



**OUM Business School**

**BBAA3103**  
Audit I

**BBA3103**

**AUDIT I**

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# COURSE GUIDE



## COURSE GUIDE DESCRIPTION

You must read this *Course Guide* carefully from the beginning to the end. It tells you briefly what the course is about and how you can work your way through the course material. It also suggests the amount of time you are likely to spend in order to complete the course successfully. Please keep on referring to the *Course Guide* as you go through the course material as it will help you to clarify important study components or points that you might miss or overlook.

## INTRODUCTION

**BBAA3103 Audit 1** is one of the courses offered by the Faculty of Business and Management at Open University Malaysia (OUM). This course is worth 3 credit hours and should be covered over 15 weeks.

## COURSE AUDIENCE

This is a core major course for students undergoing Bachelor of Accounting.

As an open and distance learner, you should be able to learn independently and optimise the learning modes and environment available to you. Before you begin this course, please confirm the course material, the course requirements and how the course is conducted.

## STUDY SCHEDULE

It is a standard OUM practice that learners accumulate 40 study hours for every credit hour. As such, for a three-credit hour course, you are expected to spend 120 study hours. Table 1 gives an estimation of how the 120 study hours could be accumulated.

**Table 1:** Estimation of Time Accumulation of Study Hours

STUDY ACTIVITIES	STUDY HOURS
Briefly go through the course content and participate in initial discussions	3
Study the module	60
Attend 3 to 5 tutorial sessions	10
Online participation	12
Revision	15
Assignment(s), Test(s) and Examination(s)	20
<b>TOTAL STUDY HOURS ACCUMULATED</b>	<b>120</b>

## LEARNING OUTCOMES

By the end of this course, you should be able to:

1. Describe the importance and purpose of auditing;
2. Discuss the nature and types of the auditor's reports;
3. Administer audit planning and the evidence accumulated in an audit process;
4. Recognise the importance of internal control function to the audit of financial statements;
5. Assess the auditor's objectives in an audit of cash balances and inventory;
6. Apply the auditor's examination of revenue and collection cycle; and
7. Review the auditor's objectives with regard to long-term assets, obligations and owners' equity.

## COURSE SYNOPSIS

This course is divided into 7 topics. The synopsis for each topic is presented below:

**Topic 1** introduces auditing services provided by the public accounting firm in Malaysia. This topic discusses the differences between accounting and auditing services, objectives of an audit and roles and responsibilities of management and

auditor. It further discusses the types of audits, auditors and the fundamental concepts in auditing.

**Topic 2** details out various types of audit reports namely (i) standard unqualified, (ii) unqualified with explanatory paragraph, (iii) qualified, (iv) adverse and (v) disclaimer. Next, it illustrates the conditions resulting in the qualifications of audit reports. Finally, it discusses the related auditing standards concerning the audit reports.

**Topic 3** introduces various phases in audit planning, the relationship between audit planning, evidence accumulation and decision making. It discusses in details the steps involve in the audit planning including the use of analytical procedures. It further explains the effect of materiality and audit risk in audit planning. The topic then explains the nature of audit evidence, types of audit procedures to gather the evidence and how the auditor evaluates them. The importance and relationship between audit planning, evidence accumulation and decision is being emphasised throughout the topic.

**Topic 4** discusses auditor's review, evaluation and testing of the client's system of internal control. This analysis of internal control will affect the auditor's decision regarding the audit programme. Sufficient understanding of the accounting and internal control system is needed to plan the audit and develop an effective audit approach.

**Topic 5** consists of two sections; the first section concerns the audit of cash balances and the subsequent section deals with the audit of inventory cycle. The first section explains how the cash-in-bank is affected by the transaction cycle, as well as providing a brief explanation on the types of cash accounts that are typically found in a company. The latter section of the topic will focus on the major parts of auditing inventory cycle and gives particular emphasis on the importance of physical observation in the audit of inventory. Similar to the other cycles, students are being exposed to relevant concepts and tests applicable to conduct the audit of cash balances and inventory cycle such as audit objective, test of control and relevant substantive procedures.

**Topic 6** discusses the importance of understanding the classes of transactions that affects revenue and collection cycle. This is to ensure that audit is conducted in the most efficient and effective manner. It explains the transactions and accounts affected by the revenue and collection cycle as well as identifying the related documents in the cycle. Significant portion of this topic discusses the transaction – related audit objectives, key internal controls and substantive tests of transaction for revenue and collection cycle. Understanding the application of these auditing concepts will help the student to understand how auditing is done in practice in the revenue and collection cycle. Examples are given, where

appropriate, in order to help the students appreciate the concepts and audit methodology discussed in this topic.

**Topic 7** discusses the auditor's examination of tangible long-term assets, obligations and owners' equity, which are often included in the balance sheet. The assets include; property, plant and equipment, investment and intangible assets. In the examination of liabilities, the auditor is usually more concerned with the detecting understatement or omission. Finally, it discusses auditor's major concern in examining the owners' equity.

## TEXT ARRANGEMENT GUIDE

Before you go through this module, it is important that you note the text arrangement. Understanding the text arrangement should help you to organise your study of this course to be more objective and more effective. Generally, the text arrangement for each topic is as follows:

**Learning Outcomes:** This section refers to what you should achieve after you have completely gone through a topic. As you go through each topic, you should frequently refer to these learning outcomes. By doing this, you can continuously gauge your progress of digesting the topic.

**Self-Check:** This component of the module is inserted at strategic locations throughout the module. It is inserted after you have gone through one sub-section or sometimes a few sub-sections. It usually comes in the form of a question that may require you to stop your reading and start thinking. When you come across this component, try to reflect on what you have already gone through. When you attempt to answer the question prompted, you should be able to gauge whether you have understood what you have read (clearly, vaguely or worse you might find out that you had not comprehended or retained the sub-section(s) that you had just gone through). Most of the time, the answers to the questions can be found directly from the module itself.

**Activity:** Like Self-Check, activities are also placed at various locations or junctures throughout the module. Compared to Self-Check, Activity can appear in various forms such as questions, short case studies or it may even ask you to conduct an observation or research. Activity may also ask your opinion and evaluation on a given scenario. When you come across an Activity, you should try to widen what you have gathered from the module and introduce it to real situations. You should engage yourself in higher order thinking where you might be required to analyse, synthesise and evaluate instead of just having to recall and define.

**Summary:** You can find this component at the end of each topic. This component helps you to recap the whole topic. By going through the summary, you should be able to gauge your knowledge retention level. Should you find points inside the summary that you do not fully understand, it would be a good idea for you to revisit the details from the module.

**Key Terms:** This component can be found at the end of each topic. You should go through this component to remind yourself of important terms or jargons used throughout the module. Should you find terms here that you are not able to explain, you should look for the terms from the module.

**References:** References is where a list of relevant and useful textbooks, journals, articles, electronic contents or sources can be found. This list can appear in a few locations such as in the Course Guide (at References section), at the end of every topic or at the back of the module. You are encouraged to read and refer to the suggested sources to elicit the additional information needed as well as to enhance your overall understanding of the course.

## PRIOR KNOWLEDGE

Learners of this course are required to pass BBFA1103 Introductory Accounting course.

## ASSESSMENT METHOD

Please refer to myINSPIRE.

## REFERENCES

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# Topic 1 ▶ Introduction to Auditing

## LEARNING OUTCOMES

By the end of this topic, you should be able to:

1. Define auditing;
2. Explain the objectives of audit;
3. Distinguish between auditing and financial accounting;
4. Discuss the roles and responsibilities of auditors;
5. Explain the types of audit and auditors; and
6. Describe the three fundamental concepts in audit.

## ▶ INTRODUCTION

Do you know the meaning of auditing? Auditing is a professional profession which renders public services to business entities. There are various groups, such as stockholders, creditors, government agencies and investment bankers that have an interest on the performance of business entities. Hence, we should be aware that audit is an integral part of the communication process. Auditing assists the users in evaluating the quality of accounting information communicated to them.

In Malaysia, companies are incorporated under the Companies Act 1965. The Act enables the company to exist as a legal entity separate and distinct from the actual owners (shareholders) who provide the resources or capital. The owners, as a body, delegate the power to management (board of directors) who run the corporation on a day-to-day basis. Shareholders generally have no direct control over decisions made by the directors as long as they act in good faith and in accordance with the requirements of Companies Act 1965. How does the management keep the shareholders informed of their investments? The directors discharge their stewardship functions by preparing the annual report, which includes the financial statements that show the financial position of the company.

An audit increases the credibility and reliability of financial statements prepared by the management. This topic introduces the basic syllabus, audit and assurance services.



**Figure 1.1:** Starbucks coffee



**Figure 1.2:** Starbucks logo

For your knowledge, accounting is the language of business. It is the method companies use to communicate financial information to their shareholders and to the public. Information is important for making decisions. You have probably bought a latte in, or at least walked by, one of Starbucks' 7,000 coffee stores throughout the world. Did you know that you could also buy a share from Starbucks stock, making you part owner of Starbucks? To buy a latte, you want to know how it tastes. To buy a share of stock, you want to know about the financial condition and prospects of Starbucks Corporation. You would want to own part of Starbucks only if you think it will continue to be successful. Figure 1.1 displays a picture of Starbucks' coffee, while Figure 1.2 shows the logo of Starbucks Coffee.

Starbucks first issued shares stock to the public in 1992. If you had bought shares at the time, today your investment would be worth \$20 for every \$1 you invested. Will Starbucks continue to be a good investment? No one can predict with certainty the financial prospects of Starbucks. However, the financial statements prepared by the Starbucks management can give you clues.

In 2003, Starbucks' annual report indicated its total revenues were \$4.1 billion and net income that Starbucks made was \$436 million. If investors want to buy shares from Starbucks, can they too rely on this report to make an economic decision?



### SELF-CHECK 1.1

1. Why do we need to study auditing?
2. What are the responsibilities of an auditor in relation to financial statements?

## 1.1 AUDITING DEFINED

Assurance services generally refer to independent professional services that improve the quality of information for decision makers. Assurance services can be performed by auditors or by others professionals. An assurance engagement involves the evaluation of a subject matter against established criteria to determine conformity of the subject matter with these criteria. One category of assurance services provided by accounting firms is attestation services. **Attestation services** can be divided into **four categories** as mentioned below:

- (a) Audit of historical financial statements;
- (b) Effectiveness of internal control system over financial reporting;
- (c) Review of historical financial statements; and
- (d) Other attestation services which may be applied to broader range of subject matter.

**Auditing** is an attest function involving the objective examination of financial statements prepared by management. Auditing of a financial statements is an independent services to enable auditors to express opinion whether the financial statements give true and fair view of the entity's affairs and have been properly prepared. The most common definitions of true and fair view are as follows:

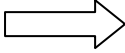
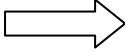
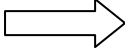
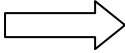
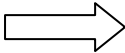
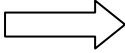
**True view** is information on the financial statements based on facts and not myths. In addition, the information conforms to required standards and law. For example, from financial statements which have been correctly extracted from the books and accounting records.

**Fair view** is information is free from bias and discrimination and in compliance with expected standards and rules. For example, the accounts should reflect the commercial substance of the company's underlying economic transactions.

Auditing is defined as 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.

The importance parts of this definition are as shown in Table 1.1.

**Table 1.1:** Definition of Auditing

<b>Systematic process</b>		Audits are structured activities that follow a logical sequence.
<b>Objectivity</b>		Essentially it means freedom from bias.
<b>Obtaining and evaluating evidence</b>		Independent examination of the underlying support for assertions or representations.
<b>Assertions about economic actions and events</b>		Description of the subject matter that is audited.
<b>Degree of correspondence</b>		Audit establishes the conformity of assertions with specified criteria.
<b>Communicating results</b>		Result of the audit need to be communicated to interested parties.

In performing an audit of financial statements, auditors should carefully carry out audit procedures designed to accumulate sufficient competence and appropriate evidence, in accordance with Auditing Standards to determine with reasonable assurance whether the financial statements are free from material misstatements. The standards stated clearly that the auditors need only provide 'reasonable assurance' and not 'absolute assurance' on the preparation and presentation of the financial statements.

This means that auditors' opinion do not certify a set of financial statements to be completely correct. This would be impossible because of the inherent limitations of an audit. This is due to the nature of the audit itself such as examining evidence on sampling basis, inherent limitation of accounting and internal control system, the possibility of collusion or misrepresentation for fraudulent purposes, most audit evidence being persuasive rather than conclusive.

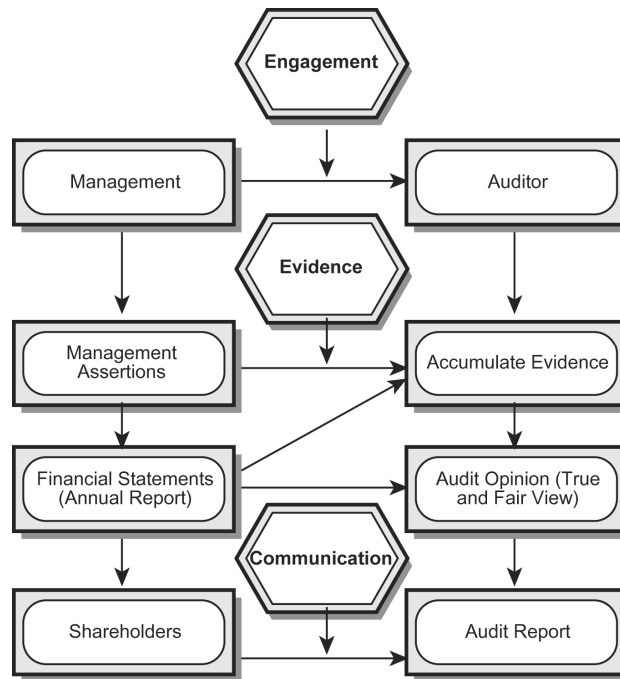


Figure 1.3: Overview of the audit process

## 1.2 AUDIT OBJECTIVES OF FINANCIAL STATEMENT

The primary audit objective is “to form and express an independent expert opinion based on the audit work performed, that the financial statement which are to be relied upon by the users (shareholders, creditors, investors, etc.) are free from material misstatements and in compliance with laws and regulations”. Hence, the audit objectives are as follows:

- To ensure compliance with accounting standards, the Financial Reporting Act 1997 established the Financial Reporting Foundation (FRF) and the Malaysian Accounting Standards Board (MASB);
- To ensure company affairs are regulated by Companies Act 1965; and
- To detect material misstatements caused by fraud and error.

## 1.3 DEMAND FOR AUDITING

The development of the corporate form of business (i.e. Company) and the expanding world economy over the years have given rise to an explosion in the demand for assurance provided by auditors. Corporations require large scale of financing, thus more companies met this need through the sale of shares or stocks to the public. This marked a shift towards an outside ownership. A company is collectively owned by a number of individual shareholders who have no relationship but has a legal status to act as a single artificial person.

Therefore, the shareholders need to be informed about the performance of the company through a set of audited financial statements. In addition, there are other **conditions** that **create a demand for an independent audit** such as:

- (a) **Conflict of Interest**  
Users (stakeholders) concerned with the possibility of bias in information provided to them when there is an actual or potential conflict of interest between the user and the provider of the information.
- (b) **Complexity**  
As information communicated has become more complex, users of information have found it more difficult or even impossible to obtain direct assurance as to the quality of the information received.
- (c) **Remoteness**  
This is caused by the separation of the user of the information and the information source prevents the user from directly assessing the quality of the information received.
- (d) **Consequence**  
When information is used as input for decisions of significant consequence, users are concerned with the possibility of biased, misleading, irrelevant or incomplete information.

## 1.4 ACCOUNTING VERSUS AUDITING

### 1.4.1 Distinction between Accounting and Auditing

The distinction between accounting and auditing is as stated below:

- **Accounting**  
It is a process of recording, classifying and summarising economic events in a logical manner for the purpose of providing financial information for decision making by the various users of financial statements.
- **Auditing**  
It is a process of enhancing the credibility of financial statements. The auditor must thoroughly understand the accounting principles and rules as the criteria for evaluating whether the accounting information is properly recorded and properly reflects the economic events that occurred during the accounting period.

**Accounting and auditing** standards and procedures are interrelated and integrated. The conformance of financial statements to the application of generally accepted accounting principles must be determined through auditing procedures.

### 1.4.2 The Management Assertions

The company's directors have to make known of their business conduct to the absentee owners (shareholders). Directors discharge their responsibility by making representations through the financial statements in the annual report. These representations are known as management assertions that can be defined as "explicit or implicit representations by management that are embodied in the financial statements".

**Assertions** are generally classified into **five broad categories** as follows:

- (a) Existence or occurrence;
- (b) Completeness;
- (c) Rights and obligations;
- (d) Valuation or allocation; and
- (e) Presentations and disclosures.

The five broad categories are explained further in Table 1.2.

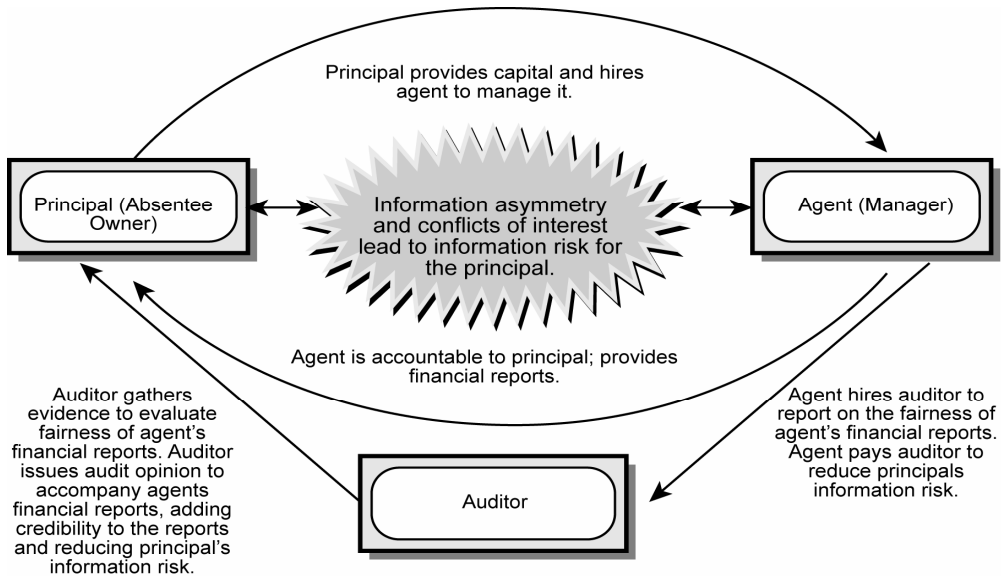
**Table 1.2:** Categories of Management Assertions

<b>Assertions</b>	<b>Explanation</b>
1. <b>Existence or Occurrence</b>	Reported assets and liabilities actually exist at the balance sheet date, and transaction reported in the income statements actually occurred during the period covered by the financial statements.
2. <b>Completeness</b>	All transactions and accounts that should be included in the financial statements are included, or there are no undisclosed assets, liabilities, or transactions.
3. <b>Rights and Obligations</b>	The company owns and has clear title to the assets, the liabilities are obligations of the company, and the company was actually a party to reported transactions.
4. <b>Valuation or Allocation</b>	The assets, liabilities, equity, revenues and expenses are valued properly.
5. <b>Presentations and Disclosures</b>	The assets, liabilities, revenues, and expenses are properly described and disclosed in the financial statements.

