute for the auditor expressing a modified opinion when required by the circumstances of a specific audit engagement in accordance with PSA 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report*.

3. A substitute for reporting in accordance with PSA 570 (Revised), *Going Concern*, when a material uncertainty exists relating to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern.

4. A separate opinion on individual matters.

From the matters communicated with TCWG, the auditor determines the matter that required significant auditor attention. From the matters that required the auditor's significant attention, the auditor determines which were the matters of most significance in the audit of the current period. These matters are KAM.

In most cases, KAM relate to significant complex matters disclosed in the financial statements, e.g., valuation of goodwill and other long-term assets, valuation of financial instruments, difficult or unique aspects of revenue recognition, or accounting for significant acquisitions.

Determining Key Audit Matters

KAM is defined in the standard as *"Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period. Key audit matters are selected from matters communicated with those charged with governance"*. In essence, KAM are drawn from matters that are communicated with those charged with governance (TCWG).

PSA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, includes a judgment-based decision-making framework to help the auditor decide which matters, from those communicated with those charged with governance, would count as KAMs.

The auditor firstly narrows the matters communicated with TCWG to matters that required significant auditor attention. In doing so, auditors will explicitly consider:

1. Areas of higher risk of financial statements material misstatement
2. Significant auditor judgments relating to areas in the financial statements that involved significant management judgment, including accounting estimates that have been identified as having high estimation uncertainty
3. The effect on the audit of significant events or transactions that occurred during the period

The fact that these considerations are required does not imply that matters related to them are always KAM.

Communicating Key Audit Matters

Unless law or regulations prescribed otherwise, when KAM are communicated, auditors are required to describe each key audit matter, using an appropriate subheading, in a separate section of the auditor's report under the heading "Key Audit Matters". The introductory language in this section of the auditor's report shall state that:

1. Key audit matters are those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period.

2. These matters were addressed in the context of the audit of the financial statements as a whole, and in forming the auditor's opinion thereon, and the auditor does not provide a separate opinion on these matters.

Although standardized in nature, this language is intended to provide an appropriate context for users of the auditor's report to understand the new concept of KAM – in particular that the communication of KAM:

1. Is not intended to imply that the matter has not been appropriately resolved by the auditor in forming the opinion on the financial statements.
2. Is not intended to represent or imply discrete opinions on separate elements of the financial statements (a "piecemeal opinion").

In addition, the "Auditor's Responsibilities for the Audit of the Financial Statements" section of the auditor's report will include the following description in relation to KAM:

> From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

Required Elements in the Description of a Key Audit Matter

The description of each key audit matter in the Key Audit Matters section of the auditor's report should address:

1. Why the matter was considered to be one of most significance in the audit and therefore determined to be a key audit matter. Explaining the factors that led the auditor to conclude that a particular matter required significant auditor attention and was of most significance in the audit is likely to be of interest to intended users.

2. How the matter was addressed in the audit. Auditors may describe how a KAM was addressed in the audit by describing aspects of the auditor's response or approach that were most relevant to the matter or specific to the assessed risk of material misstatement; a brief overview of procedures performed; an indication of the outcome of the auditor's procedures; or key observations with respect to the matter; or some combination of these elements.

If the auditor provides an indication of the outcome of the auditor's procedures in the description of a KAM, care is needed to avoid the auditor giving the impression that the description is conveying a separate opinion on an individual KAM or that in any way may call into question the auditor's opinion on the financial statements as a whole.

3. Include a reference to the related disclosure(s), if any, in the financial statements. Reference to any related disclosures enables intended users to further understand how management has addressed the matter in preparing the financial statements. In addition to referring to related disclosure(s), the auditor's description of a KAM may draw attention to key aspects of such disclosures.

In a nutshell, the auditor is required to describe KAM in the auditor's report as follows:

Issue (i.e., the KAM)	Audit Response	Financial Statement Note Disclosure
why the matter was considered to be one of the most significant in the audit and therefore determined to be a KAM	how the matter was addressed in the audit	reference to the related financial statement note disclosure(s), if any

The requirement in PSA 701, *Communicating Key Audit Matters in the Independent Auditor's Report*, relating to the description of a KAM is intended to provide a succinct and balanced explanation about the matter. However, the level of detail in the description of each KAM is a matter of professional judgment, and may vary depending on the specific facts and circumstances of the particular engagement.

Exhibit 15.2 is an example of how a key audit matter could be communicated and described in the auditor's report:

EXHIBIT 15.2 Illustrative Example of a Key Audit Matter

Goodwill

Under PFRSs, the Company is required to annually test the amount of goodwill for impairment. This annual impairment test was significant to our audit because the balance of Php xxx as of December 31, 20X1 is material to the financial statements and management's assessment process is complex and highly judgmental and is based on assumptions, specifically [describe significant assumptions], which are affected by expected future market or economic conditions, particularly those in [name of country or geographic area] and cause a high degree of estimation uncertainty.

Our audit procedures included, among others, using the work of a valuation expert to assist us in evaluating the methodologies, assumptions and data used by the Company, in particular those assumptions relating to the forecasted revenue growth and profit margins for [name of business line]. We also focused on the adequacy of the Company's disclosures about those significant assumptions to which the outcome of the impairment test is most sensitive, that is, those that have the most significant effect on the determination of the recoverable amount of goodwill and cause the high degree of estimation uncertainty.

The Company's disclosures about goodwill are included in Note X, which specifically explains that small changes in the significant assumptions used could give rise to an impairment of the goodwill balance in the future.

describe the issue

describe the audit response

refer to the financial statement note disclosure

EMPHASIS OF MATTER PARAGRAPHS AND OTHER MATTER PARAGRAPHS

The auditor may include an Emphasis of Matter paragraph or an Other Matter paragraph in an auditor's report with an unmodified opinion when, in the auditor's judgment, such communication is appropriate to draw users' attention to a matter or matters presented or disclosed in the financial statements or to any other matter or matters which may be fundamental or relevant to their understanding of the financial statements, audit, auditor's responsibilities or the auditor's report. The inclusion of such matters paragraphs does not affect the auditor's opinion.

An **Emphasis of Matter paragraph** draws users' attention to a matter appropriately presented or disclosed in the financial statements that the auditor judges important to their understanding of the financial statements. An Emphasis of Matter paragraph does not affect the auditor's opinion because it can only be included in the audit report if the matter is presented or disclosed in the financial statements in accordance with the applicable financial reporting framework.

On the other hand, an **Other Matter paragraph** draws users' attention to any other matter, other than those presented or disclosed in the financial statement that may be relevant to their understanding of the audit, the auditor's responsibilities or the auditor's report. An Other Matter paragraph does not affect the auditor's opinion because it relates to matters other than those required to be presented or disclosed in the financial statements.

In certain circumstances, the auditor may consider a matter presented or disclosed in the financial statements to be of such importance to users' understanding of the financial statements as a whole that it would be appropriate to draw their attention to it. An Emphasis of Matter paragraph in the auditor's report provides the means for the auditor to do so.

PSA 706 (Revised), *Emphasis of Matter Paragraphs and Other Matters Paragraphs in the Independent Auditor's Report* provides the following circumstances where the auditor may consider it appropriate or necessary to emphasize in the auditor's report a matter presented or disclosed in the financial statements:

1. Amendment of the previously issued financial statements and the earlier report issued by the auditor due to the discovery of facts existed at the date of the auditor's report that, if know at that date, would have caused the financial statements to be amended or the auditor's opinion to be modified.
2. Material uncertainty regarding an entity's ability to continue as a going concern.
3. When a financial reporting framework prescribed by law or regulation would be unacceptable but for the fact that it is prescribed by law or regulation.
4. To alert users that the financial statements are prepared in accordance with a special framework.
5. When facts become known to the auditor after the date of the auditor's report and the auditor provides a new or amended auditor's report (i.e., subsequent events).
6. An uncertainty relating to the future outcome of an exceptional litigation or regulatory action.
7. A significant subsequent event that occurs between the date of the financial statements and the date of the auditor's report.
8. Early application of a new accounting standard that has a material effect on the financial statements (i.e., where early application is permitted).

9. A matter such as a major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.

An auditor may find it appropriate to use the auditor's report as a means of communicating information relating to a matter, other than those that are presented or disclosed in the financial statements, that may be relevant to users' understanding of the financial statements, the auditor's responsibilities, or the auditor's report. Such information is called other matter. The other matter in PSA 706 may include the following:

1. Information in a document containing audited financial statements that is materially inconsistent with those financial statements.
2. A predecessor auditor's report on the corresponding figures in the incoming auditor's report for the current period where the incoming auditor is permitted to make such a reference.
3. In rare circumstances, other matters that the auditor considers necessary to communicate to the user.
4. Law or regulation may require the auditor to communicate about planning and scoping matters (e.g., the planned scope of the audit, or the application of materiality in the context of the audit) in the auditor's report, or the auditor may consider it necessary to communicate about such matters in an Other Matter paragraph even if the same are unlikely to be key audit matters.
5. In the rare circumstances where auditor is unable to withdraw from an engagement due to a limitation on the scope of the audit imposed by management is pervasive and has restricted him from obtaining sufficient appropriate audit evidence. In such case, the auditor can add Other Matter paragraph explaining the reasons why withdrawal was not possible.
6. Law, regulation or generally accepted practice may require or permit the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities in the audit of the financial statements or of the auditor's report thereon.
7. In cases where auditor is engaged to report on two different sets of financial statement where each one is prepared under different general purpose framework, the auditor may include an Other Matter paragraph in the auditor's report, referring to the fact that another set of financial statements has been prepared by the same entity in accordance with another general purpose framework and that the auditor has issued a report on those financial statements.
8. Where financial statements are prepared for specific purpose meant for specific users, then auditor shall add Other Matter paragraph highlighting the fact that such financial statements are not meant for general users even if such financial statements are prepared under general purpose financial reporting framework.

The Relationship Between Emphasis of Matter Paragraphs and Key Audit Matters in the Auditor's Report

In some cases, matters which the auditor considers to be key audit matters will relate to issues that are presented and/or disclosed in the financial statements. Therefore, communicating these as KAM under PSA 701 will serve as the most useful and meaningful mechanism for highlighting the importance of the matter. When the auditor communicates matters as key audit matters, the intention is to provide additional information beyond that which would be included in an Emphasis of Matter paragraph. In recognition of this PSA 706 (Revised) states:

1. The auditor is prohibited from using an Emphasis of Matter paragraph or an Other Matter paragraph when the matter has been determined to be a key audit matters. The use of an Emphasis of Matter paragraph is not a substitute for a description of individual key audit matters.

2. If a key audit matter is also determined to be fundamental to users' understanding of the financial statement, the auditor may present this issue more prominently in the Key Audit Matters section. Alternatively, the auditor might also include additional information in the key audit matters description to indicate the importance of the matter to the user's understanding of the financial statements.

3. There may be a matter which is not determined to be a key audit matter, but which, in the auditor's judgement is fundamental to users' understanding and for which an Emphasis of Matter paragraph may be considered necessary.

Placement of Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Auditor's Report

The placement of an Emphasis of Matter paragraph or Other Matter paragraph in the auditor's report depends on the nature of the information to be communicated, and the auditor's judgment as to the relative significance of such information to intended users compared to other elements required to be reported in accordance with PSA 700 (Revised).

Emphasis of Matter Paragraphs

1. When the Emphasis of Matter paragraph relates to the applicable financial reporting framework, including circumstances where the auditor determines that the financial reporting framework prescribed by law or regulation would otherwise be unacceptable, the auditor may consider it necessary to place the paragraph immediately following the Basis of Opinion section to provide appropriate context to the auditor's opinion.

2. When a Key Audit Matters section is presented in the auditor's report, an Emphasis of Matter paragraph may be presented either directly before or after the Key Audit Matters section, based on the auditor's judgment as to the relative significance of the information included in the Emphasis of Matter paragraph.

   The auditor may also add further context to the heading "Emphasis of Matter", such as "Emphasis of Matter – Subsequent Event", to differentiate the Emphasis of Matter paragraph from the individual matters described in the Key Audit Matters section.

Other Matter Paragraphs

1. When a Key Audit Matters section is presented in the auditor's report and an Other Matter paragraph is also considered necessary, the auditor may add further context to the heading "Other Matter", such as "Other Matter – Scope of the Audit", to differentiate the Other Matter paragraph from the individual matters described in the Key Audit Matters section.

2. When an Other Matter paragraph is included to draw users' attention to a matter relating to Other Reporting Responsibilities addressed in the auditor's report, the paragraph may be included in the Report on Other Legal and Regulatory Requirements section.

3. When relevant to all the auditor's responsibilities or users' understanding of the auditor's report, the Other Matter paragraph may be included as a separate section following the Report on the Audit of the Financial Statements and the Report on Other Legal and Regulatory Requirements.

Exhibit 15.3 is an illustration of the interaction between the Key Audit Matters section, an Emphasis of Matter paragraph and an Other Matter paragraph when all are presented in the auditor's report.

EXHIBIT 15.3 **Illustration of an Auditor's Report that Includes a Key Audit Matters Section, an Emphasis of Matter Paragraph, and an Other Matter Paragraph**

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements

Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (*of*) its financial performance and its cash flows for the year then ended in accordance with Philippine Financial Reporting Standards (PFRSs).

Basis for Opinion

We conducted our audit in accordance with Philippine Standards on Auditing (PSAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Emphasis of Matter

We draw attention to Note X of the financial statements, which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[*Description of each key audit matter in accordance with PSA 701.*]

Other Matter

The financial statements of ABC Company for the year ended December 31, 20X0, were audited by another auditor who expressed an unmodified opinion on those statements on March 31, 20X1.

On the other hand, the illustrative report in Exhibit 15.4 includes an Emphasis of Matter paragraph in an auditor's report for an entity other than a listed entity that contains a qualified opinion and for which key audit matters have not been communicated.

EXHIBIT 15.4 — **Illustration of an Auditor's Report Containing a Qualified Opinion Due to a Departure from the Applicable Financial Reporting Framework and that Includes an Emphasis of Matter Paragraph**

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements

Qualified Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the accompanying financial statements present fairly, in all material respects, (or *give a true and fair view of*) the financial position of the Company as at December 31, 20X1, and (*of*) its financial performance and its cash flows for the year then ended in accordance with Philippine Financial Reporting Standards (PFRSs).

Basis for Qualified Opinion

The Company's short-term marketable securities are carried in the statement of financial position at xxx. Management has not marked these securities to market but has instead stated them at cost, which constitutes a departure from PFRSs. The Company's records indicate that had management marked the marketable securities to market, the Company would have recognized an unrealized loss of xxx in the statement of comprehensive income for the year. The carrying amount of the securities in the statement of financial position would have been reduced by the same amount at December 31, 20X1, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

We conducted our audit in accordance with Philippine Standards on Auditing (PSAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Emphasis of Matter – Effects of a Fire

We draw attention to Note X of the financial statements, which describes the effects of a fire in the Company's production facilities. Our opinion is not modified in respect of this matter.

Communication with Those Charged with Governance

The communication will enables those charged with governance to be made aware of the nature of any specific matters that the auditor intends to highlight in the auditor's report, and provides them with an opportunity to obtain further clarification from the auditor where necessary. Where the inclusion of an Other Matter paragraph on a particular matter in the auditor's report recurs on each successive engagement, the auditor may determine that it is unnecessary to repeat the communication on each engagement, unless otherwise required to do so by law or regulation.

AUDIT REPORTS WITH MODIFICATIONS TO THE AUDITOR'S OPINION

Auditing standards of reporting allow the auditor to assume differing degrees of responsibility on financial statements. The auditor can issue three types of audit report with modified opinions.

Circumstances When a Modification to the Auditor's Opinion is Required

An auditor should modify the opinion in the auditor's report when either of the following circumstances exists:

1. **Material misstatements.** The auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement.
2. **Scope limitation.** The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.

Types of Financial Statement Auditor's Reports

The three types of auditor's reports other than reports with unmodified opinions are the following:

1. **Auditor's reports with qualified opinion.** The auditor shall express a qualified opinion when the auditor concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements or when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the possible effects on the financial statements of undetected misstatements are material but not pervasive.
2. **Auditor's reports with an adverse opinion.** The auditor shall express an adverse opinion when the auditor concludes that misstatements, that are material individually or in the aggregate, are pervasive to the financial statements.
3. **Auditor's reports with a disclaimer of opinion.** The auditor shall disclaim an opinion on the financial statements when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the possible effects on the financial statements of that inability are both material and pervasive.

   The auditor shall also disclaim an opinion when, in extremely rare circumstances involving multiple uncertainties, the auditor concludes that, it is not possible to form an opinion on the financial statements due to the potential interaction of the uncertainties and their possible cumulative effect on the financial statements.

The choice of which audit report to issue depends on the condition and the materiality of the departure.

The Effect of Materiality on Financial Statements Audit Reporting

The decision regarding which type of modified opinion is appropriate depends upon the nature of the matter giving rise to the modification, i.e., whether the financial statements are materially misstated or whether there is an inability to obtain sufficient appropriate audit evidence and the

auditor's judgment about the pervasiveness of the effects or possible effects of the matter on the financial statements.

When the auditor is faced with a departure from the financial reporting framework, the auditor should consider the magnitude of the potential effects of the item and its significance to the overall financial statements. If the departure from the framework is immaterial, the auditor should issue an unmodified opinion. However, if the departure from the framework is material but not pervasive, the auditor should issue a qualified opinion. If the departure is so pervasive that its effects are highly material, the auditor should issue an adverse opinion. Judgments concerning the effects of a scope limitation are not much different. If the scope limitation is material but not pervasive, the auditor should issue a qualified opinion. However, if the possible effects cannot be confined to specific items in the financial statements or if the effect of the item could represent a substantial portion of the financial statements, the auditor is more likely to disclaim the opinion than qualify the opinion.

Table 15.1 below illustrates how the auditor's judgment about the nature of the matter giving rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed.

TABLE 15.1 Factors in Determining Qualified, Adverse and Disclaimer of Opinion

Nature of Matter Giving Rise to the Modification	Auditor's Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements	
	Material but not Pervasive	Material and Pervasive
Financial statements are materially misstated	**Qualified Opinion**	**Adverse Opinion**
Inability to obtain sufficient appropriate audit evidence	**Qualified Opinion**	**Disclaimer of Opinion**

Material Misstatements

If the financial statements are materially misstated, the auditor should express a qualified or adverse opinion, depending on materiality. A material misstatement in the financial statements may arise due to selection of inappropriate accounting policies (e.g., selected accounting policies are not consistent with the applicable financial reporting framework), inappropriate application of selected accounting policies (e.g., management has not applied the selected accounting policies consistently with the financial reporting framework) and inappropriate and inadequate disclosures in the financial statements (e.g., financial statements do not include all of the disclosures required by the applicable financial reporting framework).