You should also be aware that the auditor needs to obtain sufficient evidence that support each of the assertions for every material component of the financial statements.

## 1.5 ROLES AND RESPONSIBILITIES

### 1.5.1 The Role of Auditing



**Figure 1.4:** Role of auditor

**Source:** Auditing and Assurance Services in Malaysia (Messier, Jr & Boh, 2004)

The agency relationship between an owner and manager produces a natural conflict of interest because of the information asymmetry that exists between an absentee owner and manager. That is, the manager generally has more information about the “true” financial position and results of operations of the entity than the absentee owner does. If both parties seek to maximise their own self-interest, it is likely that the manager will not act in the best interest of the owner.

There is a demand for auditing services because the agency relationship produces a natural conflict of interest. As a result, the agent agrees to be monitored as part of his/her employment contract. Auditing appears to be the most cost-effective form of monitoring. The absentee owner is in no position to attest personally the credibility of the accounting information contained in the company’s annual report. Nevertheless, it is of great importance for them to be given information that is relevant, reliable, consistent and comparable. Credibility is quality added to information to make it more believable. Information provided by the management can be relied upon with confidence by

different users of the financial statements (e.g. shareholders, creditors and government agencies).

## 1.5.2 Responsibilities of Auditor and Management

Under Section 174 (1-3) Companies Act 1965, the auditor's duties and responsibilities is to form an opinion on the following matters:

- To ensure that proper accounting and other records have been kept by the company;
- To ensure that he or she has obtained all the information and explanation;
- To attend general meeting and to receive all communications relating to any general meeting which may concern the auditor in his capacity as auditor;
- To ensure procedures and methods used by the holding and subsidiary companies were appropriate to the circumstances of the consolidation;
- To ensure that returns received from branch offices of the company are adequate; and
- To report particulars of any deficiency, failure or shortcoming in respect of any matter mentioned above.

In general, you should know that the auditor and management have different responsibilities as outlined below.

(a) **Auditor's responsibilities are:**

- (i) To state an opinion on the financial statements in auditor's report based on his independent examination;
- (ii) To provide reasonable assurance that financial statements are free from material misstatements;
- (iii) Audit exercise must be performed with due care and professional competence; and
- (iv) The auditor must have extensive knowledge about the nature of the client's business and industry in order to determine whether financial statements assertion is valid.

(b) **Management's responsibilities are:**

- (i) Preparation of yearly financial statements;
- (ii) To maintain adequate accounting records and internal control systems;

- (iii) Safeguarding of company's assets; and
- (iv) Prevention and detection of errors, irregularities and fraud.

## 1.6 TYPES OF AUDIT AND AUDITORS

There are four types of audits. They may be classified as follows:

### 1.6.1 Four Types of Audits

(a) **Financial Statement Audit**

The audit is conducted to determine whether the overall financial statements and the quantifiable information are being verified and stated in accordance with specific criteria: approved accounting standards which are consistently applied and in accordance with the requirements of legislation and regulation. It is more efficient to have one independent external auditor from a certified public accounting firm to perform audit and draw conclusions on that financial statements that can be relied upon by the different groups of users for different purposes.

(b) **Compliance Audits**

The purpose of compliance audit is to determine whether the management is following specific procedures, regulations or rules set down by some higher authority. A compliance audit may be required to check whether the organisation has complied with prescribed policies, contractual agreements or legal requirements. The results of compliance audit are generally reported to someone within the organisational unit being audited rather than a broad group of users (creditors, investors, etc).

(c) **Operational Audits**

An operational audit is a review of any party of an organisation's operating procedures and methods (such as accounting, organisation structure, computer operations, production methods) for the purpose of evaluating efficiency and effectiveness of management itself. Recommendations to management for improving the operations are normally expected at the completion of an operational audit.

(d) **Forensic Audits**

Forensic auditing requires the use of critical analyses and investigative skills, integrated with accounting knowledge and business experience. Examples of forensic audit include cases of business or employee fraud, criminal investigations and shareholder and partnership disputes.

## 1.6.2 Four Types of Auditor

There are also four types of auditors. They are as stated below:

(a) **External Auditors**

They are approved company auditors under Section 8 of the Company Act 1965 to audit every company incorporated under the Act. The primary responsibility is to provide a true and fair view or opinion on the financial statements.

(b) **Internal Auditors**

These auditors are employees of the company who carries out an appraisal on the accounting and other operations and the results are reported to management (operational audit and compliance audit).

(c) **Government Auditors**

A government auditor is a government employee reporting to the Auditor General Department. He would carry out audits of government department and government agencies. Among his audit duties include both the audit of financial statements and compliance audits. The final reports are then reported to the responsible Ministry and Parliament.

(d) **Forensic Auditors**

Forensic auditors are trained to detect, investigate and deter fraud and white-collar crime. Forensic auditors may be employed by corporations, government agencies and investigative services firm.

## 1.6.3 Approved Company Auditor in Malaysia

Firstly, the auditor must be qualified as an accountant. The Malaysian Institute of Accountants (MIA), the country's national accountancy body established under the Accountants Act 1967 is given the function to regulate and control the practice of accountancy profession in Malaysia. The approval for the application as company auditor falls under the authority of Minister of Finance. An approved company auditor refers to a person approved by the Minister of Finance under Sec. 8(2) of the Companies Act to perform the duties of a company auditor.

## 1.7 AUDITING STANDARDS

The quality of audit examination often varies depending on the skill, understanding and professional judgement of a particular auditor. The accounting profession recognises that standards are needed to enhance the quality of audit performed by the auditor. Standards are “measures of an acceptable level of quality of professional work performed by the auditor”. It serves as a guideline when an auditor performs audit of financial statements. The International Standards on Auditing (ISAs) mentioned in Table 1.2 below are the Approved Standards on Auditing as determined by MIA.

**Table 1.2:** Approved Standards on Auditing Determined by MIA

<b>INTERNATIONAL STANDARDS ON AUDITING (ISAs)</b>	
<b>Introductory Matters</b>	
<b>AI 120</b>	Framework of ISAs
<b>Responsibility</b>	
<b>AI 200A</b>	Objective and General Principles Governing an Audit of Financial Statements
<b>AI 200</b>	Objective and General Principles Governing an Audit of Financial Statements
<b>AI 210</b>	Terms of Audit Engagements
<b>AI 220</b>	Quality Control for Audit Work
<b>AI 220R</b>	Quality Control for Audits of Historical Financial Information
<b>AI 230</b>	Documentation
<b>AI 240</b>	Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements
<b>AI 240R</b>	The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements
<b>AI 250</b>	Consideration of Laws and Regulations in an Audit of Financial Statements
<b>AI 260</b>	Communications of Audit Matters with Those Charged with Governance
<b>Planning</b>	
<b>AI 300 (Revised)</b>	Planning an Audit of Financial Statements
<b>AI 310</b>	Knowledge of the Business
<b>AI 315</b>	Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

AI 320	Audit Materiality
AI 330	The Auditor's Procedures in Response to Assesed Risks
<b>Internal Control</b>	
AI 400	Risk Assessments and Internal Control
AI 401	Auditing in a Computer Information Systems Environment
AI 402	Audit Considerations Relating to Entities Using Service Organisations
<b>Audit Evidence</b>	
AI 500	Audit Evidence
AI500R	Audit Evidence
AI 501	Audit Evidence – Additional Considerations for Specific Items
AI 505	External Confirmations
AI 510	Initial Engagements – Opening Balances
AI 520	Analytical Procedures
AI 530	Audit Sampling and Other Selective Testing Procedures
AI 540	Audit of Accounting Estimates
AI 545	Auditing Fair Value Measurements and Disclosure
AI 550	Related Parties
AI 560	Subsequent Events
AI 570	Going Concern
AI 580	Management Representations
<b>Using Work of Others</b>	
AI 600	Using the Work of Another Auditor
AI 610	Considering the Work of Internal Auditing
AI 620	Using the Work of an Expert
<b>Audit Conclusions and Reporting</b>	
AI 700	The Auditor's Report on Financial Statements
AI 710	Comparatives
AI 720	Other Information in Documents Containing Audited Financial Statements
<b>Specialised Area</b>	
AI 800	The Auditor's Report on Special Purpose Audit Engagements

In addition, auditors in Malaysia should follow the standards on professional qualities issued in the by-laws on Professional Conduct and Ethics. This includes consideration of professional qualities such as independence, competence, reporting requirement and evidence.



**ACTIVITY 1.1**

After completing this topic, form into groups and discuss:

Why are professional accountants considered as suitable providers for assurance engagements (i.e. to enhance the quality and credibility of the accounting information)?

**SUMMARY** .....

- Auditor forms an opinion on the true and fair view of the financial statements prepared by the management.
- The final stage in the auditing process is preparing the *audit report*, which is the communication of the auditor’s findings to shareholders.
- Independence auditor’s opinion will enhance the credibility and reliability of the financial statements.
- An audit of financial statements involves the gathering and evaluating of evidence in the form of accounting records and other documents supporting those financial statements.
- It provides a high degree assurance that the financial statements are free from material misstatements and are in accordance to approved accounting standards.

**KEY TERMS** .....

Accounting	Evidence
Auditing	Independence
Audit report	Information risk
Assurance services	Reporting
Competent	

## SELF-TEST 1

.....

1. What is auditing and how is it different from accounting?
2. List four types of audit. Identify four types of auditor and state their duties.
3. Explain how auditing relates to accounting.
4. Describe three fundamental concepts in audit.
5. Distinguish between the management's responsibility and the auditor's responsibility for the audited financial statements of a corporation.

## SELF-TEST 2

.....

1. MHAB Sdn Bhd is a small manufacturing business. Under the provision of the Companies Act 1965, the company is required to have annual audit. The owner of MHAB Sdn. Bhd., En Hilmy has some bookkeeping experience and has personally prepared the company's financial statements. He does not really understand why financial statements should be examined by an independent external party (auditor).

You are requested to discuss the matter with En. Hilmy and to explain an audit is considered important.

- (a) Describes the objectives of an audit.
- (b) What are the benefits derived from an audit?
- (c) Describe how audit mitigate problem associates with agency relationship between absentee owners and managers.
- (d) What are the management assertions?

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# Topic ▶ Auditor's 2 Reports

## LEARNING OUTCOMES

By the end of this topic, you should be able to:

1. Recognise the need for the audit report;
2. Recall the Companies Act, 1965 requirements for audit reporting;
3. Identify the categories of the audit report and describe the different circumstances, which require different types of audit report;
4. Explain the importance of materiality for audit report; and
5. Prepare the modified audit report under a variety of circumstances.

## ▶ INTRODUCTION

If the end product of accounting process is the financial statement, the end product for audit is the audit report. Having conducted substantive tests on the components of the financial statement which will be discussed in the later topics, auditors should be able to form their opinion on the financial statements that they have audited and subsequently issue the audit reports that is normally attached together with the financial statements. Hence, audit report preparation and consideration is the final stage of the audit process. It is however being discussed earlier in the module rather than later to enable the students to refer the various types of the audit report whilst accumulating audit evidence throughout the gathering of the audit evidence. Auditor's report of financial statements of corporations should comply with the provisions of the Companies Act 1965 and requirements of the auditing standards in ISA 700.

In this topic, we will discuss the statutory reporting obligations of auditors by exploring the issue of what is required for financial statements to be adjudged 'true and fair' and what is meant by 'proper accounting records'.

This topic will also examine the format of standard audit reports currently in use and considers the various types of audit opinion the auditor may express and the circumstances in which each is appropriate.

## 2.1 OVERVIEW OF THE TYPES OF AUDIT REPORTS

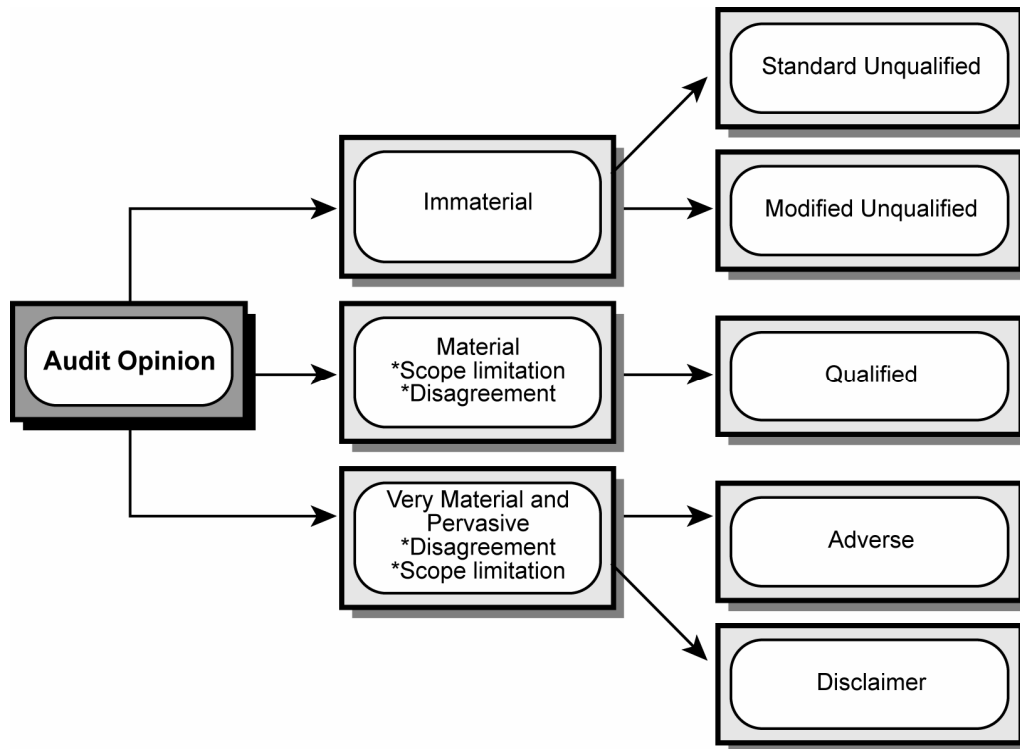


Figure 2.1: Overview of the types of audit reports



### SELF-CHECK 2.1

Why do you think audit report is an important document?

## 2.2 THE NEED FOR AUDIT REPORT

The audit process ends in the auditor's statutory report to shareholders and other users of the audited financial statements. This report is the end product of the audit examination and communicates to users of the financial statements the auditor's conclusion about, among other things, the truth and fairness with which the statement portray the entity's financial position and performance and compliance (or otherwise) of the financial statement with relevant legislation. The auditor also provides a report to the entity's management, known as a management letter.



### SELF-CHECK 2.2

Can you think of the reasons for audit report to accompany financial statements?

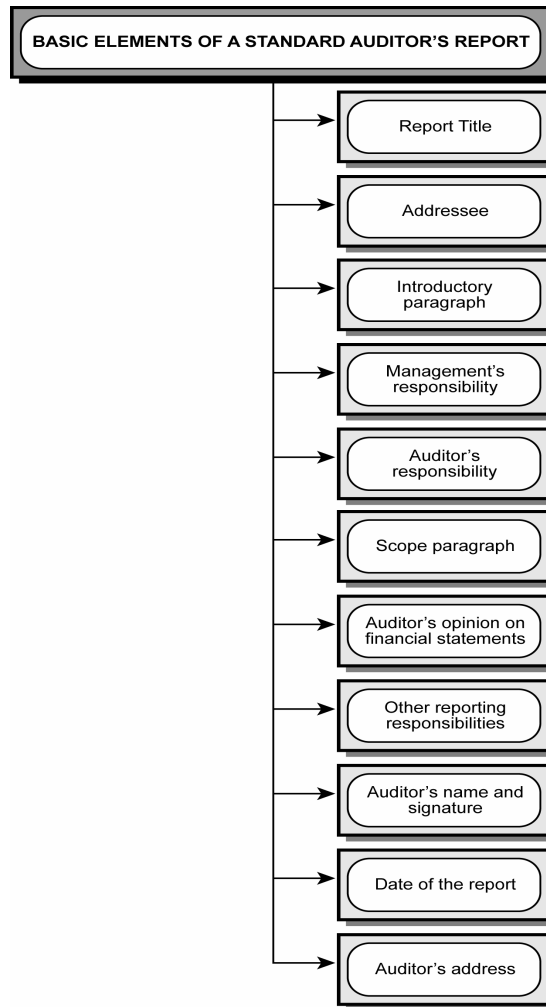
1. \_\_\_\_\_
2. \_\_\_\_\_
3. \_\_\_\_\_

What are the implications of relying on an unaudited financial statement?

1. \_\_\_\_\_
2. \_\_\_\_\_
3. \_\_\_\_\_

## 2.3 LEGAL REQUIREMENT ON AUDITORS REPORT

ISA 700 sets out the requirements on the form and content of a standard auditor's report. This is important in order to promote user's understanding and to identify unusual circumstances when they occur. A standard auditors' report on financial statements should include the basic elements as demonstrated in Figure 2.2.



**Figure 2.2:** Basic elements of a standard auditors' report on financial statements

Figure 2.2 presents an example of a standard unqualified auditors' report showing the basic elements discussed above.

The Companies Act, 1965 places a major duty on auditors as well as the company directors. First it specifies that the directors of every company must prepare the financial statements that meet the statutory requirement. The main requirement regarding the audit report is prescribed in Companies Act, 1965 given in Section 174. This section will further illustrate the specific requirement under Section 174.

(a) **Section 174 (2)(a) and (b)**

This section sets out the basic requirement relating to the auditor's reporting duties and according to this section, the auditor is required to state the following:

- (i) In his opinion, whether the financial statements are properly drawn up;
  - So as to give a true and fair view of the matters required by Section 169 to be dealt with in the financial statements;
  - In accordance with the provisions of the Act so as to give a true and fair view of the company's state of affairs and result operations; and
  - In accordance with applicable approved accounting standards.
- (ii) In his/her opinion, whether the accounting and other records and the registers required by the Act to be kept by the company have been properly kept in accordance with the provisions of the Act.

(b) **Section 174 (3)**

This section requires the auditor to form his/her opinion on the following:

- (i) Whether he has obtained all the information and explanations that he required;
- (ii) Whether proper accounting and other records (including registers have been kept by the company as required by the Act);
- (iii) Whether the returns received from branch offices of the company are adequate; and
- (iv) In the case of consolidated financial statements, whether the procedures and methods used by a holding company or a subsidiary in arriving at the amount taken into any consolidated financial statements were appropriate to the circumstances of the consolidation.

## 2.4 STANDARD UNQUALIFIED AUDIT REPORT

This is the most common type of auditor's report issued by the auditors when the management assertions (with regards to the financial statement) are usually found to conform to the requirements of the reporting framework (Financial Reporting Act 1997, generally referred to MASB approved accounting standards). The standard unqualified audit report will be issued by the auditors when there is affirmation of the requirements of each aspect of the reporting framework. Thus, that the auditor is satisfied that the financial statements present a true and fair view in accordance with the provision of the Companies Act, 1965 as well as the audit has been performed in accordance with the approved standards of auditing in Malaysia. An example of a standard unqualified audit report is shown in Figure 2.3. Next, the standard unqualified audit report, which is made up of several elements will be explained.

<b>Elements</b>		
<b>Report of the Auditor to the Members of Forster Bhd. (Incorporated in Malaysia)</b>	Report title and Addressee	
<p>We have audited the financial statements of Forster Bhd set out on pages _ to _, comprising of the balance sheet of the company and the notes to the accounts as at 31st December 2006 and the Income Statement and the Cash Flow Statement of the company for the year ended on that date. The preparations of the financial statements are the responsibility of the company directors. Our responsibility is to express opinion on the financial statement based on our audit.</p>	Introductory Paragraph	
<p>We conducted our audit in accordance with approved Standards on Auditing. Those standards require that we plan and perform the audit to obtain all the information and explanation, which we considered necessary to provide us with sufficient evidence to give reasonable assurance that the financial statements are free of material misstatement. Our audit includes examining, on a test basis, evidence relevant to the amounts and disclosures in the financial statements. Our audit includes assessment of accounting principles used and significant estimates made by the directors as well as evaluating of the adequacy of the presentation of the information in the financial statements. We believe our audit provides a reasonable basis for our opinion.</p>	Scope Paragraph	
<p>In our opinion:</p> <p>(a) the financial statements which have been prepared under the historical cost convention, as modified by the revaluation of certain assets, are properly drawn up in accordance with the provisions of the Companies Act, 1965 and applicable approved accounting standards so as to give a true and fair view of:</p> <p style="margin-left: 40px;">(i) the matters required by Section 169 of the Companies Act, 1965 to be dealt with in the accounts of the company; and</p> <p style="margin-left: 40px;">(ii) the state of affairs of the company as at 31<sup>st</sup> December 1997 and the results of the operations of the company and of the cash flows of the company for the year ended on that date; and</p> <p>(b) the accounting and other records and the registers required by the Companies Act, 1965 to be kept by the company have been properly kept in accordance with the provisions of the said Act.</p>	Opinion Paragraph	
<p>Zamri &amp; Co Firm No: xxxx Public Accountants Kuala Lumpur 12 March 2007</p>	<p>Zamri Hassan Partner Approval No: xxxx</p>	Name of the Auditor
		Address and Date

**Figure 2.3:** Standard unqualified audit report

## 2.4.1 Elements of Standard Unqualified Audit Report

Please refer to Table 2.1 that explains in detail the elements of a standard unqualified audit report.

**Table 2.1:** Elements of a Standard Unqualified Audit Report

<b>Report Title</b>	The auditor's report should have an appropriate title to ensure that it is clear to the users of the financial statement audited. It may be appropriate to use the term 'independent auditor's report' in the title to distinguish the auditor's report from the reports that might be laid before the company at its annual general meeting besides the financial statements and the audit report, such as directors' and/or management's reports.
<b>Addressee</b>	The auditor's report should be appropriately addressed. Under the Companies Act, 1965, the auditor is required to address the report to the shareholders or members of the company whose financial statements are being audited.
<b>Opening or Introductory Paragraph</b>	<p>The first paragraph of the report addresses three pertinent points;</p> <ul style="list-style-type: none"> <li>(i) To make a simple statement that the public accounting firm has done an audit in order to distinguish the report from any other compilation or review type report.</li> <li>(ii) To identify the financial statements that were audited, including the balance sheet date and the accounting period for the Income Statement and the cash flow statement. These statements are referred to specifically in the audit report.</li> <li>(iii) Finally the introductory paragraph distinguishes the responsibilities of the auditor as well as the company by clearly stating that the preparation of the financial statements are the responsibility of the management whilst the responsibility of the auditor is to express an opinion on the financial statements based on an audit.</li> </ul> <p>The purpose of these statements is to communicate that the management is responsible for selecting the appropriate approved accounting standards and making the measurement decisions and disclosures in applying those standards, and to clarify the respective roles of management and the auditor.</p> <p>Under Section 167(1) of the Companies Act, the directors and managers of a company are responsible for the maintenance of the accounting and other records of the company so as to enable true and fair accounts to be prepared. It is also their responsibility to keep the accounts in such manner as to enable them to be conveniently and properly audited.</p>

<p><b>Scope Paragraph</b></p>	<p>This is a factual statement about the things undertaken by the auditor in the audit. The paragraph mentioned the fact that the auditors followed approved standards on auditing before went describing the pertinent aspects of the financial statements audit.</p> <p>Two important areas mentioned in this paragraph are that the audit is designed to obtain reasonable assurance about whether the financial statements are free of material misstatement. Reasonable assurance is to specify that it is impossible for auditors to be expected to remove the possibility that material misstatements will still be in the financial statements. Here it is important to note that audit is therefore not a guarantee that misstatement will not exist in the financial statements. Instead, audit is just providing a high level of assurance. The word material indicates that the auditor is only responsible for looking for significant misstatements rather than insignificant misstatements that do not affect users' decision making. The concept of materiality will be explained in greater detail later in the topic.</p>
<p><b>Opinion Paragraph</b></p>	<p>The opinion report in the standard paragraph states the auditor's conclusion based on the results of the audit. It should contain the auditor's opinion as to whether the accounts give a true and fair view in accordance with approved accounting standards and whether the accounts comply with the Companies Act. This part of the report is so important that frequently the entire audit report is referred to as the auditor's opinion. The opinion paragraph is stated as an opinion rather than an absolute fact or a guarantee. The intent is to indicate that the conclusions are based on professional judgment. Hence, there may be some information risk associated with the financial statements, even though the statements have been audited.</p>
<p><b>Name and Signature of the Auditor</b></p>	<p>The audit report is signed in the name of the public accounting firm and the name of the auditor. Typically, the firm's name is given as well as the firm's number. The firm's name is given since the entire public accounting firm has the legal and professional responsibility to ensure that the quality of audit meets professional standards. In addition, the Companies Regulation also requires that the auditor's approval number granted with the audit license be stated in the audit report.</p>
<p><b>Auditor's Address</b></p>	<p>The audit report specifies the city in which the auditor's office is located.</p>

<b>Date</b>	The appropriate date for the report is the one on which the auditor has completed most important audit procedures in the field. The date is important to users because it indicates the last day of the auditor's responsibility for the review of significant events that occurred after the date of the financial statements that would have an impact on the audited accounts. Since the auditor's responsibility is to report on the financial statements for which the directors are responsible, the auditor should not date the report earlier than the date on which the financial statements are approved by the directors.
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## 2.5 UNQUALIFIED WITH EXPLANATORY PARAGRAPH

These reports normally meet the criteria of a complete audit with satisfactory results and financial statements that give a true and fair view, but the auditor believes it is important, or is required, to provide additional information. It is therefore necessary for the audit to draw the reader's attention to the matter which being explained in the notes to the financial statement. In this type of report, an emphasis of matter paragraph is included after the opinion paragraph which would reflect the auditor's opinion. It is important to remember that the additional paragraph does not affect the auditor's opinion; hence the auditor's report issued is still unqualified.

There are several circumstances, where the addition of an explanatory paragraph or modification in the wording of the unqualified standards reports may be appropriate, such as follows:

- (a) Emphasis of matter or significant uncertainty;
- (b) Auditor agrees with a departure from approved accounting standard; and
- (c) Substantial doubt about going concern.

### 2.5.1 Emphasis of Matter

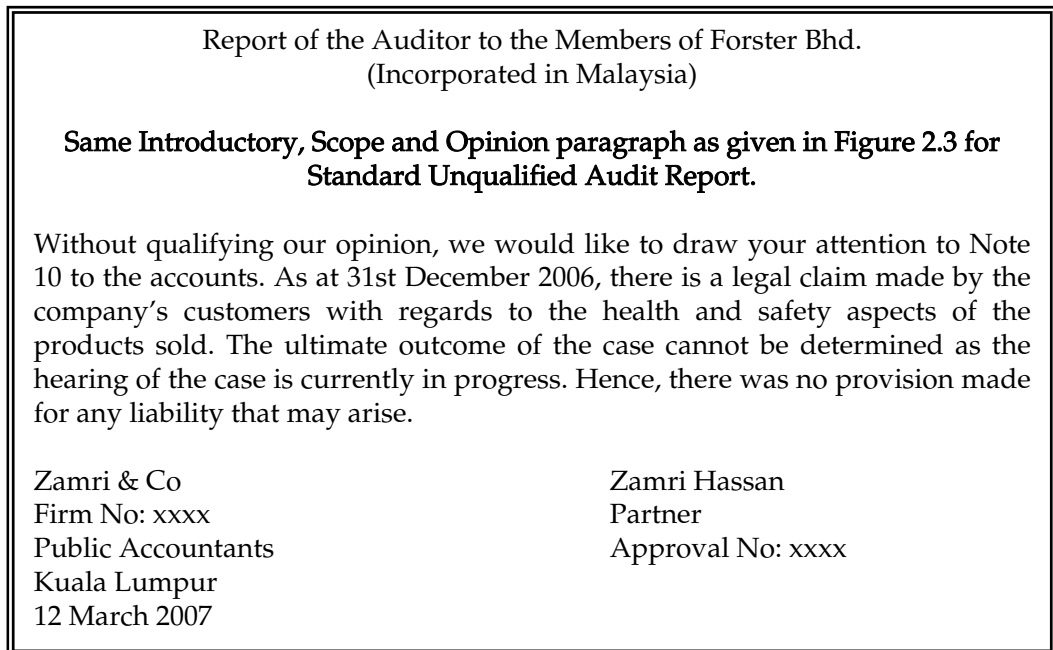
In some situations, the auditor may wish to emphasise specific matters regarding the financial statements, even though he or she intends to express an unqualified opinion. These are normally relating to significant uncertainties other than those regarding going concern issues. Such explanatory information should be included in a separate paragraph in the report after the opinion paragraph. The characteristics of an uncertainty are such that its outcome is dependent on the occurrence or non-occurrence of future events which is not directly controllable by the company. Areas which may give rise to emphasis of matter are such as the

existence of significant related party transaction, significant events occurring after the balance sheet date and the description of accounting matters affecting the comparability of the financial statements with those of the preceding year.

The unqualified report modified with an emphasis of matter paragraph meets the criteria of a complete audit with financial statements showing a true and fair view, but the auditor feels it is important to provide additional information to highlight a matter, already disclosed in the financial statement, in his/her report. In a qualified, adverse or disclaimer report, the audit has either performed a satisfactory audit or is not satisfied that the financial statements give a true and fair view.

## 2.5.2 Auditor Agrees with a Departure from an Approved Accounting Standard

In unusual situations, a departure from an approved accounting standard may be necessary in order to present a true and fair view of the financial statements. In this situation, non-compliance with approved accounting standard would ordinarily give rise to a qualified or adverse opinion. Figure 2.4 exhibits an unqualified report with explanatory paragraph.



**Figure 2.4:** Unqualified report with explanatory paragraph

### 2.5.3 Substantial Doubt about Going Concern

In view of the large number of companies which in recent years have been forced into insolvent liquidation due to financial difficulty, auditors should take positive steps to investigate the company's post-balance sheet 'health' before simply assuming that it is viable as an ongoing entity. Hence this requires an active search rather than a passive approach. If in the event that the auditor is concerned about going concern issues of the client's business, ISA 700 requires the auditor to bring this to light by adding another paragraph in the auditor's report. Although the purpose of the audit is not to evaluate the financial health of the business, the auditor has the responsibility to evaluate whether the client company is likely to continue as a going concern.

Going concern concept is an assumption that the entity will continue as a going concern in the foreseeable future. ISA 570 states that the auditor should look out for events or conditions which may render the going concern assumption inappropriate or cast doubt on the entity's ability to continue as a going concern.

The guidance, with regards to going concern issues, has been given in ISA 570, as well as the indication to be considered by the auditor in evaluating going concerns. The **guidance and indications** are as follows:

(a) **Financial Indicators**

- Net liability or net current liability position;
- Fixed term borrowing approaching maturity without realistic prospects or renewal or repayment, or excessive reliance on short-term borrowings to finance long-term assets;
- Adverse key financial ratios;
- Substantial operating losses;
- Arrears or discontinuance of dividends;
- Inability to pay the creditor on due dates;
- Difficulty in complying with the terms of loan agreements;
- Change from credit to cash-on-delivery transaction with suppliers; and
- Inability to obtain financing for essential new product development or other essential investments.

(b) **Operating Indicators**

- Loss of key management without replacement;
- Loss of major market, franchise, license or principal supplier; and
- Labour difficulties or shortage of important supplies.

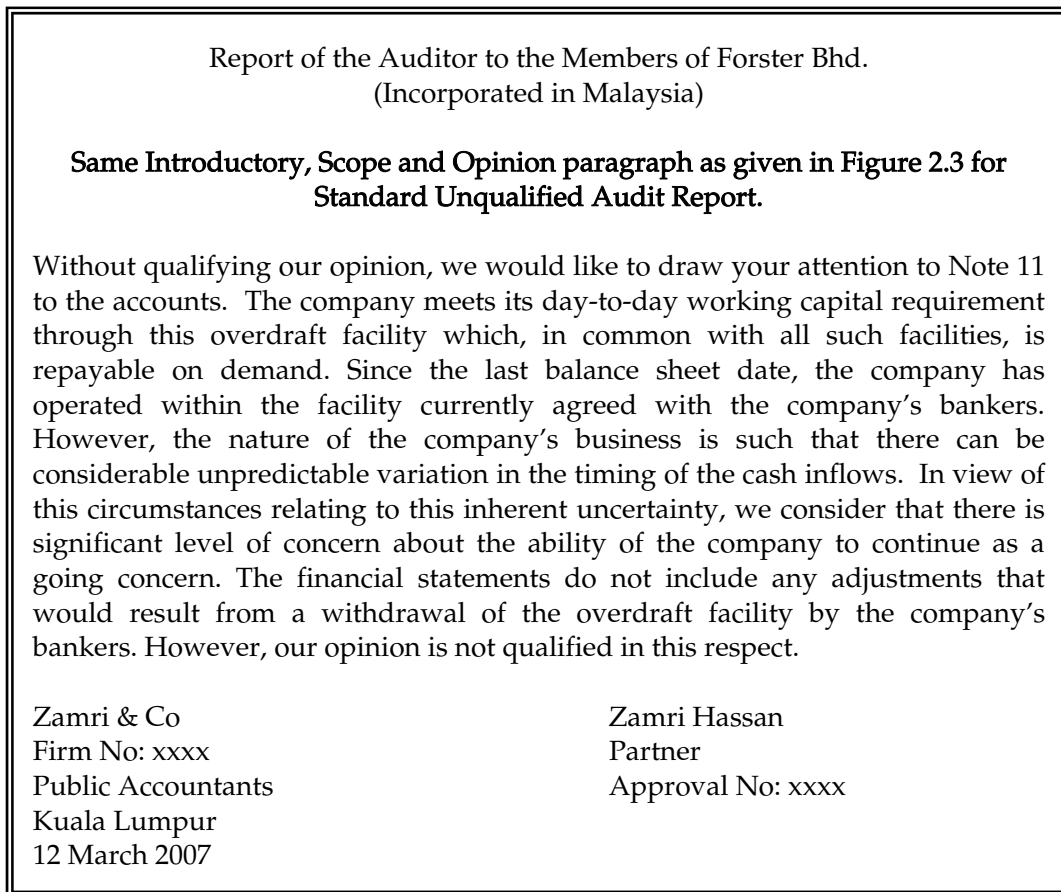
(c) **Others**

- Non-compliance with capital or other statutory requirements;
- Pending legal proceedings against the entity that may, if successful, result in judgments that could not be met; and
- Changes in legislation or government policy.

Furthermore, should the presence of one or more of such items prompt the auditors' concern, they should, at the very least:

- (i) Compare the client's cash flow forecast with the overdraft or other loan facilities available for up to twelve months from the accounting date;
- (ii) If there is any holding company, obtain a written confirmation from the company's board of directors (if any), which intends its subsidiary to continue its business and will not withdraw existing finance facilities; and
- (iii) Enquire into and obtain written evidence of the steps (if any) the client is taking in order to correct its decline in fortunes.

According to ISA 700, if adequate disclosures are made in the financial statements, the auditor should ordinarily express an unqualified audit opinion and modify the auditor's report by adding an emphasis of a matter paragraph that highlights the going concern problem by drawing the attention to the note in the financial statements that discloses matters relating to the going concern issue. On the other hand, if there is insufficient disclosure made, a qualified or adverse opinion must be expressed. Figure 2.5 shows an unqualified report with an explanatory paragraph.