Inability to Obtain Sufficient Appropriate Audit Evidence (Scope Limitation)

A scope limitation results from inability to obtain sufficient appropriate audit evidence about some component of the financial statements to conclude that the financial statements as a whole are free from material misstatements. This occurs because the auditor is unable to carry out all the audit procedures considered necessary. Such restrictions on the scope of the audit may be due to circumstances beyond the control of the entity (e.g., when the entity's accounting records have been destroyed), by the circumstances relating to the nature or timing of the auditor's work (e.g., when the timing of the auditor's appointment is such that the auditor is unable to observe the counting of the physical inventories) and imposed by the entity (e.g., when management prevents the auditor from requesting external confirmation of specific account balances). In these

circumstances, the auditor should attempt to carry out reasonable alternative procedures to obtain sufficient appropriate audit evidence to support an unmodified opinion. However, if restrictions cannot be overcome by performing alternative audit procedures, the auditor will have to issue a qualified opinion or a disclaimer of opinion.

Auditors should also be particularly cautious when a client has imposed a limitation on the scope of the audit. In such situation, the client may be trying to prevent the auditor from discovering material misstatements. Auditing standards suggest that when restrictions imposed by the client significantly limit the scope of the engagement, the auditor should request the removal of the said restrictions. If management refuses the auditor's request, the auditor should communicate the matter to those charged with governance, unless all of those charged with governance are involved in managing the entity and determine whether it is possible to perform alternative procedures to obtain sufficient appropriate audit evidence on which to base an unmodified opinion. However, if the auditor is unable to obtain sufficient appropriate audit evidence, the auditor should issue a qualified opinion or a disclaimer of opinion (i.e., only if resignation from the audit is not practicable or possible). If the auditor withdraws and before withdrawing, the auditor should communicate to those charged with governance any matters regrading misstatements identified during the audit that would have given rise to a modification of the opinion.

Prohibition on Issuing a Piecemeal Opinion

If the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements as a whole, the auditor shall not express an unmodified opinion on one or more specific elements, accounts or items of the financial statements in the same report and with respect to the same applicable financial reporting framework (a "piecemeal opinion"). To include such an unmodified opinion in the same report would contradict the auditor's adverse opinion or disclaimer or opinion on the financial statements as a whole.

Form and Content of the Auditor's Report when the Opinion is Modified

When a qualified opinion is issued, the auditor should add a paragraph explaining the matter giving rise to the modification. The auditor shall place this paragraph immediately after the opinion paragraph and use the heading "Basis for Qualified Opinion." The explanatory paragraph should disclose the effects of the departure on the financial statements. The auditor should also modify the opinion paragraph to state that, in the auditor's opinion, except for the effects of the matter(s) described in the Basis for Qualified Opinion paragraph, the accompanying financial statements "present fairly, in all material respects" in accordance with the applicable financial reporting framework. When the modification arises from an inability to obtain sufficient appropriate audit evidence, the auditor shall use the corresponding phrase "except for the possible effects of the matter(s)" for the modified opinion. The auditor for the said paragraph shall use the heading "Qualified Opinion." Exhibit 15.5 is an example of an opinion paragraph that has been qualified due to a material misstatement of the financial statements.

EXHIBIT 15.5 Qualified Opinion due to a Material Misstatement of the Financial Statements

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements

Qualified Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the accompanying financial statements present fairly, in all material respects, the financial position of the Company as at December 31, 20X1, and (*of*) its financial performance and its cash flows for the year then ended in accordance with Philippine Financial Reporting Standards (PFRSs).

Basis for Qualified Opinion

The Company's inventories are carried in the statement of financial position at xxx. Management has not stated the inventories at the lower of cost and net realizable value but has stated them solely at cost, which constitutes a departure from PFRSs. The Company's records indicate that, had management stated the inventories at the lower of cost and net realizable value, an amount of xxx would have been required to write the inventories down to their net realizable value. Accordingly, cost of sales would have been increased by xxx, and income tax, net income and shareholders' equity would have been reduced by xxx, xxx and xxx, respectively.

We conducted our audit in accordance with Philippine Standards on Auditing (PSAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the *Basis for Qualified Opinion* section we have determined the matters described below to be the key audit matters to be communicated in our report.

[Description of each key audit matter in accordance with PSA 701.]

Exhibit 15.6 is an example of an opinion paragraph that has been qualified because of scope limitation.

EXHIBIT 15.6 Qualified Opinion due to the Auditor's Inability to Obtain Sufficient Audit Evidence Regarding a Foreign Associate

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Consolidated Financial Statements

Qualified Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, except for the possible effects of the matter described in the *Basis for Qualified Opinion* section of our report, the accompanying consolidated financial statements present fairly, in all material respects, the financial position of the Group as at December 31, 20X1, and (*of*) its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with Philippine Financial Reporting Standards (PFRSs).

Basis for Qualified Opinion

The Group's investment in XYZ Company, a foreign associate acquired during the year and accounted for by the equity method, is carried at xxx on the consolidated statement of financial position as at December 31, 20X1, and ABC's share of XYZ's net income of xxx is included in ABC's income for the year then ended. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC's investment in XYZ as at December 31, 20X1 and ABC's share of XYZ's net income for the year because we were denied access to the financial information, management, and the auditors of XYZ. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

We conducted our audit in accordance with Philippine Standards on Auditing (PSAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our qualified opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters. In addition to the matter described in the *Basis for Qualified Opinion* section, we have determined the matters described below to be the key audit matters to be communicated in our report.

[Description of each key audit matter in accordance with PSA 701.]

When the auditor expresses an adverse opinion, the auditor should include a paragraph explaining the matter giving rise to the modification. The auditor shall place this paragraph immediately after the opinion paragraph and use the heading "Basis for Adverse Opinion." The explanatory paragraph should discuss the reasons for the adverse opinion and the effects of the departure on the financial statements. The auditor should also modify the opinion paragraph to state that the financial statements "do not present fairly" in accordance with the applicable financial reporting framework and will use the heading "Adverse Opinion." Exhibit 15.7 is an example of an adverse opinion.

EXHIBIT 15.7 | **Adverse Opinion due to a Material Misstatement of the Consolidated Financial Statements**

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Consolidated Financial Statements

Adverse Opinion

We have audited the consolidated financial statements of ABC Company and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 20X1, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, because of the significance of the matter discussed in the *Basis for Adverse Opinion* section of our report, the accompanying consolidated financial statements do not present fairly the consolidated financial position of the Group as at December 31, 20X1, and (*of*) its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with Philippine Financial Reporting Standards (PFRSs).

Basis for Adverse Opinion

As explained in Note X, the Group has not consolidated subsidiary XYZ Company that the Group acquired during 20X1 because it has not yet been able to determine the fair values of certain of the subsidiary's material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under PFRSs, the Company should have consolidated this subsidiary and accounted for the acquisition based on provisional amounts. Had XYZ Company been consolidated, many elements in the accompanying consolidated financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

We conducted our audit in accordance with Philippine Standards on Auditing (PSAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.

Key Audit Matters
Except for the matter described in the *Basis for Adverse Opinion* section, we have determined that there are no other key audit matters to communicate in our report.

When the auditor disclaims an opinion due to an inability to obtain sufficient appropriate audit evidence, the auditor should add a paragraph describing the reasons for any other matters that would have required a modification to the opinion and the effects thereof. The auditor shall place this paragraph immediately after the opinion paragraph and use the heading "Basis for Disclaimer of Opinion." The auditor shall also state in the opinion paragraph that, because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion and, accordingly, the auditor does not express an opinion on the accompanying financial statements. The auditor for the said paragraph shall use the heading "Disclaimer of Opinion." Exhibit 15.8 is an example of a disclaimer of opinion.

EXHIBIT 15.8 **Disclaimer of Opinion due to the Auditor's Inability to Obtain Sufficient Appropriate Audit Evidence about Multiple Elements of the Financial Statements**

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or Other Appropriate Addressee]

Report on the Audit of the Financial Statements

Disclaimer of Opinion

We were engaged to audit the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

We do not express an opinion on the accompanying financial statements of the Company. Because of the significance of the matters described in the *Basis for Disclaimer of Opinion* section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for Disclaimer of Opinion

We were not appointed as auditors of the Company until after December 31, 20X1 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at December 31, 20X0 and 20X1, which are stated in the statements of financial position at xxx and xxx, respectively. In addition, the introduction of a new computerized accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the statement of financial position at a total amount of xxx as at December 31, 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the statement of comprehensive income, statement of changes in equity and statement of cash flows.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

[*Reporting in accordance with PSA 700 (Revised)*]

Auditor's Responsibilities for the Audit of the Financial Statements

Our responsibility is to conduct an audit of the Company's financial statements in accordance with Philippine Standards on Auditing and to issue an auditor's report. However, because of the matters described in the *Basis for Disclaimer of Opinion* section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements.

REPORTS ON COMPARATIVES

Auditing standards (PSA 700) requires that the auditor in the Opinion paragraph of the audit report specifies the date and the period covered by the financial statements. Often financial reporting frameworks require comparative financial information, referred to as **comparatives**, for one or more preceding periods. Such information is useful to identify financial trends and changes in the entity's financial performance over period of time.

Comparatives may be corresponding figures or comparative financial statements. Corresponding figures are an integral part of the current period financial statements and are intended to be read only in relation with the amounts and other disclosures of the current period. These corresponding figures are not presented as complete financial statements capable of standing alone. Comparative financial statements are included for comparison with the financial statements of the current period but do not form part of the current period financial statements. The essential audit reporting differences are that for corresponding figures, the auditor's report only refers to the financial statements of the current period, whereas, for comparative financial statements, the auditor's report refers to each period that financial statements are presented.

Auditing standards (PSA 710) requires that the auditor determines whether the financial statements include the comparatives required by the applicable financial reporting framework and such information is appropriately classified. The extent of audit procedures performed on comparatives is significantly less than for the audit of the current period statements. Relevant audit procedures include assessment of consistency in application of accounting policies in the prior period with the current period, and agreement of the comparatives with the amounts and disclosures presented in the prior period. When the auditor becomes aware of a possible material misstatement in the comparatives while performing the current period audit, the auditor performs additional audit procedures as are appropriate in the circumstances to obtain sufficient appropriate audit evidence to determine whether a material misstatement exists.

When the comparatives are presented as comparative financial statements, the auditor should issue a report in which the comparatives are specifically identified because the auditor's opinion is expressed individually on the financial statements for each of the periods presented. The comparatives are specifically identified in the Opinion paragraph of the audit report.

Since the auditor's report on comparative financial statements applies to the individual financial statements presented, the auditor may express a qualified or adverse opinion, disclaim an opinion, or include an Emphasis of Matter paragraph with respect to one or more financial statements for one or more periods, while issuing a different report on the other financial statements. Additionally, when reporting on the prior period financial statements in connection with the current year's audit, the opinion on such prior period financial statements may be different from the opinion previously expressed. This may arise when the auditor becomes aware of circumstances or events that materially affect the financial statements of a prior period during the course of the audit of the current period. In such case the auditor should disclose the substantive reasons for the different opinion in an Other Matter paragraph.

Corresponding figures are included as part of the current period financial statements. If corresponding figures are presented, the auditor should issue an audit report in which the comparatives are not specifically identified because the auditor's opinion is on the current period financial statements as a whole, including the corresponding figures. For example, auditing standards (PSA 710) require such modification when the auditor's report on the prior period included a modified opinion (i.e., a qualified opinion, a disclaimer of opinion, or an adverse opinion) and the matter which gave rise to the modification is unresolved, whether resulting in a modified opinion in the auditor's report regarding the current figures or not. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

1. Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period figures are material.

2. In other cases, explain that the audit opinion has been modified because the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

Exhibit 15.9 illustrates the reporting when the unresolved matter also results in a qualified opinion for the current period figures.

EXHIBIT 15.9 Sample Modified Auditor's Report on Corresponding Figures

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Company [or other Appropriate Addressee]

Report on the Audit of the Financial Report

Qualified Opinion

We have audited the financial statements of ABC Company (the Company), which comprise the statement of financial position as at December 31, 20X1, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, except for the effects of the matter described in the *Basis for Qualified Opinion* section of our report, the accompanying financial statements presents fairly, in all material respects, the financial position of the Company as at December 31, 20X1, and (*of*) its financial performance and its cash flows for the year then ended in accordance with Philippine Financial Reporting Standards (PFRSs).

Basis for Qualified Opinion

As discussed in Note X to the financial statements, no depreciation has been provided in the financial statement which constitutes a departure from PFRSs. This is the result of a decision taken by management at the start of the preceding financial year and caused us to qualify our audit opinion on the financial report relating to that year. Based on the straight-line method of depreciation and annual rates of 5% for the building and 20% for the equipment, the loss for the year should be increased by ₱xxx in 20X1 and ₱xxx in 20X0, property, plant and equipment should be reduced by accumulated depreciation of ₱xxx in 20X1 and ₱xxx in 20X0, and the accumulated loss should be increased by ₱xxx in 20X1 and ₱xxx in 20X0.

We conducted our audit in accordance with Philippine Standards on Auditing (PSAs). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Consolidated Financial Statements* section of our report. We are independent of the Group in accordance with the ethical requirements that are relevant to our audit of the consolidated financial statements in [*jurisdiction*], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.

When the matter which gave rise to the modified opinion on the prior period is resolved and properly dealt with in the financial statements, the current audit reports does not ordinarily refer to the previous modification.

Prior Period Financial Statements Audited by a Predecessor Auditor

The prior period financial statements may be audited by a predecessor auditor. The incoming auditor is permitted to refer to the predecessor auditor's report on the corresponding figures in the incoming auditor's report for the current period. When the auditor decides to refer to the predecessor auditor, the incoming auditor's report should state in an Other Matter paragraph that the financial statements of the prior period were audited by predecessor auditor, the type of

opinion expressed by the predecessor auditor, and the date of the report. If a predecessor auditor's opinion was modified, the reasons for the modification should be disclosed.

Similar disclosure requirements in an Other Matter paragraph of the auditor's report as those referred to above should be made when comparative financial statements were audited by a predecessor auditor. Alternatively, the predecessor auditor may reissue the audit report on the prior period with the incoming auditor only reporting on the current period.

Prior Period Financial Statements Not Audited

When the prior period financial statements are not audited, the incoming auditor should state in an Other Matter paragraph of the auditor's report that the corresponding figures or comparative financial statements are unaudited. Such a statement does not, however, relieve the auditor of the requirement to obtain sufficient appropriate audit evidence that the opening balances of the current period do not contain misstatements that materially affect the current period's financial statements.

If the auditor is unable to obtain sufficient appropriate audit evidence regarding the opening balances, the auditor is required to express a qualified opinion or disclaim an opinion on the financial statements, as appropriate. On the other hand, if the auditor encountered significant difficulty in obtaining sufficient appropriate audit evidence that the opening balances do not contain misstatements that materially affect the current period's financial statements; the auditor may determine this to be a key audit matter.

OTHER INFORMATION (OTHER THAN FINANCIAL STATEMENTS AND AUDITOR'S REPORT) INCLUDED IN AN ENTITY'S ANNUAL REPORT

An entity ordinarily issues an annual report which includes other information in addition to the audited financial statements together with the auditor's report thereon. Such **other information** may be financial and non-financial information which is included in a document, or combination of documents, prepared typically on an annual basis by management or those charged with governance in accordance with law, regulation or custom, the purpose of which is to provide owners (or similar stakeholders) with information on the entity's operations and the entity's financial results and financial position as set out in the financial statements.

An annual report contains or accompanies the financial statements and the auditor's report thereon and usually includes information about the entity's developments, its future outlook and risks and uncertainties, a statement by the entity's governing body, and reports covering governance matters.

Examples of other information include a report by management or those in charged with governance on operations, financial summaries or highlights, employment data, planned capital expenditures, financial ratios, names of officers and directors and selected quarterly data. Exhibit 15.10 contains other examples of amounts or other items that may be included in the other information.

EXHIBIT 15.10 Examples of Amounts or Other Items that May Be Included in the Other Information

The following are examples of amounts and other items that may be included in other information. This list is not intended to be exhaustive.

Amounts

- Items in a summary of key financial results, such as net income, earnings per share, dividends, sales and other operating revenues, and purchases and operating expenses.
- Selected operating data, such as income from continuing operations by major operating area, or sales by geographical segment or product line.
- Special items, such as asset dispositions, litigation provisions, asset impairments, tax adjustments, environmental remediation provisions, and restructuring and reorganization expenses.
- Liquidity and capital resource information, such as cash, cash equivalents and marketable securities; dividends; and debt, capital lease and minority interest obligations.
- Capital expenditures by segment or division.
- Amounts involved in, and related financial effects of, off-balance sheet arrangements.
- Amounts involved in guarantees, contractual obligations, legal or environmental claims, and other contingencies.
- Financial measures or ratios, such as gross margin, return on average capital employed, return on average shareholders' equity, current ratio, interest coverage ratio and debt ratio. Some of these may be directly reconcilable to the financial statements.

Other Items

- Explanations of critical accounting estimates and related assumptions.
- Identification of related parties and descriptions of transactions with them.
- Articulation of the entity's policies or approach to manage commodity, foreign exchange or interest rate risks, such as through the use of forward contracts, interest rate swaps, or other financial instruments.
- Descriptions of the nature of off-balance sheet arrangements.
- Descriptions of guarantees, indemnifications, contractual obligations, litigation or environmental liability cases, and other contingencies, including management's qualitative assessments of the entity's related exposures.
- Descriptions of changes in legal or regulatory requirements, such as new tax or environmental regulations, that have materially impacted the entity's operations or fiscal position, or will have a material impact on the entity's future financial prospects.
- Management's qualitative assessments of the impacts of new financial reporting standards that have come into effect during the period, or will come into effect in the following period, on the entity's financial results, financial position and cash flows.
- General descriptions of the business environment and outlook.
- Overview of strategy.
- Descriptions of trends in market prices of key commodities or raw materials.
- Contrasts of supply, demand and regulatory circumstances between geographic regions.
- Explanations of specific factors influencing the entity's profitability in specific segments.

Obtaining the Other Information

The auditor should:

1. Determine, through discussion with management, which document(s) comprises the annual report, and the entity's planned manner and timing of the issuance of such document(s).

2. Make appropriate arrangements with management to obtain in a timely manner and, if possible, prior to the date of the auditor's report, the final version of the document(s) comprising the annual report.

3. When some or all of the document(s) determined in (a) will not be available until after the date of the auditor's report, request management to provide a written representation that the final version of the document(s) will be provided to the auditor when available, and prior to its issuance by the entity, such that the auditor can complete the procedures required by the auditing standards.

Reading and Considering the Other Information

The auditor should read the other information and, in doing so shall consider whether there is a:

1. Material inconsistency between the other information and the financial statements. To evaluate their consistency, the auditor should compare selected amounts or other items (e.g., tables, charts or graphs containing extracts of the financial statements) in the other information with such amounts or other items in the financial statements.

2. Material inconsistency between the other information and the auditor's knowledge obtained in the audit, in the context of audit evidence obtained and conclusions reached in the audit.