**Figure 2.5:** Unqualified report with an explanatory paragraph

## 2.5.4 Conditions Requiring Departure from Unqualified Audit Report

There are several situations in which require departure from unqualified audit reports namely, inherent uncertainty, disagreement and scope limitation.

(a) **Inherent Uncertainty**

This includes situations which might affect the financial statement and which by their nature rather than by limitations in the scope of the audit, means that their outcome cannot be objectively or reasonably determined which includes situations regarding going concern or the outcome of long term contracts. These situations normally involve reasonable estimates such as judgments regarding saleability of stocks or collect ability of debts.

**(b) Limitation on the Scope of the Audit**

Limitation normally arises when the auditor is not able to obtain for any reason, all the information and explanation which he considers necessary for the audit. This would include inability to carry out procedures considered necessary or the absence of proper documents or accounting records. There are two major categories of scope limitations:

- (i) Caused by restrictions imposed by clients. For example, the management refusal to permit the auditor to obtain direct confirmation for material receivables or to physically examine inventory.
- (ii) Caused by circumstances beyond either the client's or auditor's control, such as when the engagement has not been agreed upon until after the client's year end and as a consequence, was unable to attend the previous year's stock take or confirm receivables or perform other important procedures after the balance sheet date.

**(c) Disagreement**

Disagreement arises in the situations where the auditor is able to form an opinion but this opinion differs from the view expressed by the management in the financial statements. Examples of situations which would give rise to disagreements are such as:

- (i) Non-compliance with the provisions of the Companies Act, 1965 and other legislation.
- (ii) Non-conformity with the accounting standards.
- (iii) Disagreements with facts or amounts included in the financial statements.
- (iv) Inadequate disclosure of facts or amounts included in the financial statements.

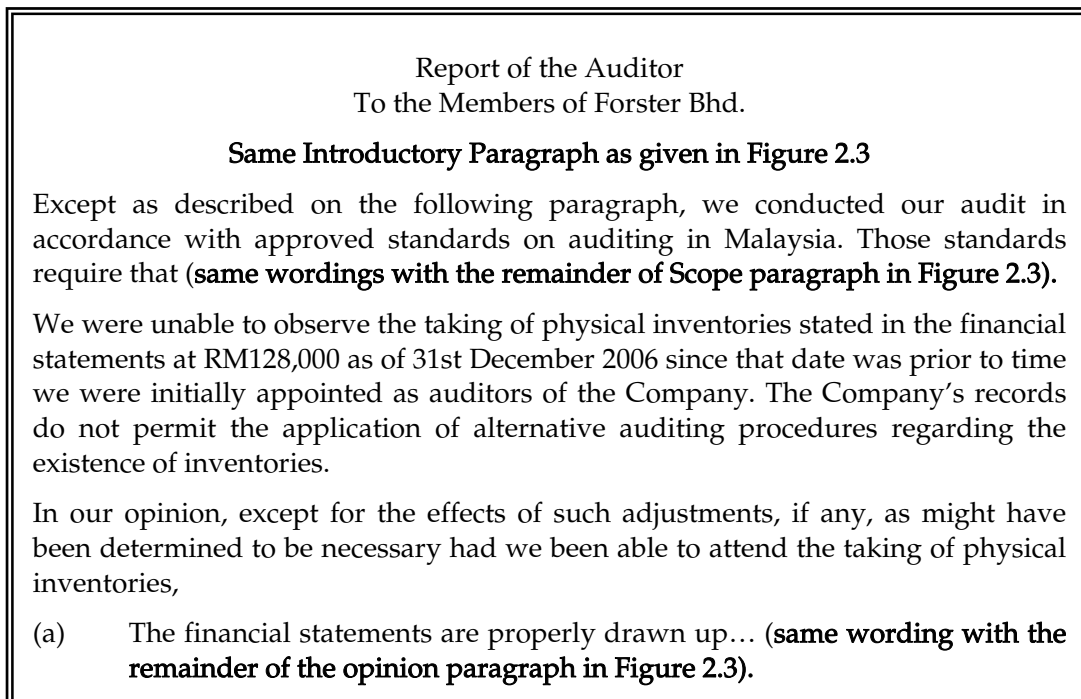
In certain exceptional circumstances, the auditor may reach the opinion that is in compliance or applicable with the provisions of legislation. Hence, approved accounting means that the financial statements do not give a true and fair view. Since true and fair view is the primary objective in the preparation of the financial statements, it is overriding when in conflict with legislation or approved accounting standards.

## 2.6 QUALIFIED

A qualified opinion report can result from an inherent uncertainty, a limitation on the scope of the audit or a disagreement. A qualified opinion can be used only when the auditor concludes that the overall financial statements give a true and

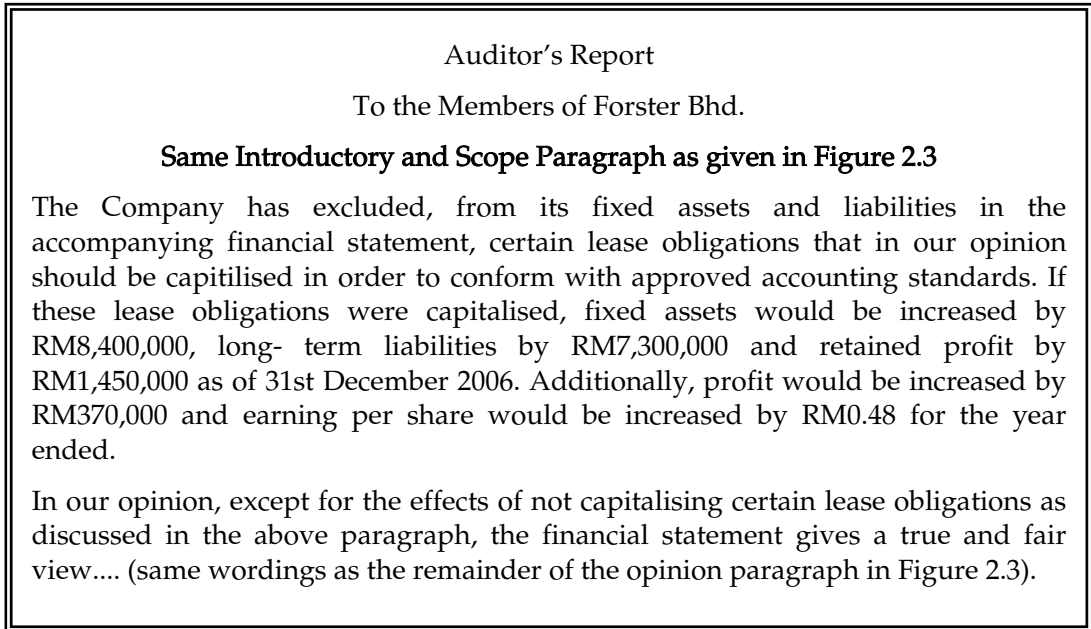
fair view. A disclaimer or an adverse report must be used if the auditor believes that the condition being reported upon is material and pervasive. For this reason, the qualified opinion is considered the least severe type of departure from an unqualified report.

A qualified report can take in the form of a **qualification of both the scope and the opinion or of the opinion alone**. A scope and opinion qualification can be issued only when the audit has not been able to accumulate all the evidence required by approved auditing standards. Therefore, this type of qualification is used when the auditor's scope has been restricted by the client or when circumstances exist that prevents the auditor from conducting a complete audit. The use of a qualification of the opinion alone is applicable to those situations in which the financial statements are not stated in accordance with a particular approved accounting standard or are not in compliance with certain provisions of the Act. This therefore means that the opinion of the auditors that the overall financial statement is true and fair, hence the opinion paragraph will be modified with 'except for'. Figure 2.6 displays a qualified auditor's report with scope limitation.



**Figure 2.6:** Qualified auditor's report – scope limitation

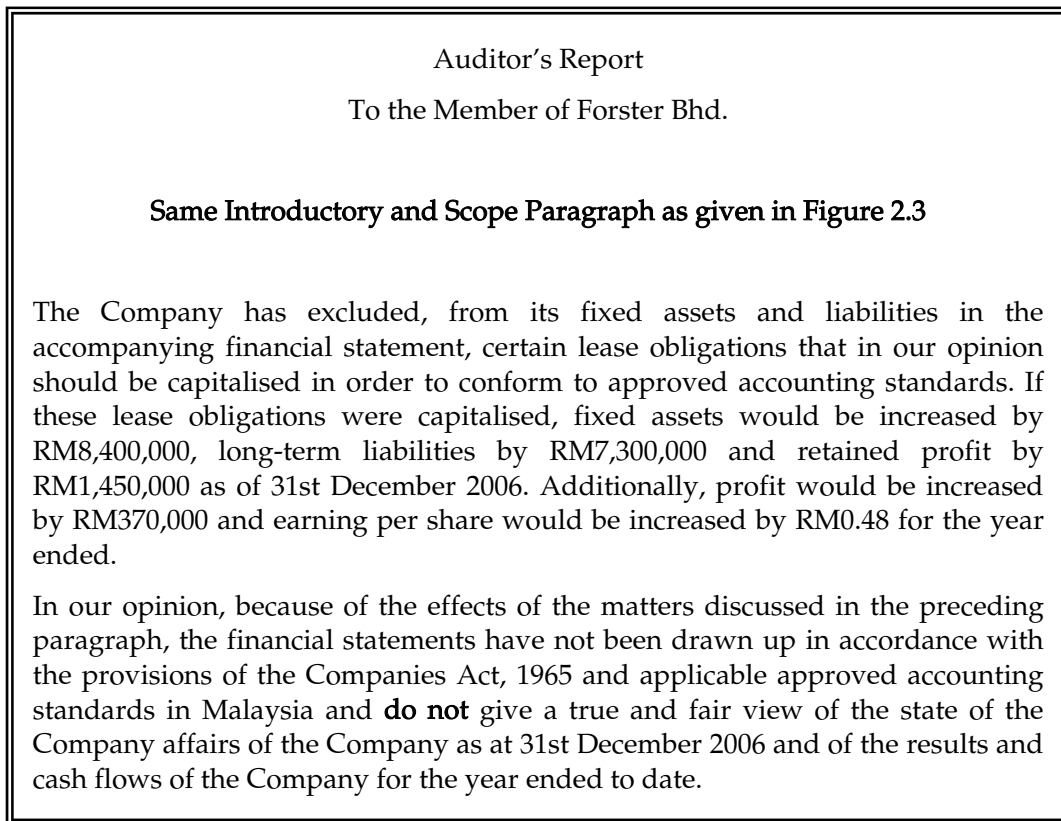
Figure 2.7 displays qualified auditor's report with disagreement.



**Figure 2.7:** Qualified auditor's report – disagreement

## 2.7 ADVERSE

An adverse opinion is used only when the auditor believes that the overall financial statements are so materially misstated or misleading that they do not present a true and fair view of the financial positions or results of operations and cash flows in conformity with approved accounting standards. This adverse opinion report can only arise when the auditor disagree and the effect of the disagreement is so material and pervasive that the financial statement *do not give a true and fair view* in accordance with approved accounting standards. In this case, the non-compliance with accounting standard is so significant that it affects the overall financial statement. Figure 2.8 displays an auditor's report with adverse opinion.



**Figure 2.8:** Adverse opinion

## 2.8 DISCLAIMER

A disclaimer is issued whenever the auditor has been unable to satisfy himself or herself that the overall financial statements show a true and fair view. The necessity for disclaiming an opinion may arise because of severe limitation on the scope of the audit. This occurs when the possible effect of a scope limitation is so material and pervasive that the auditor has not been able to form an opinion on the financial statement. According to ISA 570, the auditor also has an option, but it not required to issue a disclaimer of opinion for a going concern uncertainty.

A disclaimer of opinion is distinguished from an adverse opinion in that the former can arise only from a lack of knowledge by the auditor, whereas to express an adverse opinion, the auditor must have conclusive knowledge that the financial statements do not present a true and fair view. Both disclaimers and adverse opinions are used only when the condition is highly material and pervasive. Figure 2.9 shows an auditor's report with disclaimer opinion.

**Auditor's Report**  
**To the Member of Forster Bhd.**

We have audited the financial statement set out on pages \_\_ to \_\_. These financial statements are the responsibility of the Company's directors. **(Omit the sentences stating the responsibility of the auditor)**

**(Scope paragraph of standard report should be omitted or amended according to the circumstances)**

We were unable to confirm the account receivables as well as observe all the physical inventories as of the 31st December 2006 due to the limitation of scope placed on us by the Company.

Because of the significance of the matters discussed in the preceding paragraph, we are unable to express our opinion on the financial statements.

**Figure 2.9:** Disclaimer opinion

The auditor should consider the combined effects of all the uncertainties and disagreements when deciding on the form of audit opinion and should refer to all material-matters about which he has reservations. As stated in ISA 700, whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effects on the financial statement. Ordinarily, this information would be set out in a separate paragraph preceding the opinion and may include a reference to a more extensive discussion, if any, in a note to the financial statements. Refer to Table 2.2 for an example.

**Table 2.2:** Information of Substantive Reasons in the Report

<b>Circumstances</b>	<b>Not So Material and Pervasive</b>	<b>Material and Pervasive</b>
Inherent Uncertainty	Except for/Modified	Disclaimer
Limitation Scope of Audit	Except for	Disclaimer of opinion
Disagreement	Except for	Adverse Opinion

## 2.9 REPORTING ON ACCOUNTING AND OTHER RECORDS

When the auditor is not able to issue an unqualified opinion on the balance sheet and profit and loss account, he considers whether his opinions extends to the accounting and other records as required by Section 174(2)(b) of the Companies Act 1965 and the statement of changes in financial position required by the Ninth Schedule.

It is conceivable that the accounting and other records are properly kept in accordance with the Act even when the opinion regarding the accounts requires qualification. Table 2.3 below shows the form of report that may be issued when the auditor finds exception in the accounting and other records.

**Table 2.3:** Form of Report Issued When The Auditor Finds Exception in the Accounting and other Records

Circumstances	Not so Material and Pervasive	Material & Pervasive
Scope Limitation	Not applicable S174(2) & (3)	Disclaimer S174(2)(a) &(b) S174(4) & S174(5)
Disagreement	Not applicable under S174	Adverse opinion

Notice that in the Table 2.3, the concept of 'material but not pervasive' does not operate, as Section 174 is specific in that accounting and other records are either kept in accordance with the Act or they are not. Thus, unless the records are unavailable for the same reason the auditor's duties clearly require either an adverse or an unqualified opinion. A disclaimer of opinion regarding accounting records would indicate that the auditor has not had a satisfactory access to those records. This would normally lead to a general disclaimer on the balance sheet and income statement and cash flow statement.

## 2.10 THE CONCEPT OF MATERIALITY – A BRIEF INTRODUCTION

Materiality can be defined as 'a misstatement in the financial statements if knowledge of the misstatement would affect a decision of a reasonable user of the statements'. In applying the materiality concept in the auditing context, there

are three levels of materiality being used to determine the type of audit opinion to issue.

(a) **Amounts are Immaterial**

When a misstatement in the financial statement exists, but it is unlikely to affect the decisions of a reasonable user, it is considered to be immaterial. An unqualified opinion is therefore appropriate. For example, assume that management recorded an unexpired insurance as an asset in the previous year and decides to expense it in the current year to reduce record keeping costs. Management has failed to follow approved accounting standards and has not applied approved accounting standards consistently, but if the amounts are small, the misstatement would be immaterial and an unqualified audit report would be appropriate.

(b) **Amounts are Material but not Pervasive**

The second level of materiality exist when a misstatement in the financial statements would affect a user's decision but the overall statements still present a true and fair view, and therefore useful. For example, knowledge about a large misstatement of inventory might affect a user's willingness to loan money to the company if the inventory were the collateral. However, this misstatement does not mean the cash, accounts receivable and other elements of the financial statements or the financial statements as a whole are materially incorrect.

To make materiality decisions when a condition requiring a departure from an unqualified report exists, the auditor must evaluate all effects on the financial statements. Assume that the auditor is unable to justify himself or herself whether inventory is fairly stated in deciding on the appropriate type of opinion. Because of the effect of a misstatement in inventory on other accounts and on totals in the statement, the auditor needs to consider the materiality of the combined effect of inventory, total current assets, total working capital, total assets and other components of the financial statement.

(c) **Amounts are so Material and Pervasive that the Overall Truth and Fairness of the Financial Statements is in Question**

The highest level of materiality exists when users are likely to make incorrect decisions if they rely on the overall financial statement. To return to the previous example, if inventory is the largest balance on the financial statements, a large misstatement would probably be so material that the auditor's report should indicate that the financial statements taken as a whole cannot be considered to give a true and fair view. When the highest level of materiality exists, the auditor must issue either a disclaimer or opinion or an adverse opinion depending on the attending circumstances.

When determining whether a misstatement is pervasive, the extent to which the misstatement affects different parts of the financial statement must be considered which is normally referred to as *pervasiveness*. A misclassification between cash and accounts receivable affects only those two accounts and is therefore not pervasive. On the other hand, failure to record a material sale is highly pervasive in that it affects sales, accounts receivable, income tax and etc.

A misstatement becomes more pervasive, the likelihood of issuing an adverse opinion rather than a qualified opinion increases. For example, suppose the auditor decides a misclassification between cash and accounts receivable should result in a qualified opinion because it is material, the failure to record a sale of the same amount may result in an adverse opinion because of pervasiveness.

## SUMMARY

- This topic has outlined several types of the auditor's report in use including standard unqualified, unqualified with explanatory paragraph, qualified, adverse and disclaimer including the situations which may give rise to the audit opinions other than unqualified opinion.
- It is very important for the preparers of the financial statement to understand the different responsibilities of the auditor and the Company management.
- Several new terms in the auditor's report context have been introduced and explained.

## KEY TERMS

Disagreement

Inherent uncertainty

Limitation of scope

**SELF-TEST 1** .....

1. Briefly explain on the importance of auditor's report to users of the financial statement.
2. What are the basic elements of the standard unqualified auditor's report?
3. Explain the purpose of the scope and the opinion paragraph.
4. Differentiate between standard unqualified and unqualified with explanatory paragraph auditor's report.
5. Distinguish between client-imposed and circumstance-imposed scope limitation. In your opinion, why is one more serious than the other?
6. Consider and describe the form of an unqualified or qualified audit report you would give in each of the following situations:
  - (a) On Syarikat Jaya's financial statement if you agree with the director's statement about the uncertainty relating to the value of the tangible fixed assets of the company.
  - (b) On Syarikat Jaya's financial statement if you have come to the conclusion that trading condition will not improve and the company will have to close the company.
  - (c) On Giant Supermarket Bhd's financial statement if the significant uncertainty about the misappropriation of inventory and cash takings relates only to the sale of fresh fruit and vegetables which comprise 10% of the company's sales.

**SELF-TEST 2** .....

Given below are several independent situations that you faced when auditing the companies. By giving reasons, state the most appropriate audit opinion:

1. Fast Movers Sdn. Bhd. has been audited by your public firm for the past five years. In the last three years, the financial condition of the Company has deteriorated. For the first time, the current ratio for the year under review is less than 2.1 which is the minimum requirement specified in Fast Mover's major loan agreement. You now have reservations in the ability of Fast Movers to continue as a going concern.
2. Your client, Noel Sdn. Bhd. has changed from straight line to reducing balance depreciation method. Although the effect on the current year's

income is immaterial, but the effects in the future years are likely to be material. The matters however have been adequately disclosed in the notes to the accounts.

3. The financial controller of Medina Sdn. Bhd. did not allow you to confirm the receivable balance from several of its major suppliers. You were unable to satisfy yourself as to the receivable balance from other alternative procedures and the amount of the receivable is material in relation to Medina's financial statement.
4. The management of Tastees Bhd., a public listed company has decided not to disclose a major related party transaction because the management feels that such disclosure is confidential and sensitive.
5. On 31<sup>st</sup> January 2007, Hanson Toys hired your firm to audit the company's financial statements for the year ended 2006. You were unable to observe the client's inventory on 31<sup>st</sup> December 2006 but were able to satisfy yourself about the inventory balance using alternative procedures.
6. You are auditing Hyperama Materials Bhd. for the year ended 31<sup>st</sup> December 2006. The company is a defendant in a lawsuit involving breach of contract. Upon consultation with the company's legal counsel, it was discovered that they are of the opinion that the company is likely to be liable, but the company does not want to disclose this information in the financial statement.
7. During the year 2006 audit of Exotic Sdn. Bhd., the company had its freehold land and buildings appraised by an independent professional valuer. The increase in the carrying amount of the property and building has been credited to reserves.

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# Topic 3 ▶ Audit Planning and Evidence

## LEARNING OUTCOMES

By the end of this topic, you should be able to:

1. Discuss the importance of audit planning;
2. Explain the nature of evidence;
3. Define audit evidence;
4. Identify the types of audit procedures;
5. Describe the use of analytical procedures; and
6. Justify how the auditor evaluates audit evidence.

## ▶ INTRODUCTION

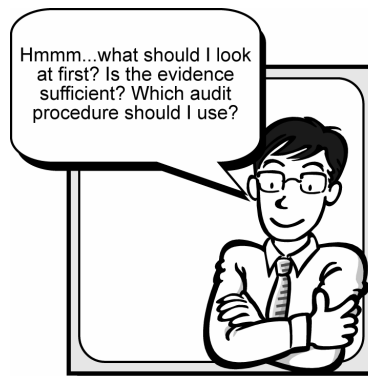


Figure 3.1: Audit planning

In Topic 3, we are going to discuss about audit planning and evidence. To begin our discussion, take note that ISA 300 states that an auditor should plan the audit

work so that the audit will be performed in an effective manner. Figure 3.1 illustrates how an auditor plans his/her work. This topic will explain the major parts involved in audit planning, evidence accumulation and audit decision making. It will also discuss the use of analytical procedures in audit planning as one of the types of audit procedures. Please look at the following scenario.

Osman Jailani is an audit partner in the Osman, Kassim and Yeoh firm. He has reviewed the audit files for the audit of a new client, Tambi Sdn. Bhd., which is a computer components' provider to a local computer manufacturing company. Osman has conducted his first review after the field work has been almost completed. Normally, he would have conducted an initial review during the planning phase. However, due to the time constraints to complete the audit of a big client, he merely asked his newly-promoted manager, Shima, to perform the whole part of the audit planning for this new client.

Now, Osman finds that he is confronted with a couple of problems. First, the firm has accepted Tambi Sdn. Bhd. without following the new-client acceptance procedures, where no communication has been initiated to the predecessor audit firm. Second, the review to Shima's audit file revealed that Shima has noted "contact the predecessor" but found no indication that it was done. Osman is very worried about the possible risk to the firm arising from these problems.

### 3.1 IMPORTANCE OF AUDIT PLANNING

The problems highlighted above are some of the examples that the audit firm may experience if the adequate planning do not take place in an audit. There are three important reasons why the auditor should properly plan the audit. They are as follows:

- (i) To enable the auditor to obtain sufficient appropriate audit evidence;
- (ii) To minimise the audit costs; and
- (iii) To avoid misunderstandings with the client.

Obtaining sufficient appropriate audit evidence is essential to minimise legal liabilities and to maintain good reputation in the business industry. We will discuss in detail on the sufficiency and appropriateness of audit evidence later in this topic. Keeping cost reasonable will increase competitiveness of the firm, and avoiding misunderstandings with the client is important for facilitating high-quality work at reasonable costs.



### SELF-CHECK 3.1

1. What are the auditor's major considerations in planning an audit?
2. How would the understanding of the concept of materiality and audit risk help the auditor perform the audit effectively?

## 3.2 PREPLANNING

**Preplanning** or **initial audit planning** involves four activities. First, the auditor decides whether to accept a new client or continue serving existing client. Second, the auditor identifies client's reason for audit. Third, the auditor obtains an understanding with the client about the terms of the engagement to avoid misunderstandings. Finally, the staff of the engagement is selected, including the need to use audit specialists.

### 3.2.1 Client Acceptance and Continuance

An audit firm must exercise reasonable care in deciding which client is acceptable. Among the criterion that needs to be considered is the client standing in the business community, client's financial stability and client's relation with previous accounting firm. It is important also for the successor firm to communicate with the predecessor to enquire whether there is any professional or other reasons for the proposed change of which the successor firm need to be aware and to request for all the details. This information will help the successor auditor evaluate whether to accept the client. Consequently, the communication may reveal, for instance, the client's lack of integrity, illegal acts or any dispute over accounting practices. Upon receipt of the request from the successor auditor, predecessor is required by *By-Laws B-8.3(3) (b) (Changes in Professional Appointments)* to seek permission from the client to respond to the successor auditor.

Many audit firms also evaluate their existing client to determine whether they should continue to audit the client. Client's lack of integrity, disputes over accounting practices, scope limitation or unpaid audit fees may be a reasonable ground for the auditor not to accept the client. Even if is no such problem exists, the audit firm may decide not to continue doing audit for a client if the acceptable audit risk is below the accounting firm's threshold. We will discuss about the audit risk in the subsequent section in this topic. Additionally, the auditors are encouraged to not continuously audit the same client to prevent

possible impairment to auditor independence. Hence, it is necessary for the company to switch auditor after certain interval.

### **3.2.2 Identify Client's Reason for Audit**

Apart from compliance to the statutory requirement under Companies Act 1965, companies may require an audit for other purposes such as for obtaining bank loans, merger or sale of business. It is important for the auditor to determine the client's reason for audit as two of the factors affecting the appropriate evidence to accumulate are the likely statement users and their intended uses of the statements. The auditor is likely to accumulate more evidence when the statements are to be used extensively. Examples are in the case of companies which have extensive indebtedness and the companies that are to be sold in the future. The most likely uses of the statements can be determined from previous experience and discussion with the management. The information may affect the auditor's assessment of acceptable audit risk.

### **3.2.3 Establish the Term of the Engagement**

Once the auditor has agreed to audit a client, a clear understanding of the term of the engagement should exist between the client and the audit firm. The engagement letter should document understanding between client and audit firm in term of conduct of the audit and related services. It should clearly specify the services to be provided, any restriction imposed by the client such as deadline to complete the audit work and act as a means of informing the client that the auditor cannot guarantee all the fraudulent acts will be discovered. The engagement letter should contain the objective of the engagement, responsibility of the auditor and management, limitation and scope of engagement, timing of the engagement and agreement on fees.

### **3.2.4 Selection of Staff**

In addition, you should be aware that preplanning also involves the selection of appropriate staff for the engagement. Assigning the appropriate staff for the engagement is important to meet the requirement of ISA 300 and to promote audit efficiency. Staff assigned to the engagement must be competent and knowledgeable about the client's industry. On a large engagement, there are likely to be one or more partners and staff at several experience levels doing the audit. On certain engagement, specialist in certain technical areas such as information technology specialist, engineers, geologist or lawyers may also be assigned. On a small engagement, there may be only one or two staff member. A major consideration affecting staffing is the need for continuity from year to year.

This is to maintain familiarity with the client's technical and industry requirements, establish interpersonal relations with the client personally, which could help the auditor to perform the audit effectively.

### **3.3 OBTAIN BACKGROUND INFORMATION**

Do you know that broad understandings of the client's business and industry as well as knowledge about the company's operations are essential for conducting an adequate audit?

There are three primary reasons for obtaining a good understanding of the client's industry and external environment.

- First, there are risks associated with specific industries. Certain industries are more risky than others, such as insurance industry as compared to education industry.
- Second, there are inherent risks that are typically common to all clients in certain industries. For example the risk of potential inventory obsolescence in an IT-related industry or fashion clothing industry.
- Third, many industries have unique accounting requirements, policies or procedures that the auditor must possess an in-depth knowledge in order to evaluate whether the client's financial statements are in accordance with generally accepted accounting principles. For example, if the auditor is to audit a government agency, he needs to understand specific governmental circulars that governed the institution or if he is to audit construction companies, understanding of construction industry's unique accounting requirements is essential for an adequate audit.

#### **3.3.1 Understanding Business Operations and Processes**

It is important to note that the auditor must also understand the client's business operations and processes such as major resources of revenue, key customers and suppliers, sources of financing, and information about related parties that may indicate areas of increased client business risk. For example, many technology firms are dependent on one or a few products that may become obsolete due to new technologies or stronger competitors. Dependence on a few major customers may result in highly material losses from bad debts or obsolete inventory. Source of financing is also an important factor in determining whether the company is likely to continue as a going concern. Difficulty in obtaining financing could be an indication of inability to continue the business in the future.

### 3.3.2 Tour the Plant and Offices

For us to better understand the business operations of a client, a tour of the client's facilities is useful as it provides an opportunity for the auditors to observe the business activities and to meet key personnel. Discussions with non-accounting personnel during the tour and throughout the audit are valuable in maintaining a broad perspective. The tour may also assist the auditor in identifying inherent risks. For example, during the tour, the auditor may find an abandon equipment or inventory, it may affect the assessment of inherent risks for equipment and inventory.

### 3.3.3 Identify Related Parties

Transactions with related parties are important to the auditors because FRS 124 requires that such transactions to be disclosed in financial statements if they are material. A related party transaction is any transaction between the client and related parties. According to FRS 124, parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making any decisions. Examples of related party transactions are sales or purchase transaction between the parent company and its subsidiaries and loans to officers.

### 3.3.4 Management and Governance

Management's philosophy and operating style, ability to identify and respond to risk, significantly impact the risk of material misstatements in the financial statements. For example, the attitude or the aggressiveness of managements to show high earnings might be due to the unacceptable accounting practices encouraged by the managements. Governance includes the client's organisational structure, as well as activities of the board of directors and audit committee. An effective board of directors help ensure that the company takes appropriate risks. The audit committee, through oversight of financial reporting, can reduce the likelihood of overly aggressive accounting practices.

### 3.3.5 Minutes of Meetings

The corporate minutes are the official record of the meetings of the board of directors and shareholders. It is another important source for the auditor to obtain understanding of the client's business and operations. They usually include a summary of the discussions about organisation's strategies, and decisions made by the directors and shareholders in annual general meeting and extraordinary general meeting. Information such as declaration of dividends,

authorisation of compensation of officers, acceptance of contracts and agreements, authorisation of the acquisition of property are most common information found in minutes of the meetings.

## 3.4 ESTABLISH MATERIALITY AND ASSESS RISKS

“**Materiality**” is defined in the International Accounting Standards Committee’s “Framework for the Preparation and Presentation of Financial Statements” in the following terms:

“**Information**” is material if its omission or misstatement could influence the economic decisions of users taken on the basis of financial statement. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being primary qualitative characteristics which information must have if it is to be useful.

The auditor’s responsibility is to determine whether financial statements are materially misstated. If the auditor determines that there is a material misstatement, the auditor will bring it to the client’s attention so that the correction can be made. If the client refuses to correct the misstatement, a qualified or adverse opinion can be issued, depending on how material the misstatement is. As stated in ISA 320, Audit Materiality the assessment of what is material depends on the auditor’s professional judgement.

### 3.4.1 Steps in Applying Materiality

There are three major steps in application of materiality to an audit. Step 1 and 2 are normally performed early in the engagement, as part of planning the audit. Meanwhile, step 3 is conducted when the auditor evaluates the evidence at the completion of the audit. This is to determine if it supports the fair presentation of the financial statements. Examples and a brief discussion on these three steps are as follows:

(a) **Step 1**

**Establish a Preliminary Judgement about Materiality**

ISA 320 states that in designing the audit plan, the auditor need to establish an acceptable materiality level so as to detect quantitatively material misstatements. This may also be referred to as preliminary judgement about materiality. This is because it is a professional judgement and may change during the engagement if circumstances change. Preliminary judgement about materiality is the amount by which the financial

statements could be misstated and still not affect the decision of reasonable users. The reason for setting the preliminary judgement of materiality is to help the auditor plan the appropriate evidence to accumulate. If the auditor sets a low Ringgit amount, more evidence is needed to accumulate than for a high Ringgit amount. The auditor will often change the preliminary judgement about materiality during the audit for instance when there is a change in one of the factors used to determine the preliminary judgement.

The **factors affecting the Auditor Judgement on Materiality** are explained below:

- (i) **Materiality is a Relative Subjective Concept Rather than Absolute**  
A misstatement of a given magnitude is material for a small company not for a large company. For example, RM100,000 maybe material for a company which has total assets about RM50 millions and net income before taxes less than RM10 millions. A misstatement of this amount would be immaterial for a company, which has a total asset and net income of several billion ringgit.
- (ii) **Bases are Needed for Evaluating Materiality**  
Because materiality is a relative subjective concept, it is necessary to have bases for establishing whether misstatements are material. We should note that net income before taxes is normally the primary base for deciding what material is because it is regarded as a critical item of information for users. Some firms use a different primary base because net income often fluctuates considerably from year to year and therefore does not provide a stable base. Other primary bases used by the auditor are net sales, gross profit and total assets. The auditor will then multiply the base with the percentage or ratio factor to determine the initial quantitative judgement about materiality. The resulting materiality amount can be adjusted for any qualitative factors that may be relevant to the engagement.
- (iii) **Qualitative Factors**  
Certain types of misstatements are likely to be more important to users than the others, even if the Ringgit amounts are the same. For example:
  - Amounts involving fraud are usually considered more important than unintentional errors of equal Ringgit amounts because fraud reflects on honesty and reliability of management or other personnel involved. For example, if the auditor suspect that the misstatement of RM1000 in inventory is due to fraud such as theft or pilferage of inventory, the auditor will regard this more important than the RM1000 misstatement found in the same

account when no likelihood of fraud exists such as the misstatements due to the clerical errors or casting error.

- Misstatement that otherwise minor may be material if there are possible consequences arising from contractual obligations. For example, if the company have to maintain certain account receivable ratio in order to continue getting financial facilities from its bank, a small amount of misstatement involving account receivable that could lead to violation of the contractual obligation may deem material by the auditor.
- Misstatements that are otherwise immaterial may be material if they affect a trend in earnings. For example, if the company used to have at least 10 percent increase in net profit every year, misstatement that lead to substantial changes in the trend of the net profit growth will be considered material although the amount is within the acceptable materiality level.

(b) **Step 2**

**Allocate the Preliminary Judgement about Materiality to Account Balances or Classes of Transactions**

When the auditors allocate the preliminary judgment about materiality to account balance, it is referred to as tolerable misstatements. For example, if the auditor decides to allocate RM50,000 of total preliminary judgment about materiality of RM150,000 to account receivable, tolerable misstatement for accounts receivable is RM50,000. This means that the auditor is willing to consider accounts receivable fairly stated if it is misstated by RM50,000 or less.

(c) **Step 3**

**Estimate Misstatement and Compare with Preliminary Judgement**

The last step is to estimate the likely misstatement in actual audit test and compare to materiality. For example, in audit of inventory, the auditor found RM5,000 of net overstatement of account receivable in a sample of RM50,000 of the total population of RM500,000. One way to calculate the estimate of the misstatements is to make a direct proportion from the sample to the population and add an estimate of sampling error. The calculation of the direct projection estimate of misstatement is as shown below in Figure 3.2.

Net Misstatements in the sample (RM5,000)	X	Total recorded Population Value (RM500,000)	=	Direct Projection estimate of misstatement (RM50,000)
Total sampled (RM50,000)				
<b>Estimated Misstatement Amount</b>				
Account	Tolerable Misstatement	Direct Projection	Sampling	Total
Cash	5000	0	N/A	0
Account				
Receivable	20,000	12,000	6,000	18,000
Inventory	70,000	50,000	25,000	75,000
Total estimated				
Misstatement		62,000	20,000	82,000
Amount				
Preliminary judgment				
About Materiality	80,000			

**Figure 3.2:** Calculation of the direct projection estimate of misstatement

Apart from that, the auditor has to estimate sampling error because the auditor has sampled only a portion of the population. In this simplified example, the estimate for sampling error is assumed to be 50 percent of the direct projection of misstatement amounts. It should be noted that the total of sampling error is less than the sum of the individual sampling errors. This is because sampling error represents the maximum misstatement in account details not audited. It is unlikely that the maximum misstatement amount would exist in all accounts subjected to sampling. Assuming the preliminary judgement about materiality is

RM80,000 as shown in Table 3.2 and estimated misstatement is RM82,000, therefore estimated combined misstatements exceeds the preliminary judgement about materiality and the auditor should decide that financial statements are not acceptable. The auditor can either determine whether the estimated misstatement actually exceeds RM80,000 by performing additional procedures or require the client to make adjustment for estimated misstatements.