While reading the other information, the auditor should remain alert for indications that the other information not related to the financial statements or the auditor's knowledge obtained in the audit appears to be materially misstated. This will assists the auditor in complying with relevant ethical requirements that require the auditor to avoid being knowingly associated with other information that the auditor believes contains a materially false or misleading statement, a statement furnished recklessly, or omits or obscures necessary information such that the other information is misleading.

Responding When a Material Inconsistency Appears to Exist or Other Information Appears to Be Materially Misstated

If, on reading the other information, the auditor identifies that a material inconsistency appears to exist (or becomes aware that the other information appears to be materially misstated), the auditor should discuss the matter with management and, if necessary, perform other procedures to conclude whether the other information or the audited financial statements is materially misstated or the auditor's understanding of the entity and its environment needs to be updated.

Responding When the Auditor Concludes That a Material Misstatement of the Other Information Exists

If the auditor concludes that a material misstatement of the other information exists, the auditor should request management to correct the other information. If management agrees to make the correction, the auditor should determine that the correction has been made. However, if it refuses to make the correction, the auditor should communicate the matter with those charged with governance and request that the correction be made.

If the auditor concludes that a material misstatement exists in other information obtained prior to the date of the auditor's report, and the other information is not corrected after communicating with those charged with governance, the auditor should take appropriate action, including:

1. Considering the implications for the auditor's report and communicating with those charged with governance about how the auditor plans to address the material misstatement in the auditor's report.

2. Withdrawing from the engagement, where withdrawal is possible under applicable law or regulation.

Moreover, if the auditor concludes that a material misstatement exists in other information obtained after the date of the auditor's report, the auditor should:

1. If the other information is corrected, perform the procedures necessary in the circumstances such as determining that the correction has been made and reviewing the steps taken by management to communicate with those in receipt of the other information, if previously issued, to inform them of the revision.

2. If the other information is not corrected after communicating with those charged with governance, take appropriate action considering the auditor's legal rights and obligations, to seek to have the uncorrected material misstatement appropriately brought to the attention of users for whom the auditor's report is prepared.

Responding When a Material Misstatement in the Financial Statements Exists or the Auditor's Understanding of the Entity and Its Environment Needs to Be Updated

If, on reading the other information, the auditor concludes that a material misstatement in the financial statements exists or the auditor's understanding of the entity and its environment needs to be updated, the auditor shall respond appropriately in accordance with the other auditing standards. As such, the auditor may become aware of new information that has implications for:

1. The auditor's understanding of the entity and its environment and, accordingly, may indicate the need to revise the auditor's risk assessment.
2. The auditor's responsibility to evaluate the effect of identified misstatements on the audit and of uncorrected misstatements, if any, on the financial statements.
3. The auditor's responsibilities relating to subsequent events.

Reporting

The auditor's report should include a separate section with a heading "Other Information", or other appropriate heading, when, at the date of the auditor's report:

1. For an audit of financial statements of a listed entity, the auditor has obtained, or expects to obtain, the other information.
2. For an audit of financial statements of an entity other than a listed entity, the auditor has obtained some or all of the other information.

When the auditor's report is required to include an Other Information section, this section shall include:

1. A statement that management is responsible for the other information.
2. An identification of: (a) other information, if any, obtained by the auditor prior to the date of the auditor's report and (b) for an audit of financial statements of a listed entity, other information, if any, expected to be obtained after the date of the auditor's report.
3. A statement that the auditor's opinion does not cover the other information and, accordingly, that the auditor does not express (or will not express) an audit opinion or any form of assurance conclusion thereon.
4. A description of the auditor's responsibilities relating to reading, considering and

reporting on other information as required by PSA 720 (Revised), *The Auditor's Responsibilities Relating to Other Information*.

When other information has been obtained prior to the date of the auditor's report, either: (a) a statement that the auditor has nothing to report or (b) if the auditor has concluded that there is an uncorrected material misstatement of the other information, a statement that describes the uncorrected material misstatement of the other information.

REVIEW QUESTIONS

1. When is a standard auditor's report with an unmodified opinion issued? Enumerate and describe the nine basic elements in an audit report with an unmodified opinion.

2. Explain why the inclusion of an emphasis of matter paragraph and on other matters paragraph do not affect the auditor's opinion. What are the instances that an auditor may include of matter paragraph and on other matters paragraph in the audit report?

3. What are the circumstances that an auditor should modify its opinion in the auditor's report?

4. What are the three types of audit reports with modified opinions and when are these reports used?

5. How does the materiality of a condition that might lead to a departure from the applicable financial reporting framework affect the auditor's choice of financial statement audit reports?

6. Give examples of a client-imposed and a condition imposed scope limitation. Why a client-imposed limitation is generally considered more serious?

7. Describe the form and content of the auditor's report when the opinion is modified.

8. What are the types of comparative financial information? Differentiate one from the other.

9. What are the auditor's responsibilities for other information included in an entity's annual report?

10. If the auditor determines that other information contained with the audited financial statements is incorrect and the client refuses to correct the other information, what actions can the auditor take?

MULTIPLE CHOICE QUESTIONS

1. In which of the following circumstances would an auditor's report least likely include specific reference to the corresponding figures?
   a. When the auditor's report on the prior period financial statements containing a material misstatement included an unmodified opinion and the prior period financial statements have not been revised and reissued, and the corresponding figures have not been properly restated and/or appropriate disclosures have not been made.
   b. When the auditor's report on the prior period, as previously issued, included a modified opinion and the matter which gave rise to the modification is resolved and properly dealt with in the financial statements.
   c. When the auditor's report on the prior period, as previously issued, included a modified opinion and the matter which gave rise to the modification in unresolved, and results in a modification of the auditor's report regarding the current period figures.

d. When the auditor's report on the prior period, as previously issued, included a modified opinion and the matter which gave rise to the modification is unresolved but does not result in a modification of the auditor's report regarding the current period figures.

2. To distinguish it from reports that might be issued by others, such as by officers of the entity, the board of directors, or form the reports of other auditors who may not have to abide by the same ethical requirements as the independent auditor, the auditor's report should have an appropriate
   a. Addressee.
   b. Opinion.
   c. Signature.
   d. Title.

3. Which of the following is included in the introductory or opening paragraph of the auditor's report?
   a. A statement that the audit was conducted in accordance with Philippine Standards on Auditing.
   b. A statement that the financial statements are the responsibility of the entity's management.
   c. A statement that the responsibility of the auditor is to express an opinion on the financial statements based on the audit.
   d. Identification of the financial statements audited, including the date of and period covered by the financial statements.

4. An auditor's responsibility to express an opinion on the financial statements is
   a. Explicitly represented in the "Auditor's Responsibility" paragraph of the auditor's report.
   b. Explicitly represented in the "Management's Responsibility" paragraph of the auditor's report.
   c. Explicitly represented in the opinion paragraph of the auditor's report.
   d. Implicitly represented in the auditor's report.

5. Which of the following statements is a basic element of the auditor's report?
   a. An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements.
   b. The auditor is responsible for the preparation and fair presentation of the financial statements.
   c. The disclosures provide reasonable assurance that the financial statements are free of material misstatement.
   d. The financial statements are consistent with those of the prior period.

6. An independent auditor discovers that a payroll supervisor of the company being audited has misappropriated ₱ 50,000. The company's total assets and income before tax are P 70 million and ₱ 15 million, respectively. Assuming no other issues affect the report, the auditor's report will most likely contain a/an
   a. Adverse opinion.
   b. Disclaimer of opinion.
   c. Scope qualification.
   d. Unqualified opinion.

7. Which paragraphs of an auditor's report on financial statements should refer to Philippine Financial Reporting Standards?
   a. Management's Responsibility and Opinion.
   b. Introductory and Opinion.
   c. Introductory and Auditor's Responsibility.
   d. Auditor's Responsibility and Management's Responsibility.

8. The following statements relate to the date of the auditor's report. Which is false?
   a. The date of the auditor's report should not be later than the date on which the financial statements are signed or approved by management.
   b. The date of the auditor's report should not be earlier than the date on which the financial statements are signed or approved by management.
   c. The date of the auditor's report should always be later than the date of the financial statements (i.e., the balance sheet date).
   d. The auditor should date the report as of the completion date of the audit.

9. In which of the following circumstances would an auditor most likely add an emphasis of matter paragraph to the auditor's report while expressing an unqualified opinion.
   a. Certain transactions cannot be tested because of management's record retention policy.
   b. Management's estimates of the effects of future events are unreasonable.
   c. No depreciation has been provided in the financial statements.
   d. There is a substantial doubt about the entity's ability to continue as a going concern.

10. In which of the following situations would an auditor ordinarily choose between expressing a qualified opinion or an adverse opinion?
   a. Events disclosed in the financial statements cause the auditor to have substantial doubt about the entity's ability to continue as a going concern.
   b. The auditor did not observe the entity's physical inventory and is unable to become satisfied as to its balance by other auditing procedures.
   c. The auditor wishes to emphasize an unusually important subsequent event.
   d. The financial statements fail to disclose information that is required by Philippine Financial Reporting Standards.

11. Which of the following phrases would an auditor most likely include in the auditor's report when expressing a qualified opinion because of inadequate disclosure?
   a. With the foregoing explanation of these omitted procedures.
   b. Subject to the departure from generally accepted accounting principles, as described above.
   c. Expect for the omission of the information included in the preceding paragraph.
   d. Do not present fairly in all material respects.

12. An auditor decides to express a qualified opinion on an entity's financial statements because a major inadequacy in its computerized accounting records prevents the auditor from applying necessary procedures. The opinion paragraph of the auditor's report should state that the qualification pertains to
   a. The possible effects on the financial statements.
   b. Inadequate disclosure of necessary information.
   c. A departure from PFRS.
   d. A client-imposed scope limitation.

13. The auditor's report should be addressed
    a. Only to the shareholders of the entity whose financial statements are being audited.
    b. Only to the board of directors of the entity whose financial statements are being audited.
    c. Either to the shareholders or the board of directors, or both, of the entity whose financial statements are being audited.
    d. Either to the shareholders or the board of directors of the entity whose financial statements are being audited.

14. An entity's management is responsible for the preparation and fair presentation of the financial statements. Its responsibility includes the following except
    a. Assessing the risks of material misstatements of the financial statements.
    b. Designing, implementing, and maintaining internal control relevant to the preparation and presentation of financial statements.
    c. Making accounting estimates that are reasonable in the circumstances.
    d. Selecting and applying appropriate accounting policies.

15. The existence of audit risk is recognized by the statement in the auditor's report that the auditor
    a. Realizes some matters, either individually or in the aggregate, are important while others are not important.
    b. Obtains reasonable assurance about whether the financial statements are free of material misstatement.
    c. Is responsible for expressing an opinion on the financial statements, which are the responsibility of management.
    d. Assesses the accounting principles used and also evaluates the overall financial statements presentation.

16. A client makes test counts on the basis of a statistical plan. The auditor observes such counts as are deemed necessary and is able to become satisfied as to the reliability of the client's procedures. In reporting on the results of the audit, the auditor
    a. Must qualify the opinion if the inventories are material.
    b. Must comment in an emphasis of matter paragraph as to the inability to observe year-end inventories.
    c. Is required to disclaim an opinion if the inventories were material.
    d. Can express an unqualified opinion.

17. A note to the financial statements of the Vergel Bank indicates that all of the records relating to the bank's business operations are stored on a magnetic disks, and that no emergency backup systems or duplicate disks are stored because the bank and its auditors consider the occurrence of a catastrophe to be remote. Based upon this note, the auditor's report should express
    a. An unqualified opinion.
    b. An adverse opinion.
    c. A qualified opinion.
    d. A "subject to" opinion.

18. The date of the CPA's opinion on the financial statements of his or her client should be the date of the
    a. Closing of the client's books.
    b. Completion of all important audit procedures.

c. Receipt of the client's letter of representation.
d. Submission of the report to the client.

19. The auditor may express an unqualified opinion with an emphasis of matter paragraph under all of the following circumstances except
    a. For uncertainty accounted for in conformity with generally accepted accounting principles.
    b. An opinion based in part on the report of another auditor.
    c. A substantial doubt about an entity's going concern status accounted for in conformity with generally accepted accounting principles.
    d. A scope limitation resulting from the client's refusal to permit confirmation of receivables.

20. An emphasis of matter paragraph of an auditor's report describes an uncertainty as follows: *"Without our opinion, we draw attention to Note 7 to the financial statements. The Company is the defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counter action and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot be determined, and no provision for any liability that may result has been made in the financial statements."*
    What type of opinion should the auditor express under these circumstances?
    a. "Except for" qualified.
    b. "Subject to" qualified.
    c. Disclaimer.
    d. Unqualified.

21. In which of the following circumstances would an auditor usually choose between expressing a qualified opinion and disclaiming an opinion?
    a. Departure from generally accepted accounting principles.
    b. Inability to obtain sufficient appropriate audit evidence.
    c. Inadequate disclosure of accounting policies.
    d. Unreasonable justification for a change in accounting principles.

22. An auditor's report includes the following statement: "In our opinion, because of the effects of the matters discussed in the preceding paragraph, the financial statements do not present fairly, in all material respects, the financial position of de Dios Inc. as of December 31, 2019, and of its financial performance and its cash flows for the year then ended in accordance with Philippine Financial Reporting Standards." This auditor's report contains a(an)
    b. Following the introductory paragraph.
    a. Following the opinion paragraph.
    c. Preceding the opinion paragraph.
    d. Within the notes to the financial statements.

23. When a publicly held company refuses to include in its audited financial statements any of the segment information that the auditor believes is required, the auditor should express a(an)
    a. Adverse opinion because of a significant uncertainty.
    b. Disclaimer of opinion because of the significant scope limitation.
    c. Qualified opinion because of inadequate disclosure.
    d. Unqualified opinion with an emphasis of matter paragraph emphasizing the matter.

24. Marquez, CPA, was engaged to audit the financial statements of Joey Corp. after its fiscal year has ended. The timing of Marquez's appointment as auditor and the start of fieldwork made confirmation of accounts receivable by direct communication with the debtor ineffective. However, Marquez applied other procedures and was satisfied as to the reasonableness of the account balances. Marquez's auditor's report most likely contained a(an)
    a. Qualified opinion because of a departure from GAAS.
    b. Qualified opinion because of a scope limitation.
    c. Unqualified opinion with an emphasis of matter paragraph.
    d. Unqualified opinion.

25. When an auditor expresses an adverse opinion, the opinion paragraph should include
    a. A description of the uncertainty or scope limitation that prevents an unqualified opinion.
    b. A direct reference to a separate paragraph disclosing the basis for the opinion.
    c. The principal effects of the departure from GAAP.
    d. The substantive reasons for the financial statements being misleading.

26. There are two broad financial reporting frameworks for comparatives: the corresponding figures and the comparative financial statements. Which of the following statements is correct concerning these reporting frameworks?
    a. Under the comparative financial statements framework, the amounts and other disclosures for the prior period(s) form part of the current period financial statements.
    b. Under the comparative financial statements framework, the comparative financial statements for the prior period(s) are intended to be read in conjunction with the amounts and other disclosures relating to the current period.
    c. Under the corresponding figures framework, the corresponding figures for the prior period(s) are integral part of the current period financial statements.
    d. Under the corresponding figures framework, the corresponding figures for the prior period(s) are considered separate financial statements.

27. A client is presenting comparative (two-year) financial statements. Which of the following is correct concerning reporting responsibilities of a continuing auditor?
    a. The auditor may issue one audit report on both presented years, or two audit reports, one on each year.
    b. The auditor should issue one audit report that is both on presented years.
    c. The auditor should issue one audit report, but only on the most recent year.
    d. The auditor should issue two audit reports, one on each year.

28. When comparative financial statements are presented, the auditor's opinion on the financial statements "taken as a whole" should be considered to apply to the financial statements of the
    a. Periods presented plus one preceding period.
    b. Current period only.
    c. Current period and those of the other periods presented.
    d. Current and immediately preceding period only.

29. Comparative financial statements include the financial statements of the prior year that were audited by the predecessor auditor whose report is not presented. If the predecessor's report was qualified, the incoming auditor should
    a. Request the client to reissue the predecessor's report on the prior year's statements.
    b. Issue an updated comparative audit report indicating the division of responsibility.

c. Indicate the substantive reasons for the qualification on the predecessor auditor's opinion.
d. Express an opinion only on the current year's statements and make no reference to the prior year's statements.

30. The predecessor auditor, who is satisfied after properly communicating with the incoming auditor, has reissued his/her auditor's report on prior year financial statements. The predecessor auditor's report should
    a. Not refer to the report or the work of the incoming auditor.
    b. Refer to both the work and the report of the incoming auditor only in the opinion paragraph.
    c. Refer to the report of the incoming auditor only in the scope paragraph.
    d. Refer to the work of the incoming auditor in the scope and opinion paragraphs.

31. When audited financial statements are presented in a documents (e.g., annual report) containing other information, the auditor
    a. Has an obligation to perform auditing procedures to corroborate the other information.
    b. Has no responsibility for other information because it is not part of the basic financial statements.
    c. Is required to express a qualified opinion if the other information has a material misstatement of fact.
    d. Should read the other information to consider whether it is inconsistent with the audited financial statements.

32. PSA 720 states, "If, on reading the other information, the auditor identifies a material inconstancy, the auditor should determine whether the audited financial statements or other information needs to be amended." What type of opinion should be expressed if the client refuses to make the necessary amendment in the financial statements?
    a. Disclaimer of opinion.
    b. Qualified opinion or disclaimer of opinion.
    c. Qualified or adverse opinion.
    d. Unqualified opinion with an emphasis of matter paragraph describing the material inconsistency.

33. A CPA will issue an adverse auditor's opinion if
    a. He or she did not perform sufficient auditing procedures to form an opinion on the financial statements taken as a whole.
    b. His or her exception to the fairness of presentation is so material that an "except for" opinion is not justified.
    c. Major uncertainties exist concerning the company's future.
    d. The scope of his or her audit is limited by the client.

34. In which of the following circumstances would an auditor be most likely to express an adverse opinion?
    a. Information comes to the auditor's attention that raises substantial doubt about the entity's ability to continue as a going concern.
    b. Tests of controls show that the entity's internal control is so poor that it cannot be relied upon.
    c. The chief executive officer refuses the auditor access to minutes of board of directors' meetings.

d. The financial statements are not in conformity with the Philippine Accounting Standards (PAS) on capitalization of leases.

35. Under which of the following circumstances would a disclaimer of opinion not be appropriate?
   a. The auditor is engaged after fiscal year end and is unable to observe the physical inventories or apply alternative procedures to verify their balances.
   b. The auditor is unable to determine the amounts associated with fraud committed by client's management.
   c. The client refuses to permit its attorney to furnish information requested in a letter of audit inquiry.
   d. The financial statements fail to contain adequate disclosure concerning related party transactions.