### 3.4.2 Audit Risk

One should differentiate between audit risk and auditor's business risk. The former refers to the risk of expressing an inappropriate audit opinion, such as issuing unqualified audit opinion when financial statements contain material misstatement. The latter refers to the risk of auditor's exposure to loss or injury to professional practice from litigation, adverse publicity, or other events arising in connection with financial statements audited and reported on.

Auditor normally accepts some level of risk or uncertainty in performing the audit. The auditor recognises that there is uncertainty surrounding the evidence and on the effectiveness of the client's internal controls.

- **Audit Risk Model**

The audit risk model is used primarily for planning purposes in deciding how much evidence to accumulate in each cycle. The audit risk model and brief explanation of its element is as follows:

$$\text{AAR} = \text{IR} \times \text{CR} \times \text{PDR}$$

Where;	<b>AAR</b>	=	acceptable audit risk
	<b>IR</b>	=	inherent risk
	<b>CR</b>	=	control risk
	<b>PDR</b>	=	planned detection risk

Planned detection risk is a measure of the risk that audit evidence for a segment will fail to detect misstatements exceeding a tolerable amount, should such misstatement exist. It depends on the other three factors in the model. Planned detection risk will change only if the auditor changes the other factors. It determines the amount of substantive evidence that the auditor plans to accumulate, inversely with the size of planned detection risk. If planned detection risk is reduced, the auditor needs to accumulate more evidence to achieve the reduced planned risk.

Inherent risk is the susceptibility of financial statement assertion to the risk of material misstatement, assuming no internal controls. If the auditor concludes that there is a high likelihood of misstatement, ignoring internal controls, the auditor would conclude that inherent risk is high.

At financial statement level, the auditor may consider factors like integrity of the management, experience and knowledge of the management and changes in management, unusual pressure to the management such as the company is facing financial difficulty, nature of business such as potential for technological obsolescence, economic and competitive conditions.

At account balances and class of transaction level, the auditor is likely to consider factor such as accounts which involve high degree of estimation, complexity of transaction which might require using work of an expert, assets susceptibility to loss or misappropriation and transaction not subjected to ordinary or routine processing. Inherent risk is inversely related to planned detection risk and directly related to evidence.

Control risk is the risk that client's internal control fails to detect material misstatement. If the auditor assessment of control risk seems too high, the auditor needs to accumulate more evidence to satisfy their opinion. Before auditors can set control risk less than 100 percent, they must obtain an understanding of internal control, evaluate how well it should function based on the understanding and test its effectiveness. When assessing a preliminary level of CR, the auditor must be concerned about the extent of Information technology (IT) is used in processing accounting information, including the extent that information technology is used in each business process, the complexity of the entity's computer operations, the organisational structure of the IT activities, the availability of the data and the need for IT assisted techniques to gather and conduct audit procedures. There is inverse relationship between control risk and planned detection risks and direct relationship between control risk and substantive evidence.

Acceptable audit risk is a measure of how willing the auditor is to accept that the financial statements maybe materially misstated after the audit is completed and an unqualified opinion has been issued. When the auditor decides on a lower acceptable audit risk, it means the auditor wants to be more certain that the financial statements are not materially misstated. Based on the audit risk model, there is a direct relationship between acceptable audit risk and planned detection risk, and an inverse relationship between acceptable audit risk and planned evidence.

### **3.5 PERFORM PRELIMINARY ANALYTICAL PROCEDURES**

An auditor also performs preliminary analytical procedures to obtain an understanding about client's business and business risk. Comparison of client ratios to industry or prior year ratio provides an indication of the company's performance. By conducting analytical procedures any changes or differences from preceding year audited information and industry data with this year information are revealed. These changes can represent important trends or specific events of which will influence audit planning. Typically, changes in ratios as compared to prior years or industry help the auditor in identifying areas that have likelihood of risk of material misstatements that require further attention during the audit. For example, the auditor will calculate debt to equity ratio and time interest earned to determine the client's ability to meet long term obligations. The details discussion on analytical procedures will follow in subsequent section.

### **3.6 DEVELOP OVERALL AUDIT PLAN**

The auditor needs to develop overall audit plan in order to perform the audit effectively. It includes the decision about type of audit test need to be performed in the audit. There are two main categories of audit test; test of control and substantive test.

Test of Control is the test executed by the auditor to determine whether the internal control of the company is effective in detecting material misstatements. It includes inquiries of appropriate management, supervisory and staff personnel, inspection of documents, reports, and electronic files, observation of the application of specific internal control and re-performance of the application of the control by the auditor. For example, if the auditor wants to determine the effectiveness of client's internal control over cash function, he may review the prelisting in the cash receipts book to determine whether cash is prelisted daily.

Substantive tests are divided into two; substantive test of transaction and substantive test of account balance. A substantive test of transactions is test of error or fraud in the individual transactions whereas tests of account balances concentrate on details of the amount in the account balance. Example of substantive test of transactions is reconciling the recorded cash receipts on the prelisting with the cash receipts journal and the bank statement for a one month period to determine whether all receipts from customer has been recorded in the customer accounts and deposited to the bank account. An example of substantive test of account balances is the auditor trace the deposit not yet credited by the bank, that appear in bank reconciliation statement at the end of the month

(deposit in transit) to cash receipt journal to determine that the cash is actually received.

The overall audit plan should be properly documented and most audit firms use some kind of audit programme to document the execution of planned audit procedures. An audit programme consists of specific audit procedures, usually prepared for each of the components of the audit such as audit programme for revenue or audit programme for purchase cycle.

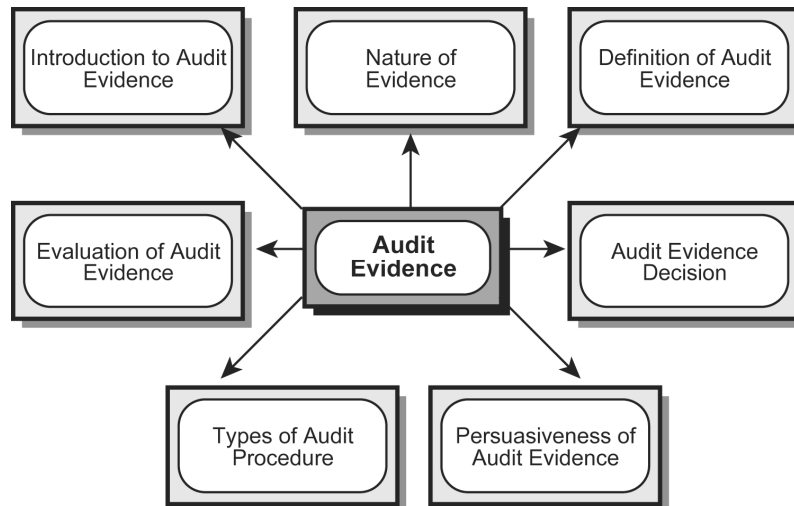


### ACTIVITY 3.1

Recent increase in the fuel price gives significant impacts to many industries. Describe how this situation could affect the auditor's planning in construction industries.

## AUDIT EVIDENCE

As mentioned earlier, one of the important reason auditors give much attention to planning is to enable them to obtain sufficient appropriate evidence to support their opinion. Therefore to facilitate more understanding on the importance of evidence in an audit, the following sections will be discussed in detail. They are the nature, definition and evidence decision. Then, we will also identify the seven types of audit evidence.



**Figure 3.3:** Seven types of audit evidence

## 3.7 INTRODUCTION TO AUDIT EVIDENCE

The underpinning of any audit is the evidence gathered and evaluated by the auditor. The auditor must have the skills and knowledge to acquire and accumulate sufficient appropriate audit evidence to meet the standard of the profession. Obtaining sufficient appropriate audit evidence is crucial for the auditor to draw reasonable conclusion on the true and fair view of the financial statements.

## 3.8 NATURE OF EVIDENCE

The use of evidence does not uniquely belong to the audit professions. Evidence has been widely used in the legal and scientific profession. One may be familiar with the evidence that is sought by the lawyer in determining the innocence and guilt of the parties charged with criminal offence in TV series such as Law and Order or the Practice.

Similarly, in scientific experiment, scientists conduct experiments in order to find evidence to draw a conclusion about a theory. For example a forensic will examine and conduct operations on murdered victim to find evidence to establish the cause and time of the death.

In the audit of financial statements, auditors also gather evidence to help them to arrive at conclusion whether financial statement has been prepared according to the requirements of the law and stipulated standards. Although the nature, type and the manner in which the evidence is used differ among lawyers, doctor or auditors, but in all of these cases the evidence is used to help the decision maker to draw a conclusion.

## 3.9 DEFINITION OF AUDIT EVIDENCE

By now, you should know that according to ISA 500, audit evidence is defined as all of the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Audit evidence includes information such as accounting records and documents underlying the financial statements, as well as corroborating information from other sources.

Accounting records are accounting entries such as journal, general ledger, subsidiary ledgers and cash book. Although an auditor can rely on the accounting records as a source of evidence, it is not sufficient to help him or her to base an opinion on the financial statements. Hence, the auditor needs to seek other audit evidence or corroborating evidence to support his or her conclusion and opinion. Other forms of audit evidence includes information from internal or

external to the organisation such as, minutes of board of director, agreements, memorandum of associations, supplier statements, bank statements, confirmation from external parties, industries data and evidence sought by the auditor through observation, discussion with the clients' personnel and physical examination.



### SELF-CHECK 3.2

1. How does the auditor determine persuasiveness of any type of audit evidence?
2. What are the types of audit evidence?

## 3.10 AUDIT EVIDENCE DECISION

One of the critical decisions that need to be made by the auditor is to determine the amount and the appropriate type of evidence to accumulate. This will enable the auditor to draw reasonable conclusion as to the true and fair view of the financial statements under consideration.

The auditor's decision on evidence accumulation can be divided into four types of decisions:

- Which audit procedure to use?
- What sample size to select for a particular procedure?
- What items to select from the population?
- When to perform the procedures?

### (a) Which Audit Procedure to Use?

An audit procedure is the detailed instruction for the collection of a type of audit evidence that needs to be obtained at some time during the audit. A set of audit procedures prepared to test audit objectives for a specific component of the financial statements is referred to as an audit programme. An example of an audit procedure used in order to achieve the objective of accuracy in terms of the price charged to the customer is that the auditor makes a comparison of selling price in the price lists with duplicate copies of sales invoice.

**(b) What Sample Size to Select for a Particular Procedure?**

Once an audit procedure is selected, it is possible to vary the sample size from one to all the items in the population being tested. The decision of how many items to test must be made by the auditor for each audit procedure. The sample size for any given procedure is likely to vary from audit to audit.

**(c) What Items to Select from the Population?**

After the sample size has been determined for an audit procedure, it is still necessary to decide which items in the population to test. For example, if the auditor wants to select 40 account receivables, he can choose to select 40 large account receivables or he can choose to select randomly from the total account receivables.

**(d) When to Perform the Procedures?**

This involves the timing of the audit evidence that needs to be collected. Timing decision is affected by many factors, such as when the client needs the audit to be completed, when the auditor believes collection of evidence will be most effective and also the availability of the staff to conduct the audit. For example, the auditor may choose to collect evidence when he thinks the likelihood of misstatement is high such as a week before or after the year end. It is also sometimes depends on the availability of audit staff.

### 3.11 PERSUASIVENESS OF AUDIT EVIDENCE

ISA 500 requires the auditor to accumulate sufficient appropriate audit evidence to support the opinion issued. As explained in ISA 500, appropriateness of audit evidence relates to its relevance to a particular assertion and to its reliability.

The two determinants of the persuasiveness of evidence are appropriateness and sufficiency as explained next.

**(a) Appropriateness**

Evidence is considered appropriate if it can be believable or reliable. If evidence is considered highly appropriate, it is a great help in persuading the auditor that the financial statement reflects a true and fair view. Appropriateness of audit evidence deals only with audit procedure selected. Appropriateness cannot be improved only by selecting a larger sample size or different population items.

**(b) Characteristics of Appropriate Evidence**

The characteristics of appropriate evidence are listed as follows:

**(i) Relevance**

Relevance must pertain to or be relevant to audit objective that the auditor is testing before it can be reliable. For example, assume that the auditor wants to verify the ownership of the client's vehicle. If the auditor personally examine that the vehicle is parked at the client's compound, this does not constitute appropriate evidence to test ownership objective. A relevant procedure would be to examine the name of the owner stated on the registration card.

**(ii) Independence of Provider**

Evidence obtained from a source outside the entity is more reliable than the evidence obtained from within. For example, confirmation received from the bank or attorney is considered more reliable than the client's record.

**(iii) Effectiveness of Client's Internal Controls**

When a client's internal control are effective, evidence obtained is more reliable than when internal controls are weak. For example, if internal controls over sales and billings are effective, the auditor could obtain more appropriate evidence from sales invoices and shipping documents than if the controls were inadequate.

**(iv) Auditor's Direct Knowledge**

Evidence obtained directly by the auditor through physical examination, observation, inquiry, computation and inspection is more appropriate than information obtained indirectly. For example, if the auditors recalculate the total of account receivable listing is more reliable than if the auditors just rely on the client's casting.

**(v) Qualification of Individuals Providing the Information**

Although the source of the information is independent, the evidence may not be reliable unless the individual providing it is qualified to do so. For example, confirmation of account receivable received from individual not familiar with business environment is less reliable than confirmation received from business entities. Besides, evidence obtained directly by the auditor may not be reliable if the auditor is not qualified to evaluate such evidence, for instance to value stock in the case of diamonds or jewellery.

(vi) **Degree of Objectivity**

Objective evidence is more reliable than evidence that requires considerable judgement to determine its accuracy. For example, evidence like physical count of inventory or confirmation about account receivable balance is more objective than observation of obsolescence of inventory during the physical count of inventory.

(vii) **Timeliness**

The timeliness of audit evidence refers to the time evidence is obtained i.e. when it is accumulated or to the period under review. For example, evidence is often more reliable for balance sheet accounts if it is obtained close to the balance sheet date and for income statement account if the sample is from the entire period under audit rather than only from one part of the period.

(viii) **Sufficiency**

Sufficiency refers to the quantity of evidence obtained. Sufficiency of evidence is measured primarily by the sample size the auditor select. Several factors determine the appropriate sample size for the audit. The two most important ones are the auditor's expectation of misstatements and the effectiveness of client's internal control. For example, if the auditor concludes that the internal control over sales cycle is effective, the auditor may select smaller sample size of duplicate sales invoice to determine the existence of the transaction. Assume the auditor concerns about the effect of the changes of the management personnel towards the approval process in client's payment function; the auditor may select more sample size of payment register to verify the existence of proper approval.

Besides the sample size, the individual items tested affect the sufficiency of evidence. Samples containing population items with large dollar values, items with high likelihood of misstatement and items that are representative of population are usually considered sufficient.

The persuasiveness of audit evidence can be evaluated only after considering the combination of appropriateness and sufficiency, including the effects of the factors influencing appropriateness and sufficiency. A large sample of evidence provided by independent party is not persuasive unless it is relevant to audit objective being tested. A large sample of evidence that is relevant but not objective is also not persuasive.

## 3.12 TYPES OF AUDIT PROCEDURE

In deciding which audit procedure to use, the auditor can choose from seven broad categories of audit procedures. They are defined and discussed below. The relationship between the type of audit procedures and appropriateness of audit evidence are summarised in Table 3.1.

(a) **Physical Examination**

Physical examination refers to the inspection or count by the auditor of a tangible asset. This type of procedure is most often associated with inventory and cash, but also applicable to the verification of securities, notes receivable and tangible fixed assets. The distinction between physical examination of assets such as marketable securities and shares with examination of documents such as sales invoice is important for auditing purposes. If the object being examined, such as sales invoice has no inherent value, the evidence is called documentation. For example, before a cheque is signed, it is a document; after it is signed, it becomes an asset and when it is cancelled, it becomes a document again.

Physical examination is a direct means in verifying that the asset actually exists and is regarded as one of the most useful type of audit procedure. Generally, physical examination is an objective means of ascertaining both the quantity and description of the assets.

However, we should be aware that physical examination is not a sufficient procedure to determine the ownership of the assets.

(b) **Confirmation**

Confirmation refers to the receipt of written or oral response from an independent third party verifying the accuracy of information that was requested by the auditor. The request is made to the client and the client then asks the independent third party to respond directly to the auditor. Because the evidence is derived from a third party, an auditor always regards confirmation as highly important audit procedure. However, confirmation is relatively costly to obtain and may cause inconvenience to the provider of the evidence. Thus, it is not used in every instance in which it is applicable. Whether or not confirmation need to be used depends on the need of the situation and the availability of alternative evidence. For example, confirmation is rarely used to verify fixed assets additions as it can be verified adequately by physical examination and documentation.

There are two common types of confirmation requests, namely;

- (i) positive confirmation; and
- (ii) negative confirmation.

Positive confirmation asks the recipient to respond in all circumstances. On the other hand, negative confirmation asks the recipient to respond only when the information is incorrect.

When practical and reasonable, the confirmation of a sample of account receivable is required by the auditor. This is because account receivables usually represent a significant balance on a financial statement, and a confirmation is a highly reliable type of procedure. Although auditors seldom use confirmation for other types of account balances, this type of procedure is very useful in verifying many types of information. To be considered a reliable procedure, confirmation must be controlled by the auditor from the time it is prepared until the time it is returned. If there is interference of the client at any part of the process, the auditor has lost control; thus the reliability of the evidence is reduced.

(c) **Documentation**

Students of auditing should know that documentation is the auditor's examination of the client's documents and records to substantiate the information that is or should be included in the financial statements. The documents examined by the auditor are the records used by the client to provide information for conducting its business in an organised manner. Documentation is a form usually used in audit as it is not costly and easily available to the auditor. Sometimes, it is the only reasonable type of evidence available.

A document can be classified into internal and external document. An internal document is one that originated from the client's organisation and retained, without ever being circulated to an outside party, such as a customer or a supplier. For example, employees time sheet, payment register and duplicate copy of sales invoices.

An external document either originates from an outside the organisation and ends up in the client's organisation, or it originates from a client's business, however, it has been in the hands of a third party and finally returned to the client, e.g. the supplier statements, bank statements and remittance advice. The primary determinants of the auditor's willingness to accept a document as reliable evidence is whether it is internal or external document. For internal documents, those created and processed under weak internal control may not constitute reliable evidence.

Unlike internal documents, an external document has been circulated and is in the hands of both client and external parties. This indicates that both parties are agreeable with the information and conditions stated on the document. Therefore the auditor always regards it as reliable evidence.

(d) **Analytical Procedures**

ISA 520 defines Analytical Procedure as the analysis of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or which deviate from predicted amounts. Analytical procedures may range from the use of simple comparisons to the use of complex models. It includes comparison of current year financial information with comparable prior period(s) after consideration of known changes, comparison of current year financial information with budgets, projections and forecasts, comparison of client financial information with industry data and relationship of financial information to non-financial information.

Earlier in this topic, we have discussed the use of analytical procedures at the planning stage to help the auditor identify significant matters which the auditor needs to focus in more detail later in the engagement. For example, the calculation of inventory turnover seems to fall significantly from prior year maybe a sign of obsolescence, which the auditor needs to exercise greater care in the physical counting of inventory. Analytical procedure done in the planning stage will assist the auditor in planning the nature, timing, and extent of other audit procedures.

Analytical procedures are often done during the testing phase as a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions.

Analytical procedures are also required to be done during the completion phase of the audit. The objective of analytical procedures as an overall review is to assist the auditor in assessing the conclusions reached and in the evaluation of the overall financial statement presentation. Auditors' analytical procedures often include the use of general financial ratios during planning and final review of the audited financial statements. The most important ratios are short-term liquidity ratios, activity ratios, profitability ratios and coverage ratios. The use of analytical procedures has increased because of their effectiveness at identifying possible misstatements at a low cost.

In addition to understanding the client's industry and business, analytical procedures are used for different purposes in audit. The purposes are as follows:

(i) **Assess the Entity's Ability to Continue as a Going Concern**

Analytical procedures are often useful to indicate the ability of the company to continue in the future. Certain analytical procedures are very useful in assessing the possibility of failure. For example, a significant increase in the debt-to-equity ratio coupled with the reduction in the asset turnover ratios could raise doubt to the ability of the company to continue operations in the future.

(ii) **Indicate the Presence of Possible Misstatements in the Financial Statement**

Significant unexpected differences between the current year's unaudited financial data and other data used in comparisons are commonly called unusual fluctuations. Unusual fluctuations occur when significant differences are not expected but do exist or when significant differences are expected but do not exist. In either case, one of the possible reasons for the fluctuation is the presence of an accounting misstatement. For example, calculation of current ratio shows a reduction from prior year ratio could be an indication of misstatement.

(iii) **Reduced Detailed Audit Test**

When an analytical procedure reveals no unusual fluctuations, the implication is that the possibility of a material misstatement is minimised. In that case, the analytical procedures constitute substantive evidence in support of the fair presentation of the related account balances, and it is possible to perform fewer detailed tests in connection with those accounts.

(e) **Inquiry**

Inquiry involves activity to obtain written or oral information from the client in response to questions from the auditor. Although considerable evidence is obtained from the client through inquiry, it usually cannot be regarded as conclusive as it is not from independent source and may be biased in the client's favour. Therefore, when the auditor obtains evidence through inquiry, it is normally necessary to obtain further corroborating evidence through other evidence.

(f) **Re-performance**

This type of audit procedure involves rechecking a sample of computations and transfers of information made by the client during the period under audit. Rechecking of computations consists of testing client's arithmetical accuracy. It includes such procedures as rechecking of transfers of information that consists of tracing amounts to be confident that the same amount has been posted correctly to appropriate account. For example, to trace the amount recorded in the cash receipts journal to the correct customer accounts or to recalculate the total of the ageing report.

(g) **Observation**

Observation is the use of the senses to assess certain activities. For example when the auditor observes the client's physical count of inventory or observes the client's employee perform specific functions. One of the limitation of observation is the client could influence the evidence by act differently when they realise that the auditor is observing their activities. Therefore other corroborating evidence is important to confirm the finding from the observation. Nevertheless, observation is still useful in most part of the audit.

**Table 3.1:** Appropriateness of Evidence and Types of Audit Procedures

Type of Procedures	Independence of the Provider	Effectiveness of Client's Internal Controls	Auditor's Direct Knowledge	Qualifications of Provider	Objectivity of Evidence	Relevance	Timeliness
Physical Examination	High	Varies	High	Normally high	High	Type of audit objective being tested	When the evidence is obtained
Confirmation	High	Not Applicable	Low	Varies (usually high)	High	Type of audit objective being met	When the evidence is obtained
Documentation	Varies-external vs. internal	Varies	Low	Varies	High	Type of audit objective being met	When the evidence is obtained
Analytical Procedures	High/Low	Varies	Low	Normally high	Varies	Type of audit objective being met	When the evidence is obtained
Inquiries of Client	Low	Not Applicable	Low	Varies	Varies	Type of audit objective being met	When the evidence is obtained
Reperformance	High	Varies	High	High	High	Type of audit objective being met	When the evidence is obtained
Observation	High	Varies	High	Normally high	Medium	Type of audit objective being met	When the evidence is obtained

Table 3.1 above lists the seven types and appropriateness of each type of audit procedure.

### 3.13 EVALUATION OF AUDIT EVIDENCE

The ability to evaluate audit evidence appropriately requires auditors to have adequate skills and professional judgment. The auditor should be able to determine the appropriateness and sufficiency of each type of evidence collected. This requires considerable knowledge about the client's business operations as well as its industries and usually the evaluation skills is developed over time through experience and continuous training. In evaluating the evidence, the auditor needs to consider whether specific audit objective being tested has been achieved. ISA 200 requires the auditor to conduct the audit with an attitude of professional scepticism recognising that circumstances may exist that cause the financial statements to be materially misstated, whether due to fraud or error.

Professional scepticism requires the auditor to evaluate the evidence objectively and should be thorough in searching for evidence and unbiased in its evaluation.



### ACTIVITY 3.2

Mr Chandra, an auditor has found that ratio and trend analysis is relatively useless as a tool in conducting audits. For several engagements, he computed the industry ratios and compared them with the client's ratio. For most engagements, the client's business was significantly different from the industry data and the client usually attributes them to the unique nature of its operations. In cases in which the client had more than one branch in different industries, Chandra found that the ratio analysis is not helping at all. How could Chandra improve the quality of his analytical procedures?

## SUMMARY

- Auditors need to properly plan the engagement to enable them to conduct the audit effectively.
- Audit plan consists of major parts such as preplanning, obtain background information, assess the materiality and business risk, conduct preliminary analytical procedure and develop overall audit plan.
- All these phases require auditor's careful consideration, relevant knowledge and professional judgment.
- One of the reasons of the audit planning is to assist the auditor in determining sufficient appropriate audit evidence, which is essential to support auditor's opinion on fairness of the financial statements.
- Therefore, considerable portion of this topic was focused on the discussion of nature, characteristics, persuasiveness and types of appropriate and sufficient audit evidence.

## KEY TERMS

Assertion	Engagement letter
Audit committee	Materiality
Audit evidence	Random sample
Audit objective	Sampling error
Budgets	

## SELF-TEST 1

1. What factors should an auditor consider prior to accepting an engagement? Explain.
2. Explain why auditors need an understanding of the client's industry. What sources are commonly used by auditors to learn about the client's industry?
3. What is an engagement letter? State the importance of the engagement letter.
4. State the types of audit procedure in each of the following cases:
  - (a) Inspecting the client's fixed asset
  - (b) Examining the client's journal entries
  - (c) Getting information from the bank on the client's current account balance
  - (d) Watching client's staff members taking stock
  - (e) Getting information from the client's cashier
  - (f) Checking the amount invoiced to customers
  - (g) Assessing going concern using ratios
5. Based on your answers in question 4, which audit procedure is most reliable and why?

6. In auditing the financial statements of a manufacturing company, that were prepared using information technology, the auditor has found that the traditional audit trail has been obscured. As a result, the auditor may place increased emphasis on analytical procedures of the data under audit. These tests which are also applied in auditing visibly posted accounting records include the computation of ratios that are compared with prior-year ratios or with industry-wide norms. Examples of analytical procedures are the computation of the rate of inventory turnover and computation of the number of days in account receivables.
- (a) Discuss the advantages of analytical procedures in an audit.
  - (b) In addition to the computations described, list the ratios that an auditor may compute during an audit on balance sheet accounts and related income accounts. For each ratio listed, name the two accounts used in its computation.
  - (c) When there has been significant change in a ratio when compared with the preceding year's, the auditor considers the possible reasons for the change. Give the possible reasons for the following significant changes in ratios:
    - (i) The rate of inventory turnover (ratio of cost of sales and average inventory) has decreased from the preceding year's rate.
    - (ii) The number of day's sales in receivables (ratio of average daily accounts receivable and sales) has increased over the prior year.

## SELF-TEST 2

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1. Identify major steps in audit planning.
2. An auditor often tries to acquire background knowledge of the client's industry as an aid to audit work. How does the acquisition of this knowledge aid the auditor in distinguishing between obsolete and current inventory?
3. Identify two types of information in the client's minutes of the board of director meetings that are likely to be relevant to the auditor. Explain why it is important to read the minutes early in the engagement.
4. What are the responsibilities of the successor and predecessor auditors when a company is changing auditors?

5. In the audit of the TMC. Bhd., the auditor performed extensive ratio and trend analysis. No material exception were discovered except for the following:
- (a) Commission expense as a percentage of sales has stayed constant for several years but has increased significantly in the current year. Commission rates have not changed.
  - (b) The rate of inventory turnover has steadily increased for 4 years.
  - (c) Inventory as a percentage of current assets has steadily increased for 4 years.
  - (d) The number of days' sales in account receivables has steadily increased for 3 years.
  - (e) Allowance for uncollectible accounts as a percentage of accounts receivable has steadily decreased for 3 years.
  - (f) The absolute amounts of depreciation expense and depreciation expense as a percentage of gross fixed assets are significantly smaller than in the preceding year.

Evaluate the potential significance of each of the exception listed above to the audit of TMC Bhd.

6. List two types of audit procedure that the auditor might use to support each of the following:
- (a) Physical attendance at stock take
  - (b) Ownership of motor vehicle
  - (c) Valuation of accounts receivable
  - (d) Balance in Bank
  - (e) Authorised and paid-up share capital
  - (f) Contingent liabilities
  - (g) Account Payables

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# Topic 4 ► Understanding Internal Control

## LEARNING OUTCOMES

By the end of this topic, you should be able to:

1. Explain the definition of internal control;
2. Discuss the concept of reasonable assurance and inherent limitations with regard to internal control structure;
3. Describe the objectives of internal control and how the auditor uses them to develop specific control objectives;
4. Define the internal control structure and each of its five components; and
5. Identify the steps in the auditor's obtaining an understanding of the internal control structure and assessing control risk and the method and procedures used by auditors.

## ► INTRODUCTION

You should know that one of the major phases in audit is to understand the client's entity and its environment, including the assessment about the entity's internal control system. The auditor's assessment about the client's internal control system determines the nature, timing and extent of substantive audit procedures to be conducted in audit. Internal control procedures vary between companies. There is no one universal system that is applicable to all business entities. As business organisations have grown in physical size, as operations have expanded in complexity, and as transactions have increased in number; it has become imperative that management supply itself promptly with reliable data based on the objectives of assets preservation, error elimination and income determination. This includes the means of evaluating company policy. Thus,

business data and accounting information must be prepared effectively and economically, so that the cost of obtaining them is less than the benefits derived. Management is not the only group that looks to the system of internal control for assurance as to the reliability of information. Independent auditors also rely on the system of internal control in determining the nature, timing and extent of their audit work. An auditor must measure the degree of the effectiveness of internal control in order to arrive at justifiable decisions. Careless financial control, careless management and careless accounting make an audit difficult and costly and limit its reliability. Auditing standards provide for a review of and reliance upon the system of internal control as an indicative guide to necessary amount of verification. Consequently, the auditor examines the procedures employed and the data produced by the client to judge the accuracy of the client's representations and thus determines the extent of the examination detail.

The topic starts with definition, components and objectives of internal control. The remainder of this topic will focus on determining components of the internal control structure and the auditor's considerations of the internal control structure in a financial statements audit.

The Art Deco Society operates a museum for the benefit and enjoyment of the community. During hours when the museum is open to the public, two clerks who are positioned at the entrance collect RM8 admission fee from each non-member patron. Members of the Art Deco Society are permitted to enter free of charge upon presentation of their membership cards.

At the end of each day, one of the clerks delivers the proceeds to the treasurer. The treasurer counts the cash in the presence of the clerk and places it in a safe. Every Friday afternoon, the treasurer and one of the clerks deliver all the cash held in the safe to the bank, and receive an authenticated deposit slip, which provides the basis for the weekly entry in cash receipts journal. The Board of Directors of the Art Deco Society has identified a need to improve its control procedures for cash admission fees. The board has determined that the cost of installing turnstiles, sales booths or otherwise altering the physical layout of the museum will greatly exceed any benefits which may be derived. However, the board has agreed that the sale of admission tickets must be an integral part of its improvement efforts.

Salleh has been asked by the Board of Directors of the Art Deco Society to review the internal control structure for cash admission fees and provide suggestions for improvement.



### SELF-CHECK 4.1

1. Indicate any deficiencies in the existing procedures for cash admission fees.
2. Identify and recommend improvement for each of the deficiencies identified.
3. Why internal control system important for an organisation?

## 4.1 OVERVIEW

As discussed in Topic 3, there are seven parts of the planning phase of audits: accept client and perform initial planning, understand the client's business and industry, assess client business risk, perform preliminary analytical procedures, set materiality and acceptable audit risk and inherent risk, **understand internal control and assess control risk**, and develop overall audit plan and programme (Figure 4.1). Therefore, understanding internal control and assessing control risk is part six of planning. It is one of the most important parts in planning. The importance of internal control to independent auditors and management has been recognised in the professional literature for many years. For the auditors, sufficient understanding of the internal control structure is to be obtained to plan the audit and to determine the nature, timing and extent of tests to be performed. For the managers, internal control improves efficiency and effectiveness of the entity's operations.

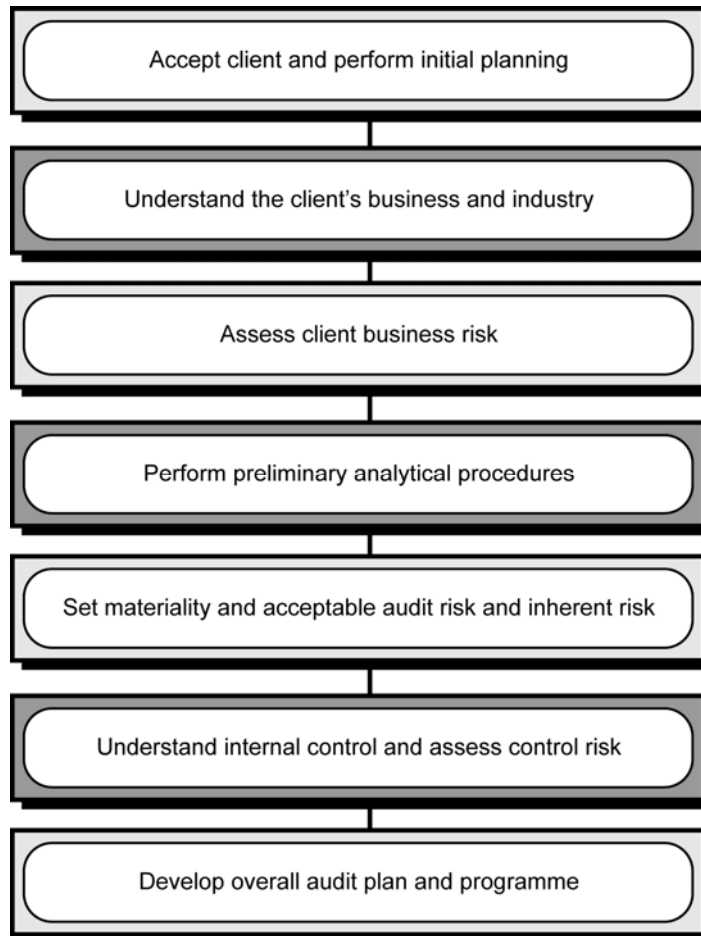


Figure 4.1: Planning phase of audits

### 4.1.1 The Importance of Internal Control

The following are the contributing factors to expand the recognition and significance of internal control:

- (a) It is impracticable for auditors to make audit of most companies within economic fee limitations without relying on the client's internal control;
- (b) The scope and size of the business entity have become so complex and widespread that management must rely on numerous reports and analyses to effectively control operations;
- (c) The check and review on system of internal control affords protection against human weaknesses and reduce the possibility that errors or irregularities will occur;

- (d) Auditors obtained reasonable assurance of the propriety and accuracy of the underlying accounting data contribute to the basis for the auditor's opinion on the financial statements; and
- (e) The relation of the effectiveness of internal control structure to evidential matter arises from its effect on the propriety and accuracy of accounting data.

## 4.2 DEFINITION AND COMPONENTS

In this section, let examine the contemporary definition of internal control and its components. The Committee of Sponsoring Organisations (COSO) of the Treadway Commission defines internal control as follows:

**Internal control** is a process, affected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:

- (a) Ensure the timely preparation of reliable financial statements (reliability of financial reporting);
- (b) Safeguards company's assets;
- (c) Carry on the business in an orderly and efficient manner (effectiveness and efficiency of operations);
- (d) Ensure the completeness and accuracy of the records; and
- (e) Compliance with applicable laws and regulations (such as Company Act 1965, FRS1997, Bursa Malaysia Listing Requirements).

**COSO identifies five interrelated components of internal control system:**

- (a) **Control environment** sets the tone of an organisation, influencing the control conciseness of its people. It is the foundation for all other components of internal control, providing discipline and structure;
- (b) **Risk assessment** is the entity's identification and analysis of relevant risks to achievement of its objective, forming a basis for determining how the risks should be managed;
- (c) **Control activities** are the policies and procedures that help ensure that management directives are carried out;
- (d) **Information and communication** are the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities; and

- (e) **Monitoring** is a process that assesses the quality of internal control performance over time.