36. Which statement is incorrect regarding corresponding figures?
   a. The auditor's report refers only to the financial statements of the current period.
   b. The auditor's report refers to each period that financial statements are presented.
   c. The corresponding figures are not presented as complete financial statements capable of standing alone.
   d. The level of detail presented in the corresponding amounts and disclosures is dictated primarily by its relevance to the current period figures.

37. Comparative financial statements include the prior year's statements that were audited by a predecessor auditor whose report is not presented. If the predecessor's report was unqualified, the incoming auditor should
   a. Express an opinion on the current year's statements alone and make no reference to the prior year's statements.
   b. Indicate in the auditor's report that the predecessor auditor expressed an unqualified opinion.
   c. Obtain a letter of representations from the predecessor auditor concerning any matters that may affect the incoming auditor's opinion.
   d. Request the predecessor auditor to reissue the prior year's report.

38. An auditor expressed a qualified opinion on the prior year's financial statements because of a lack of adequate disclosure. These financial statements are properly restated in the current year and presented in comparative form with the current year's financial statements. The auditor's updated report on the prior year's financial statements should
   a. Be accompanied by the auditor's original report on the prior year's financial statements.
   b. Continue to express a qualified opinion on the prior year's financial statements.
   c. Express an unqualified opinion on the restated financial statements of the prior year.
   d. Make no reference to the type of opinion expressed on the prior year's financial statements.

39. The following statements relate to unaudited prior year financial statements that are presented in comparative form with audited current year financial statements. Which is incorrect?
   a. Clear disclosure in the financial statements that the comparative financial statements are unaudited is encouraged.
   b. In situations where the incoming auditor identifies that the prior year unaudited figures are materially misstated, the auditor should request management to revise the

prior year's figures or if management refuses to do so, appropriately modify the report.

c. The incoming auditor need not perform audit procedures regarding opening balances of the current period.

d. The incoming auditor should state in the auditor's report that the comparative financial statements are unaudited.

40. An auditor concludes that there is a material inconsistency in the other information in an annual report to shareholders containing audited financial statements. If the auditor concludes that the financial statements do not require revision, but the client refuses to revise or eliminate the material inconsistency, the auditor may

a. Consider the matter closed because the other information is not in the audited statements.

b. Disclaim an opinion on the financial statements after explaining the material inconsistency in an emphasis of matter paragraph.

c. Express a qualified opinion after discussing the matter with the client's directors.

d. Revise the auditor's report to include an emphasis of matter paragraph describing the material inconsistency.

41. Comparative information where amounts and other disclosures for the prior period are included as an integral part of the current period financial statements, and are intended to be read only in relation to the amounts and other disclosures relating to the current period (referred to as "current period figures").

a. Consolidated amount.

b. Comparative figures.

c. Corresponding figures.

d. Comparative statements.

42. In PSA 700 (Redrafted), "financial statements" means what?

a. "a complete set of general purpose financial statements, including the related notes." The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information.

b. "a complete set of specific purpose financial statements, excluding the related notes." The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information.

c. "a complete set of general purpose financial statements, excluding the related notes." The related notes ordinarily comprise a summary of significant accounting policies and other explanatory information.

d. "a complete set of general purpose financial statements, including the related notes." The related notes ordinarily comprise a summary of significant accounting policies only.

43. A paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

a. Additional paragraph.

b. Emphasis of Matter paragraph.

c. Other Matter paragraph.
d. Key audit matters.

44. Those matters that, in the auditor's professional judgment, were of most significance in the audit of the financial statements of the current period are called
a. Additional paragraph.
b. Emphasis of Matter paragraph.
c. Other Matter paragraph.
d. Key audit matters.

45. The following are circumstances where the auditor may consider it necessary to include an emphasis of matter paragraph except
a. Early application (where permitted) of a new accounting standard that has a material effect on the financial statements.
b. A major catastrophe that has had, or continues to have, a significant effect on the entity's financial position.
c. An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
d. Where the auditor is unable to withdraw from an engagement even though the possible effect of an inability to obtain sufficient appropriate audit evidence due to a limitation on the scope of the audit imposed by management is pervasive.

COMPREHENSIVE CASES

Case 1 – Audit Reports with Modifications to the Auditor's Opinion

You are the audit manager in JonArc & Co. One of your new clients this year is Galartha Co, a company having net assets of ₱ 15 million. The audit work has been completed, but there is one outstanding matter you are currently investigating; the directors have decided not to provide depreciation on buildings in the financial statements, although Philippine Accounting Standards suggest that depreciation should be provided.

Required:

1. State the additional audit procedures and actions you should now take in respect of the above matter.

Unfortunately, you have been unable to resolve the matter regarding depreciation of buildings; the directors insist on not providing depreciation. You have therefore drafted the following extracts for your proposed audit report.

a. 'We conducted our audit in accordance with Philippine Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement (remaining words are the same as a normal unmodified report).

b. As discussed in Note 15 to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, is not in accordance with Philippine Accounting Standards.

c. The charge for the year ended 30 September 2021 should be P 420,000 based on the straight line method of depreciation using an annual rate of 5% for the buildings.

d. Accordingly, the non-current assets should be reduced by accumulated depreciation of P 1,200,000 and the profit for the year and accumulated reserve should be decreased by P 420,000 and P 1,200,000, respectively.

e. In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements give a true and fair view... (remaining words are the same as for an unmodified opinion paragraph).'

The extracts have been numbered to help you refer to them in your answer.

Required:

2. Explain the meaning and purpose of each of the above extracts in your draft audit report.

3. State the effect on your audit report of the following alternative situations:

   a. Depreciation had not been provided on any non-current asset for a number of years, the effect of which if corrected would be to turn an accumulated profit into a significant accumulated loss.

   b. JonArc & Co were appointed auditors after the end of the financial year of Galartha Co. Consequently, the auditors could not attend the year-end inventory count. Inventory is material to the financial statements.

CASE 2 – Analyzing Audit Report

The auditors' report below was drafted by Moore, a staff accountant of Tyler & Tyler, CPAs, at the completion of the audit of the financial statements of Park Publishing Co., Inc., for the year ended September 30, 2021. The report was submitted to the engagement partner who reviewed the audit working papers and properly concluded that an unqualified opinion should be issued. In drafting the report, Moore considered the following:

a. During fiscal year 2021, Park changed its depreciation method. The engagement partner concurred with this change in accounting principle and its justification and Moore included an explanatory paragraph in the auditors' report.

b. The 2021 financial statements are affected by an uncertainty concerning a lawsuit, the outcome of which cannot presently be estimated. Moore has included an explanatory paragraph in the auditors' report.

c. The financial statements for the year ended September 30, 2021, are to be presented for comparative purposes. Tyler & Tyler previously audited these statements and expressed an unqualified opinion.

Independent Auditors' Report

To the Board of Directors of Park Publishing Co., Inc.:

We have audited the accompanying balance sheets of Park Publishing Co., Inc. as of September 30, 2021, and 2020, and the related statements of income and cash flows for the years then ended. These financial statements are the responsibility of the company's management.

We conducted our audits in accordance with Philippines' generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are fairly presented. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a basis for determining whether any material modifications should be made to the accompanying financial statements.

As discussed in Note 7 to the financial statements, the company changed its method of computing depreciation in fiscal 2021.

In our opinion, except for the accounting change, with which we concur, the financial statements referred to above present fairly, in all material respects, the financial position of Park Publishing Co., Inc. as of September 30, 2021, and the results of its operations and its cash flows for the year then ended in conformity with Philippines' generally accepted accounting principles.

As discussed in Note 8 to the financial statements, the company is a defendant in a lawsuit alleging infringement of certain copyrights. The company has filed a counteraction, and preliminary hearings on both actions are in progress. Accordingly, any provision for liability is subject to adjudication of this matter.

Tyler & Tyler, CPAs

November 5, 2021

Required:

1. Identify the deficiencies in the auditors' report as drafted by Moore. Group the deficiencies by paragraph and in the order in which the deficiencies appear. Do not redraft the report.

Chapter 16
OTHER SERVICES AND REPORTS

LEARNING OBJECTIVES

Upon completion of this chapter you will

1. **Identify the types of special reports that auditors issue.**
2. **Understand the procedures and reports on special purpose audit engagements.**
3. **Learn the process involved in the examination of prospective financial information.**
4. **Learn the auditor's responsibilities and approach on engagements involving review of financial statements.**
5. **Understand the responsibilities and approach in performing agreed-upon procedures regarding financial information.**
6. **Understand and perform engagements involving compilation of financial statements.**

Chapters 1 through 15 have focused on the process of auditing financial statements that are prepared in accordance with the Philippine Financial Reporting Standards. The financial statement audit is the cornerstone of a variety of services offered by CPAs, as well as the reason for the existence of the regulatory agencies associated with granting CPA licenses. Based largely on the skills, experience, and reputation CPAs have acquired as auditors, their clients, regulatory agencies, and others have increasingly turned to the public accounting profession for a widening range of other types of audit and non-audit services. The Auditing and Assurance Standards Council has responded by developing and adopting standards for these services to promote uniformity in quality of practice and to enhance users' understanding of the differences in the types of services rendered and the levels of assurance associated with them.

In this chapter, we explore the expansion in scope of CPA services in terms of the types of financial and nonfinancial information that CPAs provide assurance on and the variety of levels of assurance that CPAs provide on that information. First, we consider special reports and other engagements covered by Philippine Standards on Auditing. Next, we consider the services covered by the Philippine Standards on Assurance Engagements i.e., examination of prospective financial information and engagements to review financial statements. Finally, we also explore the types of engagements available under the Philippine Standards on Related Services, namely, engagements on agreed-upon procedures and engagements to compile financial information.

AUDITOR'S REPORT ON SPECIAL PURPOSE AUDIT ENGAGEMENTS

Special reports are reports resulting from the audit of, or application of agreed-upon procedures to, historical financial data other than financial statements prepared in conformity with PFRS. PAS 800, *The Auditor's Report on Special Purpose Audit Engagements*, indicates that the term special reports apply to auditors' reports on the following:

1. Financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles in the Philippines.

2. Specified accounts, elements of accounts, or items in a financial statement (also known as reports on a component of financial statements).

3. Compliance with contractual agreements.

4. Summarized financial statements.

General Considerations

Before undertaking a special purpose audit engagement, the auditor should ensure that there is an agreement with the client as to the exact nature of the engagement and the form and content of the report to be issued. In planning the audit work, the auditor will need a clear understanding of the purpose for which the information being reported on is to be used, and who is likely to use it. To avoid the possibility of the auditor's report being used for purposes for which it was not intended, the auditor may wish to indicate in the report the purpose for which the report is prepared and any restrictions on its distribution and use.

The auditor's report on a special purpose audit engagement, except for a report on summarized financial statements, should include the following basic elements:

1. A title;

2. The addressee;

3. An opening or introductory paragraph:

   - Identification of the financial information audited; and
   - A statement of the responsibility of the entity's management and the responsibility of the auditor.

4. A scope paragraph (describing the nature of an audit):

   - The reference to the Philippine Standards on Auditing applicable to special purpose audit engagements; and
   - A description of the work the auditor performed.

5. An opinion paragraph containing an expression of opinion on the financial information;

6. The auditor's signature;

7. The date of the report; and

8. The auditor's address.

In issuing an auditor's report, it may be appropriate for the auditor to use the term "Independent Auditor" in the title to distinguish the auditor's report from reports that might be issued by others, such as officers of the entity, or from the reports of other auditors who may not have to abide by the same ethical requirements as the independent auditor when adoption of another reasonable interpretation would have produced a material difference in the financial information.

When requested to issue an auditor's report on financial information to be supplied by an entity to government authorities, trustees, insurers and other entities in a prescribed format which does not conform to the requirements of the applicable auditing standards, the auditor should consider the substance and wording of the prescribed report and, when necessary, should make appropriate changes to conform to the requirements of such auditing standards, either by rewording the form or by attaching a separate report.

When the information on which the auditor has been requested to report is based on the provisions of an agreement, the auditor needs to consider whether any significant interpretations of the agreement have been made by management in preparing the information. The auditor should consider whether any significant interpretations of an agreement on which the financial information is based are clearly disclosed in the financial information. The auditor may wish to make reference in the auditor's report on the special purpose audit engagement to the note within the financial information that describes such interpretations.

Reports on Financial Statements Prepared In Accordance With Other Comprehensive Basis of Accounting

A comprehensive basis of accounting comprises a set of criteria used in preparing financial statements which applies to all material items and which has substantial support. A sometimes used type of special report is employed when an entity has prepared its financial statements on a comprehensive basis other than a financial reporting framework designed to meet the common information needs of a wide range of users. Other comprehensive basis of accounting (OCBOA) is a financial reporting framework designed to meet the needs of specific users. Auditing standards (i.e., PSA 800) define OCBOA financial statements as including those prepared under the following bases:

1. Tax basis. The tax basis of accounting for a set of financial statements that accompany an entity's tax return.

2. Cash basis. The cash receipts and disbursements basis of accounting for cash flow information that a business enterprise may be requested to prepare by creditors.

3. Regulatory basis. The financial reporting provisions of a government regulatory agency for a set of financial statements prepared for regulatory purposes.

The auditor's report on financial statements prepared in accordance with an OCBOA should include a statement that indicates the basis of accounting used or should refer to the note to the financial statements giving that information. The auditor should consider whether the title of, or a note to, the financial statements makes it clear to the reader that such statements are not prepared in accordance with the Philippine Financial Reporting Standards or other financial reporting framework designed to meet the common information needs of a wide range of users. For example, a tax basis financial statement might be entitled "Statement of Income and Expenses - Income Tax Basis." If the financial statements prepared on other comprehensive basis of accounting are not suitably titled or the basis of accounting is not adequately disclosed, the auditor should issue an appropriately modified report.

The opinion paragraph should state whether the financial statements are prepared, in all material respects, in accordance with the identified basis of accounting. The term used to express the auditor's opinion is "present fairly, in all material respects."

Exhibit 16.1 is an example of auditor's reports on financial statements prepared in accordance with other comprehensive basis of accounting.

EXHIBIT 16.1 — **Sample Reports on Financial Statements Prepared in Accordance with Other Comprehensive Basis of Accounting - Statement of Cash Receipts and Disbursement**

REPORT OF INDEPENDENT AUDITOR

We have audited the accompanying statement of ABC Company's cash receipts and disbursements for the year ended December 31, 20X1. This statement is the responsibility of ABC Company's management. Our responsibility is to express an opinion on the accompanying statement based on our audit.

We conducted our audit in accordance with generally accepted auditing standards in the Philippines. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statement is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statement. An audit also includes assessing the accounting principles used and significant estimates made by management as well as evaluating the overall statement presentation. We believe that our audit provides a reasonable basis for our opinion.

The Company's policy is to prepare the accompanying statement on the cash receipts and disbursements basis. On this basis, revenue is recognized when received rather than when earned, and expenses are recognized when paid rather than when incurred.

In our opinion, the accompanying statement presents fairly, in all material respects, the revenue collected and expenses paid by the Company during the year ended December 31, 20X1 in accordance with the cash receipts and disbursements basis as described in Note 5.

AUDITOR

Date
Address

Reports on a Component of Financial Statements

An auditor may be requested to express an opinion on one or more components of financial statements. Components include a single financial statement, specified elements, accounts or items of financial statements, for example the balance sheet, accounts receivable, inventory, an employee's bonus calculation or a provision for income taxes. The component may be prepared to meet the financial information needs of specific users and have limited distribution, or may be intended to meet the information needs of a wide range of users. Thus, the basis of accounting for the component may be a financial reporting framework such as Philippine Financial Reporting Standards, an OCBOA such as the cash basis of accounting.

An engagement to express an opinion on one or more components of a financial statement may be undertaken as a separate engagement or in conjunction with an audit of the entity's financial statements. However, this type of engagement does not result in a report on the financial statements taken as a whole and, accordingly, the auditor should express an opinion only as to whether the component audited is prepared, in all material respects, in accordance with the identified basis of accounting.

Generally, an auditor's examination of a component of financial statements is more extensive than if the same component were to be audited in connection with a report on the entire financial statements. Materiality needs to be set in relation to the component of financial statements being reported upon and the auditor should consider how the component relates to other financial

statement items. For example, if the auditor is engaged to audit the entity's accounts receivable, other accounts such as sales and allowance for bad debts should also be considered.

The auditor's report on a component of financial statements should include a statement that indicates the applicable financial reporting framework or refer to an agreement that specifies the basis of accounting used. The opinion should state whether the component is prepared, in all material respects, in accordance with the applicable financial reporting framework or identified basis of accounting. When an adverse opinion or disclaimer of opinion on the entire financial statements has been expressed, the auditor should report on components of the financial statements only if those components are not so extensive as to constitute a major portion of the financial statements. To do otherwise may overshadow the report on the entire financial statements.

Exhibit 16.2 is an example of auditor's reports on components of financial statements.

EXHIBIT 16.2 **Sample Reports on Components of Financial Statements - Schedule of Accounts Receivable**

REPORT OF INDEPENDENT AUDITOR

We have audited the accompanying schedule of accounts receivable of ABC Company for the year ended December 31, 20X1. This schedule is the responsibility of ABC Company's management. Our responsibility is to express an opinion on the schedule based on our audit.

We conducted our audit in accordance with generally accepted auditing standards in the Philippines. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the schedule is free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the schedule. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the schedule. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the schedule of accounts receivable presents fairly, in all material respects, the accounts receivable of the Company as of December 31, 20X1 in accordance with generally accepted accounting principles in the Philippines.

AUDITOR

Date
Address

Reports on Compliance with Contractual Agreements Related To Audited Financial Statements

An auditor may be requested to report on an entity's compliance with certain aspects of contractual agreements related to financial statements. For example, bond indentures or loan agreements may require the entity to comply with a variety of covenants involving such matters as payments of interest, maintenance of predetermined financial ratios, restriction of dividend payments and the use of the proceeds of sales of property.

Engagements to express an opinion as to an entity's compliance with contractual agreements should be undertaken only when the overall aspects of compliance relate to accounting and financial matters within the scope of the auditor's professional competence. However, when there are particular matters forming part of the engagement that are outside the auditor's expertise, the auditor should consider using the work of an expert.

The auditor's report should state whether, in the auditor's opinion, the entity has complied with the particular provisions of the agreement. The auditor's report on compliance with contractual agreements related to audited financial statements may be given in a separate report or in one or more explanatory paragraphs following the opinion paragraph of the report on the audited financial statements.

Exhibit 16.3 is an example of auditor's reports on compliance given in a separate report.

EXHIBIT 16.3 **Sample Reports on Compliance - Separate Report**

REPORT OF INDEPENDENT AUDITOR

We have audited ABC Company's compliance with the accounting and financial reporting matters of Sections 28 to 35 inclusive of the Indenture dated May 15, 20X1 with DEF Bank.

We conducted our audit in accordance with generally accepted auditing Standards in the Philippines applicable to compliance auditing. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether ABC Company has complied with the relevant sections of the Indenture. An audit includes examining appropriate evidence on a test basis. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the Company was, in all material respects, in compliance with the accounting and financial reporting matters of the Sections of the Indenture referred to in the preceding paragraphs as of December 31, 20X1.

AUDITOR

Date
Address

Exhibit 16.4 is an example of auditor's reports on compliance given in a report accompanying financial statements.

EXHIBIT 16.4 **Sample Reports on Compliance - Report Accompanying Financial Statements**

REPORT OF INDEPENDENT AUDITOR

We have audited the accompanying balance sheet of the ABC Company as of December 31, 20X1, and the related statements of income, changes in equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit. We have also audited ABC Company's compliance with the accounting and financial reporting matters of Sections 28 to 35 inclusive of the Indenture dated May 15, 20X1 with DEF Bank.

We conducted our audits in accordance with generally accepted auditing standards in the Philippines applicable to the audit of financial statements and to compliance auditing. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and about whether ABC Company has complied with the relevant sections of the Indenture. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion:

a. The financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in accordance with ...; and

b. The Company was, in all material respects, in compliance with the accounting and financial reporting matters of the Sections of the Indenture referred to in the preceding paragraphs as of December 31, 20X1.

AUDITOR

Date
Address

Reports on Summarized Financial Statements

An entity may prepare financial statements summarizing its annual audited financial statements for the purpose of informing user groups interested only in the highlights of the entity's financial position and the results of its operations. Unless the auditor has expressed an audit opinion on the financial statements from which the summarized financial statements were derived, the auditor should not report on summarized financial statements.

Since summarized financial statements are presented in considerably less detail than annual audited financial statements, such financial statements need to clearly indicate the summarized nature of the information. The auditor should caution the reader that, for a better understanding of an entity's financial position and the results of its operations, summarized financial statements are to be read in conjunction with the entity's most recent audited financial statements which include all disclosures required by the relevant financial reporting framework.

Summarized financial statements need to be appropriately titled to identify the audited financial statements from which they have been derived, for example, "Summarized Financial Information Prepared from the Audited Financial Statements for the Year Ended December 31, 20X1." Summarized financial statements also do not contain all the information required by the Philippine Financial Reporting Standards. Consequently, wording such as "present fairly, in all material respects," is not used by the auditor when expressing an opinion on summarized financial statements.

The auditor's report on summarized financial statements should include the following basic elements ordinarily in the following layout:

1. A title;
2. The addressee;
3. An identification of the audited financial statements from which the summarized financial statements were derived;
4. A reference to the date of the audit report on the unabridged financial statements and the type of opinion given in that report;
5. An opinion as to whether the information in the summarized financial statements is consistent with the audited financial statements from which it was derived. When the auditor has issued a modified opinion on the unabridged financial statements yet is satisfied with the presentation of the summarized financial statements, the auditor's report should state that, although consistent with the unabridged financial statements, the summarized financial statements were derived from financial statements on which a modified auditor's report was issued;
6. A statement, or reference to the note within the summarized financial statements, which indicates that for a better understanding of an entity's financial performance and position and of the scope of the audit performed, the summarized financial statements should be

read in conjunction with the unabridged financial statements and the auditor's report thereon;

7. The auditor's signature;
8. The date of the report; and
9. The auditor's address.

Exhibit 16.5 is an example of auditor's reports on summarized financial statements when an unqualified opinion was expressed on the audited financial statements.

EXHIBIT 16.5	Sample Report on Summarized Financial Statements - When an Unqualified Opinion Was Expressed on the Audited Financial Statements

REPORT OF INDEPENDENT AUDITOR

We have audited the financial statements of ABC Company for the year ended December 31, 20X1, from which the summarized financial statements were derived, in accordance with generally accepted auditing standards in the Philippines. In our report dated March 10, 20X2 we expressed an unqualified opinion on the financial statements from which the summarized financial statements were derived.

In our opinion, the accompanying summarized financial statements are consistent, in all material respects, with the financial statements from which they were derived.

For a better understanding of the Company's financial position and the results of its operations for the period and of the scope of our audit, the summarized financial statements should be read in conjunction with the financial statements from which the summarized financial statements were derived and our audit report thereon.

AUDITOR

Date
Address

Exhibit 16.6 is an example of auditor's reports on summarized financial statements when qualified opinion was expressed on the audited financial statements.

EXHIBIT 16.6	Sample Report on Summarized Financial Statements - When Qualified Opinion Was Expressed on the Audited Financial Statements

REPORT OF INDEPENDENT AUDITOR

We have audited the financial statements of ABC Company for the year ended December 31, 20X1, from which the summarized financial statements were derived, in accordance with generally accepted auditing standards in the Philippines. In our report dated March 10, 20X2 we expressed an opinion that the financial statements from which the summarized financial statements were derived presented fairly, in all material respects, ... except that inventory had been overstated by ....

In our opinion, the accompanying summarized financial statements are consistent, in all material respects, with the financial statements from which they were derived and on which we expressed a qualified opinion.

For a better understanding of the Company's financial position and the results of its operations for the period and of the scope of our audit, the summarized financial statements should be read in conjunction with the financial statements from which the summarized financial statements were derived and our audit report thereon.

AUDITOR

Date
Address

ENGAGEMENTS TO EXAMINE PROSPECTIVE FINANCIAL INFORMATION

Prospective financial information can include financial statements or one or more elements of financial statements and may be prepared as an internal management tool (e.g., to assist in evaluating a possible capital investment) or for distribution to third parties (e.g., a prospectus to provide potential investors with information about future expectations, an annual report to provide information to shareholders, regulatory bodies and other interested parties, a document for the information of lenders). To enhance the credibility of the prospective financial information, an auditor may be asked to examine and report on such data. Accounting standards (i.e., PSAE 3400) defines **prospective financial information** as financial information based on assumptions about events that may occur in the future and possible actions by an entity and can be in the form of a forecast, a projection or a combination of both.

Types of Prospective Financial Information

PSAE 3400, *The Examination of Prospective Financial Information*, recognizes two types of prospective financial information as follows:

1. **Financial forecast.** Prospective financial statements that present, to the best of the responsible party's knowledge and belief, an entity's expected financial position, results of operations, and cash flows.
2. **Financial projection.** Prospective financial statements that present, to the best of the responsible party's knowledge and belief, given one or more hypothetical assumptions, an entity's expected financial position, results of operations, and cash flows.

A financial forecast and a financial projection differ in terms of assumptions in terms of assumptions and the expected course of action. A forecast is prepared on the basis of assumptions as to future events which management expects to take place and the actions management expects to take as of the date the information is prepared (best-estimate assumptions). In contrast, a projection is prepared on the basis of one or more hypothetical assumptions about future events and management actions which are not necessarily expected to take place. Such information illustrates the possible consequences as of the date the information is prepared if the events and actions were to occur (a "what-if" scenario). Both a forecast and a projection may be stated either as a single-point estimate or as a range. The two types of prospective financial information also differ as to use; a forecast is appropriate for general use, whereas a projection is for limited use by the entity alone or by the entity and third parties with whom the entity is negotiating directly.

Auditor's Assurance Regarding Prospective Financial Information

Prospective financial information relates to events and actions that have not yet occurred and may not occur. While evidence may be available to support the assumptions on which the prospective financial information is based, such evidence is itself generally future oriented and, therefore, speculative in nature, as distinct from the evidence ordinarily available in the audit of historical financial information. The auditor is, therefore, not in a position to express an opinion as to whether the results shown in the prospective financial information will be achieved.

Further, given the types of evidence available in assessing the assumptions on which the prospective financial information is based, it may be difficult for the auditor to obtain a level of satisfaction sufficient to provide a positive expression of opinion that the assumptions are free of material misstatement. Consequently, when reporting on the reasonableness of management's

assumptions the auditor provides only a moderate level of assurance. However, when in the auditor's judgment an appropriate level of satisfaction has been obtained, the auditor is not precluded from expressing positive assurance regarding the assumptions.

Acceptance of Engagement

Before accepting an engagement to examine prospective financial information, the auditor would consider, among other things:

1. The intended use of the information.
2. Whether the information will be for general or limited distribution.
3. The nature of the assumptions, that is, whether they are best-estimate or hypothetical assumptions.
4. The elements to be included in the information.
5. The period covered by the information.

The auditor should not accept, or withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use. The auditor and the client should also agree on the terms of the engagement. It is in the interests of both entity and auditor that the auditor sends an engagement letter to help in avoiding misunderstandings regarding the engagement. An engagement letter would address the matters enumerated above and set out management's responsibilities for the assumptions and for providing the auditor with all relevant information and source data used in developing the assumptions.

Knowledge of the Business

The auditor should obtain a sufficient level of knowledge of the business to be able to evaluate whether all significant assumptions required for the preparation of the prospective financial information have been identified. The auditor would also need to become familiar with the entity's process for preparing prospective financial information, for example, by considering the following:

1. The internal controls over the system used to prepare prospective financial information and the expertise and experience of those persons preparing the prospective financial information.
2. The nature of the documentation prepared by the entity supporting management's assumptions.
3. The extent to which statistical, mathematical and computer-assisted techniques are used.
4. The methods used to develop and apply assumptions.
5. The accuracy of prospective financial information prepared in prior periods and the reasons for significant variances.

The auditor should consider the extent to which reliance on the entity's historical financial information is justified. The auditor requires knowledge of the entity's historical financial information to assess whether the prospective financial information has been prepared on a basis consistent with the historical financial information and to provide a historical yardstick for

considering management's assumptions. The auditor will need to establish, for example, whether relevant historical information was audited or reviewed and whether acceptable accounting principles were used in its preparation.

If the audit or review report on prior period historical financial information was other than unmodified or if the entity is in a start-up phase, the auditor would consider the surrounding facts and the effect on the examination of the prospective financial information.

Period Covered

The auditor should consider the period of time covered by the prospective financial information. Since assumptions become more speculative as the length of the period covered increases, as that period lengthens, the ability of management to make best-estimate assumptions decreases. The period would not extend beyond the time for which management has a reasonable basis for the assumptions.

The following are some of the factors that are relevant to the auditor's consideration of the period of time covered by the prospective financial information:

1. Operating cycle, for example, in the case of a major construction project the time required to complete the project may dictate the period covered.

2. The degree of reliability of assumptions, for example, if the entity is introducing a new product the prospective period covered could be short and broken into small segments, such as weeks or months. Alternatively, if the entity's sole business owns a property under long-term lease, a relatively long prospective period might be reasonable.

3. The needs of users, for example, prospective financial information may be prepared in connection with an application for a loan for the period of time required to generate sufficient funds for repayment. Alternatively, the information may be prepared for investors in connection with the sale of debentures to illustrate the intended use of the proceeds in the subsequent period.

Examination Procedures

When determining the nature, timing and extent of examination procedures, the auditor's considerations should include the following:

1. The likelihood of material misstatement;
2. The knowledge obtained during any previous engagements;
3. Management's competence regarding the preparation of prospective financial information;
4. The extent to which the prospective financial information is affected by the management's judgment; and
5. The adequacy and reliability of the underlying data.

The auditor should assess the source and reliability of the evidence supporting management's best-estimate assumptions. Sufficient appropriate evidence supporting such assumptions would be obtained from internal and external sources including consideration of the assumptions in the light of historical information and an evaluation of whether they are based on plans that are within the entity's capacity.

The auditor should also consider whether, when hypothetical assumptions are used, all significant implications of such assumptions have been taken into consideration. For example, if sales are assumed to grow beyond the entity's current plant capacity, the prospective financial information will need to include the necessary investment in the additional plant capacity or the costs of alternative means of meeting the anticipated sales, such as subcontracting production. Although evidence supporting hypothetical assumptions need not be obtained, the auditor should need to be satisfied that they are consistent with the purpose of the prospective financial information and that there is no reason to believe they are clearly unrealistic.

The auditor will need to be satisfied that the prospective financial information is properly prepared from management's assumptions by, for example, making clerical checks such as recomputation and reviewing internal consistency, that is, the actions management intends to take are compatible with each other and there are no inconsistencies in the determination of the amounts that are based on common variables such as interest rates. The auditor should also focus on the extent to which those areas that are particularly sensitive to variation will have a material effect on the results shown in the prospective financial information. This will influence the extent to which the auditor will seek appropriate evidence. It will also influence the auditor's evaluation of the appropriateness and adequacy of disclosure. When any elapsed portion of the current period is included in the prospective financial information, the auditor should consider the extent to which procedures need to be applied to the historical information. Procedures will vary depending on the circumstances, for example, how much of the prospective period has elapsed.

Lastly, the auditor should obtain written representations from management regarding the intended use of the prospective financial information, the completeness of significant management assumptions and management's acceptance of its responsibility for the prospective financial information.

Presentation and Disclosure

When assessing the presentation and disclosure of the prospective financial information, in addition to the specific requirements of any relevant statutes, regulations or professional standards, the auditor will need to consider whether:

1. The presentation of prospective financial information is informative and not misleading;

2. The accounting policies are clearly disclosed in the notes to the prospective financial information;

3. The assumptions are adequately disclosed in the notes to the prospective financial information. It needs to be clear whether assumptions represent management's best-estimates or are hypothetical and, when assumptions are made in areas that are material and are subject to a high degree of uncertainty, this uncertainty and the resulting sensitivity of results needs to be adequately disclosed;

4. The date as of which the prospective financial information was prepared is disclosed. Management needs to confirm that the assumptions are appropriate as of this date, even though the underlying information may have been accumulated over a period of time;

5. The basis of establishing points in a range is clearly indicated and the range is not selected in a biased or misleading manner when results shown in the prospective financial information are expressed in terms of a range; and

6. Any change in accounting policy since the most recent historical financial statements is disclosed, along with the reason for the change and its effect on the prospective financial information.

Report on Examination of Prospective Financial Information

The report by an auditor on an examination of prospective financial information should contain the following:

1. A title;
2. The addressee;
3. An identification of the prospective financial information;
4. A reference to the Philippine Standard on Assurance Engagements applicable to the examination of prospective financial information;
5. A statement that management is responsible for the prospective financial information including the assumptions on which it is based;
6. When applicable, a reference to the purpose and/or restricted distribution of the prospective financial information;
7. A statement of negative assurance as to whether the assumptions provide a reasonable basis for the prospective financial information;
8. An opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with generally accepted accounting principles in the Philippines;
9. Appropriate caveats concerning the achievability of the results indicated by the prospective financial information;
10. The auditor's signature;
11. The date of the report which should be the date procedures have been completed; and
12. The auditor's address.

The auditor's report should also:

1. State whether, based on the examination of the evidence supporting the assumptions, anything has come to the auditor's attention which causes the auditor to believe that the assumptions do not provide a reasonable basis for the prospective financial information.
2. Express an opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the Philippine Financial Reporting Standards.

3. State that:

   - Actual results are likely to be different from the prospective financial information since anticipated events frequently do not occur as expected and the variation could be material. Likewise, when the prospective financial information is expressed as a range, it would be stated that there can be no assurance that actual results will fall within the range, and

   - In the case of a projection, the prospective financial information has been prepared for (state purpose), using a set of assumptions that include hypothetical assumptions about future events and management's actions that are not necessarily expected to occur. Consequently, readers are cautioned that the prospective financial information is not used for purposes other than that described.

Exhibit 16.7 is an example of an extract from an unmodified report on a forecast:

EXHIBIT 16.7 Extract of Sample Unmodified Report on a Forecast

We have examined the forecast in accordance with Philippine Standard on Assurance Engagements applicable to the examination of prospective financial information. Management is responsible for the forecast including the assumptions set out in Note 9 on which it is based.

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the forecast. Further, in our opinion the forecast is properly prepared on the basis of the assumptions and is presented in accordance with generally accepted accounting principles in the Philippines.

Actual results are likely to be different from the forecast since anticipated events frequently do not occur as expected and the variation may be material.

Exhibit 16.8 is an example of an extract from an unmodified report on a projection:

EXHIBIT 16.8 Extract of Sample Unmodified Report on a Projection

We have examined the projection in accordance with Philippine Standard on Assurance Engagements applicable to the examination of prospective financial information. Management is responsible for the projection including the assumptions set out in Note 9 on which it is based.

This projection has been prepared for ... (describe purpose). As the entity is in a start-up phase the projection has been prepared using a set of assumptions that include hypothetical assumptions about future events and management's actions that are not necessarily expected to occur. Consequently, readers are cautioned that this projection may not be appropriate for purposes other than that described above.

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the projection, assuming that ... (state or refer to the hypothetical assumptions). Further, in our opinion the projection is properly prepared on the basis of the assumptions and is presented in accordance with generally accepted accounting principles in the Philippines.

Even if the events anticipated under the hypothetical assumptions described above occur, actual results are still likely to be different from the projection since other anticipated events frequently do not occur as expected and the variation may be material.

When the auditor believes that the presentation and disclosure of the prospective financial information is not adequate, the auditor should express a qualified or adverse opinion in the report on the prospective financial information, or withdraw from the engagement as appropriate. An example would be where financial information fails to disclose adequately the consequences of any assumptions which are highly sensitive.

When the auditor believes that one or more significant assumptions do not provide a reasonable basis for the prospective financial information prepared on the basis of best-estimate assumptions or that one or more significant assumptions do not provide a reasonable basis for the prospective financial information given the hypothetical assumptions, the auditor should either express an adverse opinion in the report on the prospective financial information, or withdraw from the engagement.

When the examination is affected by conditions that preclude application of one or more procedures considered necessary in the circumstances, the auditor should either withdraw from the engagement or disclaim the opinion and describe the scope limitation in the report on the prospective financial information.

ENGAGEMENTS TO REVIEW FINANCIAL STATEMENTS

A **review of financial statements** consists of performing inquiry and analytical procedures that provide the auditor with a reasonable basis for expressing negative assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with the Philippine Financial Reporting Standards. Thus, on the basis of inquiry and analytical procedures, an accountant expresses negative assurance: more assurance than a compilation report, but less than an audit report.

Objective of a Review Engagement

The objective of a review of financial statements is to enable an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with the Philippine Financial Reporting Standards.

General Principles of a Review Engagement

In performing engagements to review financial statements, the auditor should comply with the "Code of Professional Ethics for Certified Public Accountants" promulgated by the Board of Accountancy. The ethical principles governing the auditor's professional responsibilities are the following: (a) independence, (b) integrity, (c) objectivity, (d) professional competence and due care, (e) confidentiality, (f) professional behavior, and (g) technical standards.

Scope of a Review

The term "scope of a review" refers to the review procedures deemed necessary in the circumstances to achieve the objective of the review. The procedures required to conduct a review of financial statements should be determined by the auditor having regard to the requirements of Philippine Standards on Review Engagements (PSRE) 2400, relevant professional bodies, legislation, regulation and, where appropriate, the terms of the review engagement and reporting requirements.

Terms of Engagement

The auditor and the client should agree on the terms of the engagement. The agreed terms would be recorded in an engagement letter or other suitable form such as a contract. An engagement letter will be of assistance in planning the review work and it is in the interests of both the auditor and the client that the auditor sends an engagement letter documenting the key terms of the appointment. An engagement letter confirms the auditor's acceptance of the appointment and helps avoid misunderstanding regarding such matters as the objectives and scope of the engagement, the extent of the auditor's responsibilities and the form of reports to be issued.

Matters that would be included in the engagement letter include the following:

1. The objective of the service being performed.
2. Management's responsibility for the financial statements.
3. The scope of the review, including reference to PSRE 2400.
4. Unrestricted access to whatever records, documentation and other information requested in connection with the review.
5. A sample of the report expected to be rendered.
6. The fact that the engagement cannot be relied upon to disclose errors, illegal acts or other irregularities, for example, fraud or defalcations that may exist.
7. A statement that an audit is not being performed and that an audit opinion will not be expressed. To emphasize this point and to avoid confusion, the auditor may also consider pointing out that a review engagement will not satisfy any statutory or third party requirements for an audit.

An example of an engagement letter for a review of financial statements appears in Exhibit 16.9.

EXHIBIT 16.9 **Sample Engagement Letter for a Review of Financial Statements**

Date

To the Board of Directors (or the appropriate representative of senior management):

This letter is to confirm our understanding of the terms and objectives of our engagement and the nature and limitations of the services we will provide.

We will perform the following services:

We will review the balance sheet of ABC Company as of December 31, 20X1, and the related statements of income, changes in equity and cash flows for the year then ended, in accordance with the Philippine Standard on Related Services applicable to reviews. We will not perform an audit of such financial statements and, accordingly, we will not express an audit opinion on them. Accordingly, we expect to report on the financial statements as follows:

(See Exhibit 16.10)

Responsibility for the financial statements, including adequate disclosure, is that of the management of the company. This includes the maintenance of adequate accounting records and internal controls and the selection and application of accounting policies. (As part of our

review process, we will request written representations from management concerning assertions made in connection with the review.)

This letter will be effective for future years unless it is terminated, amended or superseded (if applicable).

Our engagement cannot be relied upon to disclose whether fraud or errors, or illegal acts exist. However, we will inform you of any material matters that come to our attention.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our review of the financial statements.

XYZ & Co

Acknowledged on behalf of:

ABC Company by
(Signed)

.....
Name and Title
Date

Planning

The auditor should plan the work so that an effective engagement will be performed. Moreover, the auditor should plan and perform the review with an attitude of professional skepticism recognizing that circumstances may exist which cause the financial statements to be materially misstated.

In planning a review of financial statements, the auditor should obtain or update the knowledge of the business including consideration of the entity's organization, accounting systems, operating characteristics and the nature of its assets, liabilities, revenues and expenses.

The auditor needs to possess an understanding of such matters and other matters relevant to the financial statements, for example, knowledge of the entity's production and distribution methods, product lines, operating locations and related parties. The auditor requires this understanding to be able to make relevant inquiries and to design appropriate procedures, as well as to assess the responses and other information obtained.

Procedures and Evidence

The auditor should apply judgment in determining the specific nature, timing and extent of review procedures. The auditor will be guided by such matters as the following:

1. Any knowledge acquired by carrying out audits or reviews of the financial statements for prior periods.
2. The auditor's knowledge of the business including knowledge of the accounting principles and practices of the industry in which the entity operates.
3. The entity's accounting systems.
4. The extent to which a particular item is affected by management judgment.
5. The materiality of transactions and account balances.

The auditor should apply the same materiality considerations as would be applied if an audit opinion on the financial statements were being given. Although there is a greater risk that

misstatements will not be detected in a review than in an audit, the judgment as to what is material is made by reference to the information on which the auditor is reporting and the needs of those relying on that information, not to the level of assurance provided.

For the purpose of expressing negative assurance in the review report, the auditor should obtain sufficient appropriate evidence primarily through inquiry and analytical procedures to be able to draw conclusions. Procedures for the review of financial statements will ordinarily include the following:

1. Obtaining an understanding of the entity's business and the industry in which it operates.

2. Inquiries concerning the following:

   - The entity's accounting principles and practices.
   - The entity's procedures for recording, classifying and summarizing transactions, accumulating information for disclosure in the financial statements and preparing financial statements.
   - All material assertions in the financial statements.
   - Actions taken at meetings of shareholders, the board of directors, committees of the board of directors and other meetings that may affect the financial statements.

3. Analytical procedures designed to identify relationships and individual items that appear unusual. Such procedures would include the following:

   - Comparison of the financial statements with statements from prior periods.
   - Comparison of the financial statements with anticipated results and financial position.
   - Study of the relationships of the elements of the financial statements that would be expected to conform to a predictable pattern based on the entity's experience or industry norm.

4. Reading the financial statements to consider, on the basis of information coming to the auditor's attention, whether the financial statements appear to conform to the basis of accounting indicated.

5. Obtaining reports from other auditors, if any and if considered necessary, who have been engaged to audit or review the financial statements of components of the entity.

6. Inquiries of persons having responsibility for financial and accounting matters concerning, for example:

   - Whether all transactions have been recorded.
   - Whether the financial statements have been prepared in accordance with the basis of accounting indicated.
   - Changes in the entity's business activities and accounting principles and practices.
   - Matters as to which questions have arisen in the course of applying the foregoing procedures.
   - Obtaining written representations from management when considered appropriate.

The auditor should also inquire about events subsequent to the date of the financial statements that may require adjustment of or disclosure in the financial statements. However, the auditor does not have any responsibility to perform procedures to identify events occurring after the date of the review report.

If the auditor has reason to believe that the information subject to review may be materially misstated, the auditor should carry out additional or more extensive procedures as are necessary to be able to express negative assurance or to confirm that a modified report is required.

Conclusions and Reporting

A review engagement provides a moderate level of assurance that the information subject to review is free of material misstatement and is expressed in the form of negative assurance. The review report should contain a clear written expression of negative assurance. The auditor should review and assess the conclusions drawn from the evidence obtained as the basis for the expression of negative assurance.

Based on the work performed, the auditor should assess whether any information obtained during the review indicates that the financial statements are not presented fairly, in all material respects, in accordance with generally accepted accounting principles in the Philippines.

The report on a review of financial statements describes the scope of the engagement to enable the reader to understand the nature of the work performed and make it clear that an audit was not performed and, therefore, that an audit opinion is not expressed.

The report on a review of financial statements should contain the following basic elements, ordinarily in the following layout:

1. A title;
2. The addressee;
3. An opening or introductory paragraph including:
    - Identification of the financial statements on which the review has been performed; and
    - A statement of the responsibility of the entity's management and the responsibility of the auditor.
4. A scope paragraph, describing the nature of a review, including:
    - A reference to Philippine Standard on Related Services applicable to review engagements;
    - A statement that a review is limited primarily to inquiries and analytical procedures; and
    - A statement that an audit has not been performed, that the procedures undertaken provide less assurance than an audit and that an audit opinion is not expressed.

5. A statement of negative assurance;

6. The auditor's signature;

7. The date of the report; and

8. The auditor's address.

The review report should also:

1. State that nothing has come to the auditor's attention based on the review that causes the auditor to believe the financial statements are not presented fairly, in all material respects in accordance with the Philippine Financial Reporting Standards (negative assurance); or

2. If matters have come to the auditor's attention, describe those matters that impair a fair presentation, in all material respects in accordance with the Philippine Financial Reporting Standards, including, unless impracticable, a quantification of the possible effect(s) on the financial statements, and either:

   - Express a qualification of the negative assurance provided; or
   - When the effect of the matter is so material and pervasive to the financial statements that the auditor concludes that a qualification is not adequate to disclose the misleading or incomplete nature of the financial statements, give an adverse statement that the financial statements are not presented fairly, in all material respects in accordance with generally accepted accounting principles in the Philippines; or

3. If there has been a material scope limitation, describe the limitation and either:

   - Express a qualification of the negative assurance provided regarding the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed; or
   - When the possible effect of the limitation is so significant and pervasive that the auditor concludes that no level of assurance can be provided, do not provide any assurance.

The auditor should date the review report as of the date the review is completed, which includes performing procedures relating to events occurring up to the date of the report. However, since the auditor's responsibility is to report on the financial statements as prepared and presented by management, the auditor should not date the review report earlier than the date on which the financial statements were approved by management.

Exhibit 16.10 is an illustration of review report with an unqualified opinion.

EXHIBIT 16.10 **Sample Form of Unqualified Review Report**

REVIEW REPORT TO...

We have reviewed the accompanying balance sheet of ABC Company at December 31, 20X1, and the related statements of income, changes in equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the Philippine Standard on Review Engagements applicable to review engagements. This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provide less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

Based on our review, nothing has come to our attention that causes us to believe that the accompanying financial statements are not presented fairly, in all material respects in accordance with generally accepted accounting principles in the Philippines.

AUDITOR

Date
Address

Exhibit 16.11 is a sample form of qualified review report due to departure from the Philippine Financial Reporting Standards.

EXHIBIT 16.11 **Sample Form of Qualified Review Report - Qualification for a Departure from the Philippine Financial Reporting Standards**

REVIEW REPORT TO...

We have reviewed the accompanying balance sheet of ABC Company at December 31, 20X1, and the related statements of income, changes in equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the Philippine Standard on Review Engagements applicable to review engagements. This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provide less assurance than an audit. We have not performed an audit, and, accordingly, we do not express an audit opinion.

Management has informed us that inventory has been stated at its cost which is in excess of its net realizable value. Management's computation, which we have reviewed, shows that inventory, if valued at the lower of cost and net realizable value as required by generally accepted accounting principles in the Philippines, would have been decreased by ₱ xxxx, and net income and shareholders' equity would have been decreased by ₱ xxxx.

Based on our review, except for the effects of the overstatement of inventory described in the previous paragraph, nothing has come to our attention that causes us to believe that the accompanying financial statements are not presented fairly, in all material respects, in accordance with generally accepted accounting principles in the Philippines.

AUDITOR

Date
Address

Exhibit 16.12 is an illustration of review reports with adverse opinion due to departure from the Philippine Financial Reporting Standards.

EXHIBIT 16.12 **Sample Adverse Report for a Departure from the Philippine Financial Reporting Standards**

REVIEW REPORT TO...

We have reviewed the balance sheet of ABC Company at December 31, 20X1, and the related statements of income, changes in equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the Philippine Standard on Review Engagements applicable to review engagements. This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provide less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

As noted in footnote 7, these financial statements do not reflect the consolidation of the financial statements of subsidiary companies, the investment in which is accounted for on a cost basis. Under generally accepted accounting principles in the Philippines, the financial statements of the subsidiaries are required to be consolidated.

Based on our review, because of the pervasive effect on the financial statements of the matter discussed in the preceding paragraph, the accompanying financial statements are not presented fairly, in all material respects, in accordance with generally accepted accounting principles in the Philippines

AUDITOR

Date
Address

ENGAGEMENTS TO PERFORM AN AGREED-UPON PROCEDURES REGARDING FINANCIAL INFORMATION

An engagement to perform agreed-upon procedures may involve the auditor in performing certain procedures concerning individual items of financial data (for example, accounts payable, accounts receivable, purchases from related parties and sales and profits of a segment of an entity, etc.), a financial statement (for example, a balance sheet, etc.) or even a complete set of financial statements.

Objective of an Agreed-Upon Procedures Engagement

The objective of an agreed-upon procedures engagement is for the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings.

As the auditor simply provides a report of the factual findings of agreed-upon procedures, no assurance is expressed. Instead, users of the report assess for themselves the procedures and findings reported by the auditor and draw their own conclusions from the auditor's work.

Moreover, the report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results.

General Principles of an Agreed-Upon Procedures Engagement

Other than the independence principle (i.e., independence is not a requirement for an agreed-upon procedures engagements), which is essential to an assurance engagements, the auditor should comply with the "Code of Professional Ethics for Certified Public Accountants" promulgated by the Board of Accountancy. However, where the auditor is not independent, a statement to that effect would be made in the report of factual findings.

Defining the Terms of the Engagement

The auditor should ensure with representatives of the entity and, ordinarily, other specified parties who will receive copies of the report of factual findings, that there is a clear understanding regarding the agreed procedures and the conditions of the engagement. Matters to be agreed include the:

1. Nature of the engagement including the fact that the procedures performed will not constitute an audit or a review and that accordingly no assurance will be expressed.
2. Stated purpose for the engagement.
3. Identification of the financial information to which the agreed-upon procedures will be applied.
4. Nature, timing and extent of the specific procedures to be applied.
5. Anticipated form of the report of factual findings.
6. Limitations on distribution of the report of factual findings. When such limitation would be in conflict with the legal requirements, if any, the auditor would not accept the engagement.

In certain circumstances, for example, when the procedures have been agreed to between the regulator, industry representatives and representatives of the accounting profession, the auditor may not be able to discuss the procedures with all the parties who will receive the report. In such cases, the auditor may consider, for example, discussing the procedures to be applied with appropriate representatives of the parties involved, reviewing relevant correspondence from such parties or sending them a draft of the type of report that will be issued.

It is in the interests of both the client and the auditor that the auditor sends an engagement letter documenting the key terms of the appointment. An engagement letter confirms the auditor's acceptance of the appointment and helps avoid misunderstanding regarding such matters as the objectives and scope of the engagement, the extent of the auditor's responsibilities and the form of reports to be issued.

Matters that would be included in the engagement letter include:

1. A listing of the procedures to be performed as agreed upon between the parties.
2. A statement that the distribution of the report of factual findings would be restricted to the specified parties who have agreed to the procedures to be performed.

In addition, the auditor may consider attaching to the engagement letter a draft of the type of report of factual findings that will be issued.

An example of an engagement letter for an agreed-upon procedures engagement appears in Exhibit 16.13.

EXHIBIT 16.13 **Sample Engagement Letter for an Agreed-upon Procedures Engagements**

Date

To the Board of Directors or other appropriate representatives of the client who engaged the auditor.

This letter confirms our understanding of the terms and objectives of our engagement and the nature and limitations of the services that we will provide. Our engagement will be conducted in accordance with the Philippine Standard on Related Services applicable to agreed-upon procedures engagements and we will indicate so in our report.

We have agreed to perform the following procedures and report to you the factual findings resulting from our work:

(describe the nature, timing and extent of the procedures to be performed, including specific reference, where applicable, to the identity of documents and records to be read, individuals to be contacted and parties from whom confirmations will be obtained.)

The procedures that we will perform are solely to assist you in (state purpose). Our report is not to be used for any other purpose and is solely for your information.

The procedures that we will perform will not constitute an audit or a review made in accordance with Philippine Standards on Auditing or Philippine Standards on Review Engagements and, consequently, no assurance will be expressed.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records, documentation and other information requested in connection with our engagement.

Our fees, which will be billed as work progresses, are based on the time required by the individuals assigned to the engagement plus out-of-pocket expenses. Individual hourly rates vary according to the degree of responsibility involved and the experience and skill required.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the terms of the engagement including the specific procedures which we have agreed will be performed.

XYZ & Co

Acknowledged on behalf of:

ABC Company by
(Signed)

.....
Name and Title
Date

Procedures and Evidence

The auditor should carry out the procedures agreed upon and use the evidence obtained as the basis for the report of factual findings. The procedures applied in an engagement to perform agreed-upon procedures may include the following:

1. Inquiry and analysis.
2. Recomputation, comparison and other clerical accuracy checks.
3. Observation.
4. Inspection.
5. Obtaining confirmations.

Exhibit 16.14 is a sample report which contains an illustrative list of procedures which may be used as one part of a typical agreed-upon procedures engagement.

Reporting

The report on an agreed-upon procedures engagement needs to describe the purpose and the agreed-upon procedures of the engagement in sufficient detail to enable the reader to understand the nature and the extent of the work performed. The report of factual findings should contain:

1. A title;
2. The addressee (ordinarily the client who engaged the auditor to perform the agreed-upon procedures);
3. An identification of specific financial or non-financial information to which the agreed-upon procedures have been applied;
4. A statement that the procedures performed were those agreed upon with the recipient;
5. A statement that the engagement was performed in accordance with the Philippine Standard on Related Services applicable to agreed-upon procedures engagements;
6. When relevant, a statement that the auditor is not independent of the entity;
7. An identification of the purpose for which the agreed-upon procedures were performed;
8. A listing of the specific procedures performed;
9. A description of the auditor's factual findings including sufficient details of errors and exceptions found;
10. A statement that the procedures performed do not constitute either an audit or a review and, as such, no assurance is expressed;
11. A statement that had the auditor performed additional procedures, an audit or a review, other matters might have come to light that would have been reported;
12. A statement that the report is restricted to those parties that have agreed to the procedures to be performed;
13. A statement (when applicable) that the report relates only to the elements, accounts, items or financial and non-financial information specified and that it does not extend to the entity's financial statements taken as a whole;
14. The auditor's signature;
15. The date of the report; and
16. The auditor's address.

Figure 16.14 is an example of a report of factual findings issued in connection with an engagement to perform agreed-upon procedures regarding financial information.

EXHIBIT 16.14 Sample Report of Factual Findings in Connection with Accounts Payable

REPORT OF FACTUAL FINDINGS

To (those who engaged the auditor)

We have performed the procedures agreed with you and enumerated below with respect to the accounts payable of ABC Company as at (date), set forth in the accompanying schedules

(not shown in this example). Our engagement was undertaken in accordance with the Philippine Standard on Related Services applicable to agreed-upon procedures engagements. The procedures were performed solely to assist you in evaluating the validity of the accounts payable and are summarized as follows:

1. We obtained and checked the addition of the trial balance of accounts payable as at (date) prepared by ABC Company, and we compared the total to the balance in the related general ledger account.

2. We compared the attached list (not shown in this example) of major suppliers and the amounts owing at (date) to the related names and amounts in the trial balance.

3. We obtained suppliers' statements or requested suppliers to confirm balances owing at (date).

We compared such statements or confirmations to the amounts referred to in 2. For amounts which did not agree, we obtained reconciliations from ABC Company. For reconciliations obtained, we identified and listed outstanding invoices, credit notes and outstanding checks, each of which was greater than ₱ xxx. We located and examined such invoices and credit notes subsequently received and checks subsequently paid and we ascertained that they should in fact have been listed as outstanding on the reconciliations.

We report our findings below:

a. With respect to item 1 we found the addition to be correct and the total amount to be in agreement.

b. With respect to item 2 we found the amounts compared to be in agreement.

c. With respect to item 3 we found there were suppliers' statements for all such suppliers.

d. With respect to item 4 we found the amounts agreed, or with respect to amounts which did not agree, we found ABC Company had prepared reconciliations and that the credit notes, invoices and outstanding checks over ₱ xxx were appropriately listed as reconciling items with the following exceptions:

(Detail the exceptions)

Because the above procedures do not constitute either an audit or a review made in accordance with Philippine Standards on Auditing or Philippine Standards on Review Engagements, we do not express any assurance on the accounts payable as of (date).

Had we performed additional procedures or had we performed an audit or review of the financial statements in accordance with Philippine Standards on Auditing or Philippine Standards on Review Engagements, other matters might have come to our attention that would have been reported to you. Our report is solely for the purpose set forth in the first paragraph of this report and for your information and is not to be used for any other purpose or to be distributed to any other parties. This report relates only to the accounts and items specified above and do not extend to any financial statements of ABC Company, taken as a whole.

AUDITOR

Date
Address

ENGAGEMENTS TO COMPILE FINANCIAL INFORMATION

A compilation engagement is directed towards presenting, ordinarily in the form of financial statements (which may or may not be a complete set of financial statements), information that is the representation of management or owners without undertaking to express any assurance on the information. It may also include the collection, classification and summarization of other financial information.

Objective of a Compilation Engagement

The objective of a compilation engagement is for an accountant to use accounting expertise, as opposed to auditing expertise, to collect, classify and summarize financial information. This ordinarily entails reducing detailed data to a manageable and understandable form without a requirement to test the assertions underlying that information. The procedures employed are not designed and do not enable the accountant to express any assurance on the financial information. However, users of the compiled financial information derive some benefit as a result of the accountant's involvement because the service has been performed with professional competence and due care.

General Principles of a Compilation Engagement

Other than the independence principle (i.e., independence is not a requirement for a compilation engagements), which is essential to an assurance engagements, the accountant should comply with the "Code of Professional Ethics for Certified Public Accountants" promulgated by the Board of Accountancy. However, where the accountant is not independent, a statement to that effect would be made in the accountant's report.

Defining the Terms of the Engagement

In conducting a compilation, the accountant should ensure that there is a clear understanding between the client and the accountant regarding the terms of the engagement. Matters to be considered include the following:

1. Nature of the engagement including the fact that neither an audit nor a review will be carried out and that accordingly no assurance will be expressed.
2. Fact that the engagement cannot be relied upon to disclose errors, illegal acts or other irregularities, for example, fraud or defalcations that may exist.
3. Nature of the information to be supplied by the client.
4. Fact that management is responsible for the accuracy and completeness of the information supplied to the accountant for the completeness and accuracy of the compiled financial information.
5. Basis of accounting on which the financial information is to be compiled and the fact that it, and any known departures therefrom, will be disclosed.
6. Intended use and distribution of the information, once compiled.
7. Form of report to be rendered regarding the financial information compiled, when the accountant's name is to be associated therewith.

An engagement letter will be of assistance in planning the compilation work and it is in the interests of both the accountant and the entity that the accountant sends an engagement letter documenting the key terms of the appointment. An engagement letter confirms the accountant's acceptance of the appointment and helps avoid misunderstanding regarding such matters as the objectives and scope of the engagement, the extent of the accountant's responsibilities and the form of reports to be issued.

An example of an engagement letter for a compilation engagement appears in Exhibit 16.15.

EXHIBIT 16.15 **Sample Engagement Letter for a Compilation Engagement**

Date

To the Board of Directors or the appropriate representatives of senior management:

This letter confirms our understanding of the terms of our engagement and the nature and limitations of the services we will provide.

You have requested that we perform the following services:

On the basis of information you provide, we will compile, in accordance with the Philippine Standard on Auditing applicable to compilation engagements, the balance sheet of ABC Company as of December 31, 20X1 and related statements of income, changes in equity and cash flows for the year then ended on a cash basis. We will not carry out audit or review engagement procedures in relation to such financial statements. Consequently, no assurance on the financial statements will be expressed. Our report on the financial statements of ABC Company is presently expected to read as follows:

(See Exhibit 16.16)

Management is responsible for both the accuracy and completeness of the information supplied to us and is responsible to users for the financial information compiled by us. This includes the maintenance of adequate accounting records and internal controls and the selection and application of appropriate accounting policies. Our engagement cannot be relied upon to disclose whether fraud or errors, or illegal acts exist. However, we will inform you of any such matters which come to our attention.

The information will be prepared in accordance with generally accepted accounting principles in the Philippines. Any known departures from generally accepted accounting principles in the Philippines will be disclosed within the financial statements and when considered necessary will be referred to in our compilation report.

We understand that the intended use and distribution of the information we have compiled is [specify] and that should this change in a material respect, that you will inform us.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records, documentation and other information requested in connection with our compilation.

Our fees, which will be billed as work progresses, are based on the time required by the individuals assigned to the engagement plus out-of-pocket expenses. Individual hourly rates vary according to the degree of responsibility involved and the experience and skill required.

This letter will be effective for future years unless it is terminated, amended or superseded.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our compilation of your financial statements.

XYZ & Co

Acknowledged on behalf of:

ABC Company by
(Signed)

.....
Name and Title
Date

Procedures

The accountant should obtain a general knowledge of the business and operations of the entity and should be familiar with the accounting principles and practices of the industry in which the

entity operates and with the form and content of the financial information that is appropriate in the circumstances. The accountant ordinarily obtains knowledge of these matters through experience with the entity or inquiry of the entity's personnel.

Ordinarily, the accountant is not required to:

1. Make any inquiries of management to assess the reliability and completeness of the information provided;
2. Assess internal controls;
3. Verify any matters; or
4. Verify any explanations.

However, if the accountant becomes aware that information supplied by management is incorrect, incomplete, or otherwise unsatisfactory, the accountant should consider performing the above procedures and request management to provide additional information. If management refuses to provide additional information, the accountant should withdraw from the engagement, informing the entity of the reasons for the withdrawal.

Once the information has been compiled, the accountant should read it and consider whether it appears to be appropriate in form and free from obvious material misstatements, such as mistakes in the application of generally accepted accounting principles in the Philippines, nondisclosure of generally accepted accounting principles in the Philippines and any known departures therefrom, or nondisclosure of any other significant matters of which the accountant has become aware.

If the accountant becomes aware of material misstatements, the accountant should try to agree appropriate amendments with the entity. If such amendments are not made and the financial information is considered to be misleading, the accountant should withdraw from the engagement informing the client of the reasons for the withdrawal.

Responsibility of Management

The accountant should obtain an acknowledgment from management of its responsibility for the appropriate presentation of the financial information and of its approval of the financial information. Such acknowledgment may be provided by representations from management which cover the accuracy and completeness of the underlying accounting data and the complete disclosure of all material and relevant information to the accountant.

Reporting on a Compilation Engagement

In all circumstances when an accountant's name is associated with financial information compiled by the accountant, the accountant should issue a report. This should contain the following:

1. A title;
2. The addressee;
3. A statement that the engagement was performed in accordance with the Philippine Standard on Related Services applicable to compilation engagements;
4. When relevant, a statement that the accountant is not independent of the entity;

5. Identification of the financial information noting that it is based on information provided by management;

6. A statement that management is responsible for the financial information compiled by the accountant;

7. A statement that neither an audit nor a review has been carried out and that accordingly no assurance is expressed on the financial information;

8. A paragraph, when considered necessary, drawing attention to the disclosure of material departures from generally accepted accounting principles in the Philippines;

9. The accountant's signature;

10. The date of the report; and

11. The accountant's address.

Further, such financial information compiled by the accountant should contain a reference such as "Unaudited," "Compiled without Audit or Review" or "Refer to Compilation Report" on each page of the financial information or on the front of the complete set of financial statements.

Exhibit 16.16 sets out the form of a report on an engagement to compile financial statements, as follows:

EXHIBIT 16.16 **Sample Report on an Engagement to Compile Financial Statements**

COMPILATION REPORT TO...

On the basis of information provided by management we have compiled, in accordance with the Philippine Standard on Related Services applicable to compilation engagements, the balance sheet of ABC Company as of December 31, 20X1 and statements of income, changes in equity and cash flows for the year then ended. Management is responsible for these financial statements. We have not audited or reviewed these financial statements and accordingly express no assurance thereon.

Accountant

Date
Address

Exhibit 16.17 contains the following example of an emphasis of matter paragraph that may be added to a report on an engagement to compile financial statements that draw attention to a departure from the applicable financial reporting framework.

EXHIBIT 16.17 **Sample Report on an Engagement to Compile Financial Statements with an Additional Paragraph that Draws Attention to a Departure from the Identified Financial Reporting Framework**

COMPILATION REPORT TO...

On the basis of information provided by management we have compiled, in accordance with the Philippine Standard on Related Services applicable to compilation engagements, the balance sheet of XYZ Company as of December 31, 20X1 and the related statements of income, changes in equity and cash flows for the year then ended. Management is

responsible for these financial statements. We have not audited or reviewed these financial statements and accordingly express no assurance thereon.

We draw attention to Note X to the financial statements because management has elected not to capitalize the leases on plant and machinery which is a departure from generally accepted accounting principles in the Philippines.

Accountant

Date
Address

REVIEW QUESTIONS

1. What are special reports and its examples? What are the characteristics of each of the special reports?

2. Except for a report on summarized financial statements, what are the basic elements of an auditor's report on a special purpose audit engagement?

3. What is an other comprehensive basis of accounting (OCBOA)? What are the three bases for other OCBOA financial statements? Why it is important that these financial statements be properly titled in the audit report?

4. What is a prospective financial and information and its types? Differentiate financial forecast from financial projection.

5. What are the elements of an auditor's report on an examination of prospective financial information?

6. What are review engagements and its objective? What are the procedures being applied for the review of financial statements?

7. What are the basic elements of an auditor's report on a review of financial statements? What is the level of assurance being provided by the auditor in a review of financial statements?

8. What are agreed upon procedures engagements and its objective? What are the procedures being applied in an engagement to perform agreed-upon procedures?

9. What are the basic elements of an auditor's report of factual findings? Why it is necessary to describe in the report the purpose and the agreed-upon procedures of the engagement in sufficient detail?

10. What are compilation engagements and its objective? What are the procedures being performed in conducting compilation engagements?

11. What are the basic elements of an accountant's report on a compilation engagement? What are the references that an accountant should include on each page of the financial information or on the front of the complete set of financial statements?

MULTIPLE CHOICE QUESTIONS

1. When an auditor reports on financial statements prepared on an entity's income tax basis, the auditor's report should
   a. State that the basis of presentation is a comprehensive basis of accounting other than the Philippine Financial Reporting Standards.
   b. Not express an opinion on whether the statements are presented in conformity with the comprehensive basis of accounting used.
   c. Include an explanation of how the results of operations differ from the cash receipts and disbursements basis of accounting.
   d. Disclaim an opinion on whether the statements were examined in accordance with generally accepted auditing standards.

2. Ultra Life Insurance Co. prepares its financial statements on an accounting basis insurance companies use pursuant to the rules of an insurance commission. If Chokey, CPA, Ultra's auditor, discovers that the statements are not suitably titled, Chokey should
   a. Issue a special statutory basis report that clearly disclaims any opinion.
   b. Explain in the notes to the financial statements the terminology used.
   c. Disclose any reservations in an explanatory paragraph and qualify the opinion.
   d. Apply to the state insurance commission for an advisory opinion.

3. Reporting on components of financial statements are undertaken
   a. As a separate engagement, i.e., apart from the audit of financial statements.
   b. In conjunction with an audit of the entity's financial statements.
   c. Either (a) or (b).
   d. Neither (a) or (b).

4. Stipen, CPA, has audited the entire financial statements of Tanker Corporation. Accordingly, he issued an adverse opinion due to very material misstatements which management did not correct. Can Stipen be engaged to perform an audit of components of the said financial statements?
   a. No, because PSA 800 requires an auditor not to accept audit of components for financial statements that receive an adverse opinion.
   b. No, unless the components to be audited are so extensive as to constitute a major portion of the financial statements.
   c. Yes, because the opinion on the whole financial statements is not relevant in deciding whether to perform an audit of components.
   d. Yes, provided the components to be audited are not so extensive as to constitute a major portion of the financial statements.

5. Grace is an employee of GMM Enterprises. Helson, CPA is asked to express an opinion on Grace's profit participation in GMM's net income. Helson may accept this engagement only if
   a. Helson's report is available for distribution to GMM's other employees.
   b. Helson also audits GMM's complete financial statements.
   c. GMM's financial statements are prepared in conformity with GAAP.
   d. Grace owns controlling interest in GMM.

6. Which of the following is a prospective financial information for general use upon which an accountant may appropriately report?
   a. Financial forecast.
   b. Financial projection.
   c. Partial presentation.
   d. Pro forma financial statements.

7. Written representations on prospective financial statements must be obtain regarding
   a. Each of these representations must be obtained in writing from management.
   b. Management's acceptance of its responsibility for the prospective financial information.
   c. The completeness of significant management assumptions.
   d. The intended use of the prospective financial information.

8. When an accountant examines prospective financial statements, the accountant's report should include a separate paragraph that
   a. States that the accountant is responsible for events and circumstances up to 1 year after the report's date.
   b. Provides an explanation of the differences between an examination and an audit.
   c. Disclaims an opinion on whether the assumptions provide a reasonable basis for the prospective financial statements.
   d. Contains an opinion as to whether the prospective financial statements are properly prepared on the basis of the assumptions and are presented in accordance with generally accepted accounting principles in the Philippines.

9. The party responsible for assumptions identified in the preparation of prospective financial statements is usually
   a. The reporting accountant.
   b. The client's management.
   c. The client's independent auditor.
   d. A third-party lending institution.

10. When the auditor believes that the presentation and disclosure of prospective financial information is not adequate, the auditor may choose to withdraw from the engagement. As an alternative, what type of opinion may be expressed by the auditor?
   a. Disclaimer of opinion.
   b. Negative assurance.
   c. Qualified opinion or disclaimer of opinion.
   d. Qualified or adverse opinion.

11. While this type of engagement involves the application of audit skills and techniques and the gathering of evidence, it does not ordinarily involve an assessment of accounting and internal control systems, tests of records, and of responses to inquiries by obtaining corroborating evidence through inspection, observation, confirmation, and computation.
   a. Agreed-upon procedures.
   b. Compilation.
   c. Consultancy.
   d. Review.

12. Broadly speaking, the general principles of a review are
   a. The same as the general principles applicable to a compilation engagement.
   b. The opposite of the general principles applicable to an audit engagement.

c. Stricter compared to the general principles applicable to an audit engagement.
d. Similar to the general principles applicable to an audit engagement.

13. An engagement letter for review services may be prepared for the benefit of both the client and the auditor. Which of the following statements least likely will appear on such engagement letter?
    a. "Because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatement may remain undiscovered.
    b. "Our engagement cannot be relied upon to disclose whether fraud or errors, or illegal acts exist. However, we will inform you of any material matters that come to our attention."
    c. "Responsibility for the financial statements, including adequate disclosure, is that of the management of the company."
    d. "We will not perform an audit of such financial statements and, accordingly, we will not express an audit opinion on them."

14. An accountant's report on a review of the financial statements of an entity should state that the accountant
    a. Conducted the review in accordance with the PSRE.
    b. Does not express an opinion or any form of limited assurance on the financial statements.
    c. Examined evidence, on a test basis, supporting the amounts and disclosures in the financial statements.
    d. Obtained reasonable assurance about whether the financial statements are free of material misstatements.

15. Financial statements of an entity that have been reviewed by an accountant should be accompanied by a report stating that a review
    a. Consists principally of inquiries of company personnel and analytical procedures applied to financial data.
    b. Does not contemplate obtaining corroborating evidential matter of applying certain other procedures ordinarily performed during an audit.
    c. Includes examining, on a test basis, information that it is the representation of management.
    d. Provides only limited assurance that the financial statements are fairly presented.

16. A summary of findings rather than assurance is most likely to be included in
    a. Review report.
    b. Examination report.
    c. Compilation report.
    d. Agreed-upon procedures report.

17. Which of the following is not correct concerning "specified parties" of an agreed-upon procedures report?
    a. They must take responsibility for the adequacy of the procedures performed.
    b. They must sign an engagement letter.
    c. They must agree on the procedures to be performed.
    d. After completion of the engagement, another party may be added as a specified user.

18. Which of the following is least likely to be included in an agreed-upon procedures engagement report?
    a. A summary of procedures performed.
    b. Limited assurance on the information presented.
    c. The specified party takes responsibility for the sufficiency of procedures.
    d. Use of the report is restricted.

19. The objective of a compilation engagement is
    a. To enable an auditor to state, on the basis of the procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an identified financial reporting framework.
    b. For the auditor to provide a high, but not absolute, level of assurance that the financial information is free of material misstatements.
    c. For the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings.
    d. For the accountant to use accounting expertise, as opposed to auditing expertise, to collect, classify, and summarize financial information.

20. According to PSRS 4410, the following procedures are required whenever a CPA performs a compilation engagement:

	a	b	c	d
Use of audit expertise	Yes	Yes	No	No
Planning for the engagement	No	No	Yes	Yes
Agree with the client regarding the terms of engagement	Yes	No	Yes	No

21. When compiling the financial statements of an entity, an accountant should
    a. Understand the accounting principles and practices of the entity's industry.
    b. Review agreements with financial institutions for restriction on cash balances.
    c. Perform ratio analyses of the financial data of comparable prior periods.
    d. Inquire of key personnel concerning related parties and subsequent events.

22. On each page of the financial information or on the front of the complete set of financial statements, the financial information compiled by the accountant should contain a reference such as
    a. "Unaudited".
    b. "Refer to the completion report".
    c. "Compiled without audit or review".
    d. Any of these.

23. Wesson, CPA, is performing a compilation service for Clean and Clear Corporation. In the course of performing compilation procedures, Thomas became aware that some of the information provided by Clean and Clear's management are incomplete. Client management refuses to comply with Wesson's requests for additional information. In this case, Wesson should:
    a. Withdraw from the engagement.
    b. Issue an adverse opinion on the financial statements compiled.
    c. Issue a qualified opinion on the financial statements compiled.
    d. Issue a disclaimer of opinion on the financial statements compiled.

24. An auditor's report would be designated a special report when it is issued in connection with
    a. Limited use prospective financial statements such as a financial projection.
    b. Interim financial information of a publicly held company that is subject to a limited review.
    c. Compliance with aspects of regulatory requirements related to audited financial statements.
    d. Application of accounting principles to specified transactions.

25. Helpful Co., a nonprofit entity, prepared its financial statements on an accounting basis prescribed by a regulatory agency solely for filing with that agency. Green audited the financial statements in accordance with generally accepted auditing standards and concluded that the financial statements were fairly presented on the prescribed basis. Green should issue a
    a. Standard three-paragraph report with reference to footnote disclosure.
    b. Special report.
    c. Qualified opinion.
    d. Disclaimer of opinion.

26. When requested by the client to report in a prescribed format, and the prescribed format is different from the format presented in PSA 800
    a. The prescribed format shall always prevail over the format presented in PSA 800.
    b. The prescribed format shall always be presented together with the format required by PSA 800.
    c. The auditor, when necessary, should make appropriate changes in the prescribed format to conform to the requirements of PSA 800.
    d. Cannot be determined without additional information.

27. Other comprehensive financial reporting frameworks may include the following
    a. The financial reporting provisions of a government regulatory agency.
    b. The cash receipts and disbursements basis of accounting.
    c. That used by an entity to prepare its income tax return.
    d. All of these.

28. An auditor's special report on financial statements prepared in conformity with the cash basis of accounting should include a separate explanatory paragraph before the opinion paragraph that
    a. States whether the financial statements are fairly presented in conformity with another comprehensive basis of accounting.
    b. Refers to the note to the financial statements that describes the basis of accounting.
    c. Justifies the reasons for departing from generally accepted accounting principles.
    d. Explains how the results of operations differ from financial statements prepared in conformity with generally accepted accounting principles.

29. Reporting on components of financial statements may include reporting on
    a. Provision for income taxes.
    b. Employee's bonus calculation.
    c. Asset accounts, such as accounts receivable and inventory.
    d. All of these are examples of reporting on components of financial statements.

30. In an audit of components, the auditor's examination of a component will ordinarily be
    a. More extensive than if the same components were to be audited in connection with a report on the entire financial statements.
    b. Less extensive than if the same components were to be audited in connection with a report on the entire financial statements.
    c. Just as if the same components were to be audited in connection with a report on the entire financial statements.
    d. A non-assurance engagement since audit of components does not result in the issuance of an audit report.

31. An auditor may express an opinion on an entity's accounts receivable balance even if the auditor has disclaim an opinion on the financial statements taken as a whole provided the
    a. Use of the report on the accounts receivable is restricted.
    b. Report on the accounts receivable is presented separately from the disclaimer of opinion on the financial statements.
    c. Report on the accounts receivable discloses the reason for the disclaimer of opinion on the financial statements.
    d. Auditor also reports on the current asset portion of the entity's balance sheet.

32. The auditor may be requested to report on an entity's compliance with certain aspects of contractual agreements, such as bond indentures or loan agreements. Regarding this type of engagement, select the correct statement
    a. When there are particular matters forming part of the engagement that are outside the auditor's expertise, the auditor would consider using the work of an expert.
    b. The report should state whether, in auditor's opinion, the entity has complied with the particular provisions of the agreement.
    c. Engagements to express an opinion as to an entity's compliance with contractual agreements should be undertaken only when the overall aspects of compliance relate to accounting and financial matters within the scope of the auditor's professional competence.
    d. All of the above statements are correct.

33. The following are some of the factors that are relevant to the auditor's consideration of the period of time covered by prospective financial information, except
    a. Management's competence regarding the preparation of prospective financial information.
    b. Operating cycle.
    c. The degree of reliability of assumptions.
    d. The needs of users.

34. The auditor should not issue a report on
    a. Internal control.
    b. The achievability of forecasts.
    c. Management performance.
    d. Quarterly financial information.

35. The following statements relate to the examination of prospective financial information. Which is false?
    a. Before accepting an engagement to examine prospective financial information, the auditor should consider the intended use of the information.

b. The auditor should express an opinion as to whether the results shown in the prospective financial information will be achieved.
c. The auditor should not accept, or should withdraw from, an engagement to examine prospective financial information when the assumptions are clearly unrealistic.
d. When in the auditor's judgment an appropriate level of satisfaction has been obtained, the auditor is not precluded from expressing positive assurance regarding the assumptions.

36. An examination of a financial forecast is a professional service that involves
a. Assuming responsibility to update management of key events for one year after the report's date.
b. Compiling or assembling a financial forecast that is based on management's assumptions.
c. Evaluating the preparation of a financial forecast and the support underlying management's assumptions.
d. Limiting the distribution of the accountant's report to management and the board of directors.

37. When the auditor believes that one or more significant assumptions do not provide a reasonable basis for the prospective financial information prepared on the basis of best-estimate assumptions or hypothetical assumptions, what are the steps to betaken by the auditor?
a. Disclaim an opinion.
b. Express a qualified opinion on the report, or withdraw from the engagement.
c. Express an adverse opinion in the report, or withdraw from the engagement.
d. Withdraw from the engagement.

38. Which of the following statements best describes the objectives of a review engagement?
a. For the accountant to use accounting expertise, as opposed to auditing expertise, to collect, classify and summarize financial information.
b. For the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings.
c. To enable an auditor to state whether, on the basis of procedures which do not provided all the evidence that would be required in an audit, nothing has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with generally accepted accounting principles.
d. To enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with generally accepted accounting principles in the Philippines.

39. Which of the following statement is incorrect?
a. The auditor is required to comply with the "Code of Professional Ethics for Certified Public Accountants" promulgated by the Board of Accountancy.
b. The auditor need not exercise professional skepticism recognizing that in a review engagement only a moderate level of assurance is expressed.
c. The auditor should conduct a review in accordance with the Philippine Standards on Review Engagements.
d. All of the above statements are incorrect.

40. Review report should be dated no earlier than the
    a. Balance sheet date of the latest period reported on.
    b. Date management contracted the services of the CPA for the review engagement.
    c. Date the report is delivered to the entity reviewed.
    d. Date the review is completed.

41. One of the requirements of a review is that a conclusion must be expressed (and issued in the form of a review report). Which of the following is not an element of a review report?
    a. Addressee.
    b. Description of procedures performed.
    c. Statement of negative assurance.
    d. Title of the review report.

42. Financial statements of an entity that have been reviewed by an accountant should be accompanied by a report stating that
    a. A review includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements.
    b. A review is greater in scope than a compilation, the objective of which is to present financial statements that are free of material misstatements.
    c. The financial statements are the responsibility of the company's management.
    d. The scope of the inquiry and analytical procedures performed by the accountant has not been restricted.

43. An accountant may accept an engagement to apply agreed-upon procedures that are not sufficient to express an opinion on one or more specified accounts or items of a financial statement provided that
    a. Distribution of the accountant's report is restricted.
    b. The accountant is also the entity's continuing auditor.
    c. The accountant's report does not enumerate the procedures performed.
    d. The financial statements are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles.

44. The following statements pertain to agreed-upon procedures. Which one is incorrect?
    a. Independence is required when performing an agreed-upon procedures engagement.
    b. The auditor should conduct an agreed-upon procedures engagement in accordance with PSRS 4400 and the terms of the engagements.
    c. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results.
    d. Users of the report assess for themselves the procedures and findings reported by the auditor and draw their own conclusions from the auditor's work.

45. Which of the following is correct of the report based on agreed-upon procedures?
    a. It states that the auditor has not recognized any basis that requires a revision of the financial statements.
    b. It should state that the procedures performed are limited to analytical procedures and inquiry.
    c. It should contain an expression of limited assurance as to reasonableness of the assertion(s) presented in the financial information.
    d. It is restricted to those parties who have agreed to the procedures to be performed.

46. An accountant who is not independent may issue a
    a. Review report.
    b. Qualified opinion.
    c. Compilation report.
    d. Comfort letter.

47. According to Philippine Standards on Related Services, the procedures employed in doing compilations are:
    a. Not designed to enable the accountant to express any form of assurance.
    b. Less extensive than review procedures but more extensive than agreed-upon procedures.
    c. Designed to enable the accountant to express a negative assurance.
    d. Designed to enable the accountant to express a limited assurance.

48. When compiling an entity's financial statements, an accountant would be least likely to
    a. Read the compiled financial statements and consider whether they appear to include adequate disclosures.
    b. Plan the work so that an effective engagement will be performed.
    c. Perform analytical procedures designed to identify relationships that appear to be unusual.
    d. Obtain an acknowledgement from management of its responsibility for the financial statements.

49. Which of the following should not be included in an accountant's report based upon the compilation of an entity's financial statements?
    a. A statement that the accountant has not audited or reviewed the statements.
    b. A statement that the accountant does not express an opinion but provides only negative assurance on the statements.
    c. A statement that management is responsible for the financial statements.
    d. A statement that a compilation of the company's financial statements was made in accordance with the PSRS.

50. PSA 800 (The Auditor's Report on Special Purpose Audit Engagements) applies to
    a. Review engagements.
    b. Engagements to report on specified accounts, elements of accounts, or items in a financial statement.
    c. Compilation engagements.
    d. Agreed-upon procedures engagements.

51. An auditor's report issued in connection with which of the following is generally not considered to be a special purpose engagement report?
    a. Specified elements, accounts, or items of a financial statement presented in a document.
    b. Financial statements prepared in accordance with an entity's income tax basis.
    c. Financial information presented in a prescribed schedule that requires a prescribed form of auditor's report.
    d. Compliance with aspects of contractual agreements unrelated to audited financial statements.

52. Which of the following is not a special purpose audit engagement?
    a. Compilation of financial statements.
    b. Audits of compliance with contractual agreements.

c. Audits involving financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles in the Philippines.
d. Audit of specified accounts, elements of accounts, or items in a financial statement.

53. Financial information is presented in a printed form that prescribes the wording of the independent auditor's report. The form is not acceptable to the auditor because the form calls for statements that are inconsistent with the auditor's responsibility. Under these circumstances, the auditor most likely would
a. Express a qualified opinion with an explanation.
b. Limit distribution of the report to the party who designed the form.
c. Reword the form or attach a separate report.
d. Withdraw from the engagement.

54. If the financial statements prepared on other comprehensive bases are not suitably titled or the basis of accounting is not adequately disclosed, the auditor should
a. Issue an appropriately modified report.
b. Request for an additional representation in the management representation letter.
c. Reword the title of the financial statements.
d. Withdraw from the engagement.

55. An auditor may report on summarized financial statements that are derived from complete audited financial statements if the
a. Auditor describes the additional review procedures performed on the summarized financial statements.
b. Auditor indicates whether the information in the summarized financial statements is consistent with the audited financial statements from which it was derived.
c. Summarized financial statements are distributed only to management and the board of directors.
d. Summarized financial statements are presented in comparative form with the prior year's summarized financial statements.

56. Mateo, CPA, is requested to report on summarized financial statements of Sunrise, Inc. Mateo has not expressed an audit opinion on the financial statements from which the summarized financial statements were derived. Based solely on this information, should Mateo accept the engagement?
a. No, because PSA 800 mandates that the auditor should not report on summarized financial statements unless the auditor has expressed an audit opinion on the financial statements from which the summarized financial statements were derived.
b. None of the above choices can be selected because of lack of information.
c. Yes, because a report on summarized financial statements is a separate engagement.
d. Yes, because an audit of summarized financial statements is comparable to the audit of financial statements from which such summarized statements were derived.

57. The examination of prospective financial information is covered by:
a. PSAE 3000.
b. PSAE 3400.
c. PSRE 2400.
d. PSRS 4000.

58. These refer to prospective financial information prepared on the basis of hypothetical assumptions about future events and management actions which are not necessarily expected to take place; and a mixture of best-estimate and hypothetical assumptions.
    a. Budget.
    b. Forecast.
    c. Projection.
    d. Prospective financial statements.

59. The following statements refer to PSAE 3400. Which one is incorrect?
    a. In connection with the auditor's assurance regarding prospective financial information, the auditor is in position to express an opinion as to whether the results shown in the prospective financial information will be achieved.
    b. Prospective financial information relates to events/actions that have not yet occurred and may not occur.
    c. The auditor should consider the extent to which reliance on the entity's historical information is justified.
    d. The auditor should consider the period of time covered by the prospective financial information.

60. An accountant who reviews the financial statements of an entity should issue a report stating that a review
    a. Is substantially more in scope than a compilation.
    b. Provides less assurance than audit.
    c. Provides negative assurance that internal control is functioning as designed.
    d. Provides only limited assurance that the financial statements are fairly presented.

61. Which of the following procedures should a practitioner perform during an engagement to review an entity's financial statements?
    a. Communicating material internal control weaknesses during the assessment of control risk.
    b. Examining cash disbursements in the subsequent period for unrecorded liabilities.
    c. Obtaining a client representation letter from members of management.
    d. Sending bank confirmation letters to the entity's financial institutions.

62. Which of the following procedures is not included in a review engagement on a non-public entity?
    a. Any procedures designed to identify relationships among data that appear to be unusual.
    b. Communicating any material weaknesses discovered during the study and evaluation of internal accounting control.
    c. Inquiries of management and of personnel involved in accounting functions.
    d. Inquiries regarding events subsequent to the balance sheet date.

63. Which of the following would not be included in a practitioner's report based upon a review of an entity's financial statements?
    a. A statement describing the practitioner's conclusions based upon the results of the review.
    b. A statement describing the principal procedures performed.
    c. A statement that the financial statements are the responsibility of the company's management.

d. A statement that the review was conducted in accordance with generally accepted auditing standards in the Philippines.

64. Helson, CPA, has issued a review report for a non-public entity's financial statements. The review report should state that
   a. "A review includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements."
   b. "Based on our review, nothing has come to our attention that causes us to believe that the accompanying financial statements are not presented fairly, in all material respects, in accordance with Philippine Financial Reporting Standards."
   c. "We do not express an opinion or any form of limited assurance on the financial statements."
   d. "We obtained reasonable assurance about whether the financial statements are free of material misstatement."

65. Grace, CPA was asked to audit a set of financial statements prepared under a modified cash basis. This is acceptable provided Grace
   a. Coverts the financial statement to an accrual basis before rendering an audit report.
   b. Issues an adverse opinion.
   c. Qualifies the audit opinion for a departure from generally accepted accounting principles.
   d. States clearly in the audit report that fairness was evaluated within the framework of the other basis other than PFRS.

66. Summarized financial statements are presented
   a. None of the above choices can correctly complete the statement.
   b. In equal detail with annual audited financial statements.
   c. In considerably more detail than annual audited financial statements.
   d. In considerably less detail than annual audited financial statements.

67. The auditor's report on summarized financial statements least likely include
   a. A reference to the date of the audit report on the unabridged financial statements and the type of opinion given in that report.
   b. A statement which indicates that for a better understanding of an entity's financial performance and position and of the scope of the audit performed, the summarized financial statements should be read in conjunction with the unabridged financial statements and the audit report thereon.
   c. An identification of the audited financial statements from which the summarized financial statements were derived.
   d. An opinion as to whether the information in the summarized financial statements is presented fairly, in all material respects.

68. A prospective financial information prepared on the basis of assumptions as to future events which management expects to take place and the actions management expects to take as of the date the financial information is prepared (best-estimate assumptions) is known as
   a. Best-estimate projection.
   b. Forecast.
   c. Hypothetical financial information.
   d. Projection.

69. A financial forecast consists of prospective financial statements that present an entity's expected financial position, results of operations, and cash flow. A forecast
    a. Is based on assumptions reflecting conditions expected to exist and courses of action expected to be taken.
    b. Is based on the most conservative estimates.
    c. Present estimates given one or more hypothetical assumptions.
    d. Unlike a projection, may contain a range.

70. Prospective financial information can include financial statements or one or more elements of financial statements and may be prepared for distribution to third parties in
    a. An annual report to provide information to shareholders, regulatory bodies and other interested parties.
    b. A prospectus to provide potential investors with information about future expectations.
    c. A document for the information of lenders which may include, for example, cash flow forecasts.
    d. All of these are examples of external use of prospective financial information.

71. Procedures in a review engagement consist of inquiry and analytical procedures. Regarding review procedures, which of the following statements is incorrect?
    a. There is a greater risk that misstatements will not be detected in an audit than in a review.
    b. The judgment as to what is material is made by reference to the information on which the auditor is reporting and the needs of those relying on that information, not to the level of assurance provided.
    c. The auditor should apply the same materiality considerations as would be applied if an audit opinion on the financial statements were given.
    d. The auditor should apply judgment in determining the specific nature, timing and extent of review procedures.

72. Which of the following procedures is performed in a review of financial statements?
    a. Testing the bank reconciliation provided by client personnel.
    b. Reading the financial statements to consider whether they appear to conform with the Philippine Financial Reporting Standards.
    c. Obtaining a letter of audit inquiry from all attorneys of record.
    d. Confirming accounts receivable with client customers to test existence.

73. Which of the following inquiry or analytical procedures ordinarily is performed in an engagement to review an entity's financial statements?
    a. Inquiries of the entity's attorney concerning contingent liabilities.
    b. Inquiries concerning the entity's procedures for recording and summarizing transactions.
    c. Analytical procedures designed to test the accounting records by obtaining corroborating evidential matter.
    d. Analytical procedures designed to test management's assertions regarding continued existence.

74. If matters that impair a fair presentation have come to the auditor's attention during a review engagement, the auditor should describe those matters, including, unless impracticable, a quantification of the possible effect(s) on the financial statements, and

a. When the effect of the matter is so material and pervasive to the financial statements that the auditor concludes that a qualification is not adequate to disclose the misleading or incomplete nature of the financial statements, give an adverse statement.
b. Express a qualification of the negative assurance provided.
c. Both (a) and (b).
d. Either (a) or (b).

75. An auditor is engaged to carry out those procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on actual findings. The report is restricted to those parties that have agreed to the procedures to be performed since others, unaware of the reasons for the procedures, may misinterpret the results. This engagement is called
a. Compilation.
b. Audit.
c. Attestation.
d. Agreed-upon procedures.

COMPREHENSIVE CASES

CASE 1 – Analyzing a Compilation Report

The following report was drafted on October 25, 2021, by Major, CPA, at the completion of the engagement to compile the financial statements of Ajax Company for the year ended September 30, 2021. Ajax is a nonpublic entity in which Major's child has a material direct financial interest. Ajax decided to omit substantially all of the disclosures required by Philippines' generally accepted accounting principles because the financial statements will be for management's use only. The statement of cash flows was also omitted because management does not believe it to be a useful financial statement.

To the Board of Directors of Ajax Company:

I have compiled the accompanying financial statements of Ajax Company as of September 30, 2021, and for the year then ended. I planned and performed the compilation to obtain limited assurance about whether the financial statements are free of material misstatements.

A compilation is limited to presenting information in the form of financial statements. It is substantially less in scope than an audit in accordance with Philippines' generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. I have not audited the accompanying financial statements and, accordingly, do not express any opinion on them.

Management has elected to omit substantially all of the disclosures required by Philippines' generally accepted accounting principles. If the omitted disclosures were included in the financial statements, they might influence the user's conclusions about the Company's financial position, results of operations, and changes in financial position.

I am not independent with respect to Ajax Company. This lack of independence is due to my child's ownership of a material direct financial interest in Ajax Company.

This report is intended solely for the information and use of the Board of Directors and management of Ajax Company and should not be used for any other purpose.

Major, CPA

Required:

1. Identify the deficiencies contained in Major's report on the compiled financial statements. Group the deficiencies by paragraph where applicable. Do not redraft the report.

CASE 2 – Reports on Prospective Financial Statements

An accountant is sometimes called on by clients to report on or assemble prospective financial statements for use by third parties.

Required:

1. Identify the types of engagements that an accountant may perform under these circumstances.
2. Explain the difference between "general use" of and "limited use" of prospective financial statements.
3. Explain what types of prospective financial statements are appropriate for "general use" and what types are appropriate for "limited use."
4. Describe the contents of the accountant's standard report on a compilation of a financial projection.