These five components are described in detail in section 4.6.

## 4.3 ENTITY OBJECTIVES AND RELATED INTERNAL CONTROL RELEVANT TO AUDIT

Management and auditor are both concerned about internal controls in providing reliable data for financial reporting and safeguarding the company’s assets and records. Their concern differs in that auditor is primarily interested in the effect of the controls on the financial statements, whereas management is also concerned that internal controls promote operational efficiency and encourage adherence to prescribed policies. For publicly held companies, management should also be concerned about complying with laws and regulations.

### 4.3.1 Clients and Auditors Concerns in Designing an Effective Internal Control System

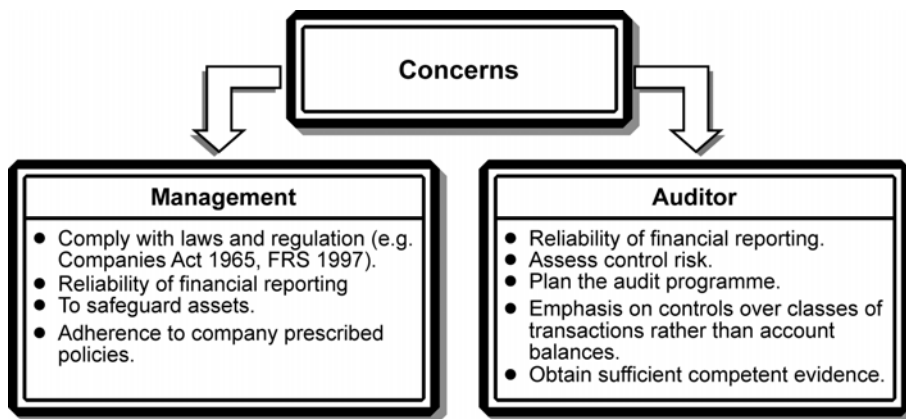


Figure 4.2: Management and auditor concerns

### 4.3.2 Relationship between Internal Control Objectives and Audit Objectives

The auditor needs to develop detailed objectives of internal control for the processing of a particular transaction class. The auditor might develop detailed control objectives based on management assertions. This means that the detailed control objectives for a particular class of transactions can conveniently serve as a framework for both assessing control risk and substantively testing the transaction processed. Table 4.1 lists the internal control objectives. Each of these objectives is identical, or similar, to the audit objectives used for testing account balances. The only exception is the disclosure objective, which applies only to account balance (see Table 4.2).

**Table 4.1:** Internal Control Objectives

<b>Internal Control Objectives</b>	
1. Validity	All transactions processed are valid.
2. Completeness	All transactions are included.
3. Timeliness	All transactions are recorded on a timely basis.
4. Authorisation	All transactions are properly authorised.
5. Valuation	All transactions are properly valued.
6. Classification	All transactions are classified into the proper account.
7. Posting and summarisation	All transactions are properly recorded in journals and posted in special general journals.

**Table 4.2:** Management Assertions, Internal Control Objectives and Audit Objectives

Management Assertions	Internal Control Objectives	Audit Objectives
1. <b>Existence/Occurrence</b>	<b>Validity</b> – recorded transactions are valid.	Validity
2. <b>Rights and obligations</b>	<b>Authorisation</b> – transactions are properly authorised. <b>Segregation of duties</b> – independent check on existing and recorded transactions.	Ownership
3. <b>Completeness</b>	<b>Completeness</b> – existing transactions are recorded.	Completeness
4. <b>Valuation/Allocation</b>	<b>Valuation</b> – transaction are properly valued. <b>Classification</b> – transaction are properly classified. <b>Timing</b> – transaction are recorded at proper time.	Valuation Classification Cut-off

## 4.4 INHERENT LIMITATION OF ENTITY'S INTERNAL CONTROL SYSTEM

Internal control system established by the management only provides reasonable assurance that management's objectives are reached because of the inherent limitations of internal control such as:

(a) **Management override**

Management can override the control set up by them for illegitimate purposes such as personal gain or enhanced presentation of an entity's financial position or compliance status (e.g., inflated reported earnings, violations of debt covenant agreements or non-compliance with laws and regulations).

(b) **Collusion**

Individuals acting together, such as employee who performs important control acting with another employee, customer or supplier, may be able to perpetrate and conceal fraud so as to prevent its detection by internal control. (e.g., collusion between storekeeper and clerk to conceal the theft of stocks).

(c) **Breakdowns**

It may occur when the personnel misunderstand instructions or make errors due to inefficiency, carelessness, fatigue and negligence.

(d) **Cost versus benefits**

The cost of an entity's internal control system should not exceed the benefits that are expected to ensue.

(e) **Mistakes in judgement**

Management or entity's personnel may exercise poor judgement in making business decisions or in performing routine duties because of the inadequate information, time constraints, or other procedures.

## 4.5 ROLES AND RESPONSIBILITIES

Let us now look at the roles and responsibilities of related parties and their roles towards internal control. Based on COSO report, everyone in an organisational has some responsibility for, and is actually as part of, the organisation's internal control. Several responsible parties and their roles are as follows:

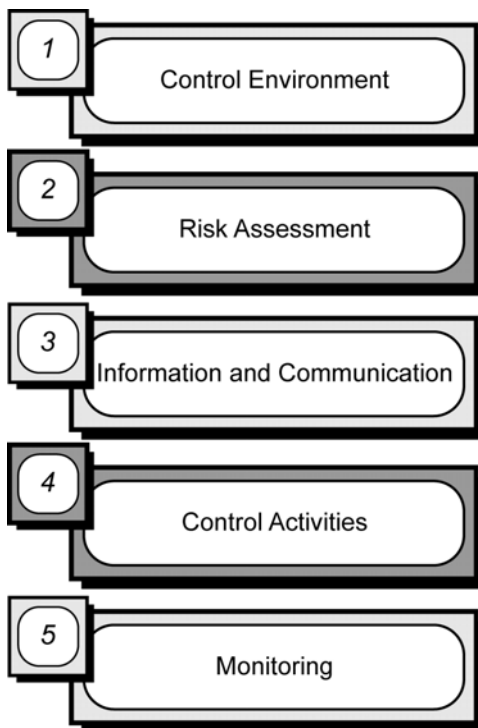
**Table 4.3:** Responsible Parties and Their Roles Towards Internal Control

Parties	Responsibilities
1. <b>Management</b>	<ul style="list-style-type: none"> <li>• Establish effective internal control.</li> <li>• Senior management set the tone for control consciousness throughout the organisation.</li> <li>• Ensure all the components of internal control are in place.</li> <li>• The CEO and CFO of public companies must also make an assessment of the adequacy of internal controls over financial reporting.</li> </ul>
2. <b>Independent Auditors</b>	<ul style="list-style-type: none"> <li>• Recommendation for any weakness of internal control identified during control risk assessment.</li> </ul>
3. <b>Board of Directors and Audit Committee</b>	<ul style="list-style-type: none"> <li>• As part of their general governance and oversight activities according to Malaysian Code of Corporate Governance (MCCG).</li> <li>• Responsible for establishing and maintaining internal control.</li> </ul>

<p>4. <b>Internal Auditors</b></p>	<ul style="list-style-type: none"> <li>Periodically examine and evaluate the adequacy of an entity’s internal control and make recommendations for improvement. They are part of monitoring component of internal control.</li> </ul>
<p>5. <b>Other Entity Personnel</b></p>	<ul style="list-style-type: none"> <li>Responsible to communicate any problems with non-compliance with control or illegal acts of which they become aware to a higher level (top management) in the organisation.</li> </ul>

## 4.6 DEVELOP OVERALL AUDIT PLAN

The COSO report identified five interrelated components of internal control as listed in Figure 4.3. Each component is explained in a following section.



**Figure 4.3:** Components of internal control

## 4.6.1 Control Environment

**Control environment** represents the tone set by management of an entity that influence the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. The control environments that establish, enhance, or mitigate the effectiveness of specific controls, and their components, are:

(a) **Integrity and Ethical Values**

The effectiveness and controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical values are essential elements of the control environment, affecting the design, administration, and monitoring of the other components. Integrity and ethical behaviour are the product of the entity's ethical and behavioural standards, how they are communicated, and how they are reinforced in practice.

(b) **A Commitment to Competence**

Management must specify the competence level for a particular job and translate it into required level of knowledge and skill. Management must then hire employees who have the appropriate competence for a job.

(c) **Assignment of Authority and Responsibility**

This factor includes how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established. This includes policies regarding acceptable business practices, the knowledge and experience of key personnel, and the resources provided for carrying out duties. It also includes policies and communications directed toward ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognise how and for what they will held accountable.

(d) **Participation of Board of Directors and Audit Committee**

The board of directors and audit committee significantly influence the control consciousness of the entity. Factors that affect the effectiveness of the board and audit committee include the following: its independence from the management, the experience and stature of its members, the extent of its involvement with and scrutiny of the entity's activities, the appropriateness of its actions, the degree to which difficult questions are raised and pursued with management, and its interaction with the internal and external auditors.

(e) **Organisational Structure**

The organisational structure defines how authority and responsibility are delegated and monitored. Establishing a relevant organisational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. It provides a framework for planning, executing and monitoring operations. An entity develops an organisational structure that depends on its size and nature of its business.

(f) **Human Resource Policies and Procedures**

The quality of internal control is a direct function of the quality of the personnel operating the system. The entity should have personnel policies for hiring, training, evaluating, counselling, promoting, compensating and taking remedial action.

## 4.6.2 Risk Assessment

Risk assessment is the organisation's process for identifying and analysing the risks relevant to the achievement of its objectives. The risk assessment forms the basis for determining how the risks should be managed. The risk assessment for financial reporting purposes is an entity's identification, analysis and management of risk relevant to the preparation of financial statements that are fairly presented in conformity with generally accepted accounting principles.

Auditors also should obtain sufficient information about the entity's risk assessment process to understand how management consider risks relevant to financial reporting objectives and decides how to address those risks. Examples of circumstances that can cause risks to arise or change include new personnel, rapid growth, new technology, new products or activities, changes to information systems and corporate restructurings.

## 4.6.3 Information and Communication

Information and Communication system relevant to financial reporting objectives, which includes the accounting system, consists of the methods and records established to identify, assemble, analyse, classify, record and report entity transactions. This is to maintain accountability for the related assets and liabilities. Communication involves providing a clear understanding of individual roles and responsibilities pertaining to internal control over financial reporting.

For financial reporting purposes, the accounting system is the most significant aspect of the information and communication component. An effective accounting system gives appropriate consideration to establishing records and method that will:

- (a) Identify and record all valid transactions;
- (b) Record on a timely basis the transactions, sufficient to permit proper classification of transactions for financial reporting purposes;
- (c) Measure the value of transactions that permits proper recording of monetary value in the financial statements;
- (d) Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period; and
- (e) Present properly the transactions and related disclosures in the financial statements.

#### **4.6.4 Control Activities**

Control Activities are those policies and procedures that help ensure that management directive actions are carried out. They help ensure that necessary actions are taken to address risks to achieve the entity's objectives. Control activities have various objectives and are applied at various organisation and functional levels. Control procedures can be categorised as follows:

- (a) Proper authorisation and approval of transactions and activities;
- (b) Adequate segregation of duties that reduce opportunities to allow any person to be in the position to both perpetrate and conceal errors or irregularities in the norms of his or her duties. For example; assigning different people the responsibilities of authorising transactions, recording transactions, and maintaining custody of assets;
- (c) Design and use adequate documents and records to help ensure the proper recording of transactions and events, such as pre-numbered shipping documents and invoices;
- (d) Adequate safeguards over access to and use of assets and records, such as secured facilities and authorisation to access to computer programs; and
- (e) Independent checks on performance and proper valuation of recorded amounts, for examples, clerical checks, reconciliations and management review of reports.

### 4.6.5 Monitoring

Monitoring is a process that assesses the quality of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions. For financial reporting purposes, two important aspects of monitoring are management control methods and internal audit function.

Management’s use of budgets and other financial reports to monitor operations can be a significant factor in monitoring control. Control is enhanced if management regularly compares recorded transactions and balances with expected results, based on sources such as budgets, standard costs and prior experience.

An internal audit’s function is to be responsible in monitoring the accounting system and related control procedures. The internal audit function determines that the internal control structure is functioning effectively. Internal auditor reviews operating practices to promote increased efficiency. Table 4.4 outlines examples of various control components.

**Table 4.4:** UEM Builders Berhad: Statement of Internal Control

Control Components	Description
<p>1. <b>Control Environment</b></p> <ul style="list-style-type: none"> <li>• Participation of the Board of Directors and Audit Committee</li> <li>• Assignment of Authority and Responsibility</li> <li>• Organisational Structure</li> </ul>	<ul style="list-style-type: none"> <li>• The internal auditors (IA) attend all the audit committee (AC) meetings. The external auditor also invited to brief the AC in respect of each year’s audit on statutory financial statements.</li> <li>• Authority limits for financial and non-financial transactions have been set up by the Board for each level of management within the group. The authority levels are regularly reviewed and revised to ensure their effectiveness.</li> <li>• In addition to AC, specific responsibilities have been delegated to three other committees, i.e., Remuneration, Nominations and Project Review Committees. These committees have the authority to examine all matters within their scope of responsibility based on written terms of reference and report to the Board with their recommendation for the Board’s decision.</li> <li>• The group has a well-defined structure aligned to the business needs. Its operations are divided into three core activities, namely Engineering</li> </ul>

	and Construction, Toll Collection and Infrastructure and Facilities Maintenance. The management of the entire operations of the group is delegated to the Managing Director whose roles, responsibilities and authority limits are set by the Board. The managing director is assisted by the Chief Operating Officer, Chief Financial Officer and Directors of the various divisions.
<ul style="list-style-type: none"> <li>Human Resource Policies and Procedures</li> </ul>	<ul style="list-style-type: none"> <li>A standardised Performance Management System is adopted throughout the group to review and improve the performance of each employee, which adds to their ability to operate and monitor systems of control effectively. This system is supported by a comprehensive employee database that serves as a guide for planning the manpower needs of the Group. Continuous education, training and development activities are provided to enhance the employees' knowledge, skills and abilities. The effectiveness of this system is further enhanced by measuring actual results against objectives set for each employee. Annual increments, bonuses and other incentives are provided to employees on the basis of their performance.</li> </ul>
2. <b>Entity Risk Assessment</b>	The board had approved a Risk Management Framework. The framework outlines the overall risk policy and objectives, processes, limits and reporting responsibilities.
3. <b>Information and Communication</b>	UEM has a direct reporting relationship to the AC, which ensures the adequacy, objectivity and effectiveness of internal audit function and resources.
4. <b>Control Procedures</b>	Detailed policies and procedures were developed to cover various operational areas including standard operating procedures and are regularly updated to provide guidance to all levels of staff.
5. <b>Monitoring</b>	The group has established a comprehensive performance monitoring and budgetary system covering all key financial and operating indicators for

	<p>monitoring of performance against the strategic plan approved by the board. The board acknowledges its responsibility to maintain a sound internal control system to safeguard shareholders' investment and the company's assets. Compliance with the system of internal control is closely monitored by the IA, where the findings are tabled to the AC.</p>
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## 4.7 UNDERSTANDING INTERNAL CONTROL

ISA400 emphasises that the auditors need reasonable assurance that the accounting system is adequate and the effective operation of the related internal controls normally contributes to such assurance. The auditor should gain an understanding of the accounting system and related internal controls and evaluate the operations of those internal controls upon which he wishes to rely in determining the nature, timing and extent of other audit procedures.

An audit is an independent professional examination of the company's financial information conducted with a view to express an opinion. Therefore, the auditor needs to study and understand the flow of transactions through the accounting system.

The purpose of obtaining an understanding of internal control is to find out how client believes the internal controls operate. It involves evaluating the design of internal controls and determining whether those controls have been placed in operation. Assessing control risk means to state the degree to which the auditor intends to rely on internal controls to reduce substantive test. For example auditor might assess control risk as low. Assessing control risk is done judgmentally, based upon the findings in the understanding of internal control and the result of the test of control.

The major steps used by auditors to understand and assess the internal control are as follows:

(a) **Methods of Understanding or Ascertaining the Internal Control System**

The auditor gains knowledge about the entity's internal controls by:

- (i) Examining last year's audit working paper;
- (ii) Enquiring the client's personnel;
- (iii) Observation of client's activities;
- (iv) Inspection documentation of client's records such as accounting records and internal control procedures manual; and

- (v) Tracing few transactions to follow particular sequence relating to single transactions.

(b) **Methods of Recording the Internal Control System**

Once the auditor understands and studies the nature of the client's internal control, the auditor needs to record his understanding using the following techniques:

(i) **Narrative Notes**

Narrative notes are written descriptions of accounting system and internal control. A memorandum may be used to supplement flowcharts or other forms of documentation by summarising the auditor's overall understanding of internal control, individual components of internal control, or specific policies or procedures. Figure 4.4 illustrates this type of documentation.

Client: TMI Inc.	Balance sheet date: 31/12		
Completed by: Man	Date: 30/08/X5	Reviewed by: Lan	Date: 15/03/X5
Updated by: Man	Date: 29/08/X6	Reviewed by: Lan	Date: 25/09/X6
<b>Understanding of the Control Environment</b>			
<p>The company manufactures plastic fishing worms at one location and is managed by its sole owner, Azman. Management of the company is dominated by Azman, who is responsible for marketing, purchasing, hiring and approving major transactions. He has an understanding of the business and the industry in which it operates. Azman believes that hiring experienced personnel is particularly important because there are no layer of supervisory personnel and thus, because of limited segregation of duties, there will be less independent checks of employees' work. Azman has a moderate-to-conservative attitude towards business risks. The business has demonstrated consistent profitability and, because Azman considers lower taxes to be as important as financial results, he has a conservative attitude toward accounting estimates.</p> <p>Hanni and Liza, the bookkeeper, readily consult with our firm on routine accounting questions, including the preparation of accounting estimates (tax accrual, inventory obsolescences, or bad debts) our firm also assists in assembling the financial statements.</p> <p>The company's board of directors is composed of family members. The board is not expected to monitor the business or the owner-manager activities.</p> <p>Azman made the decision to purchase a microcomputer and a turn key accounting software package. The source code is not available for this software. Access to the computer and computer files is limited to Hanni and Liza and Azman, who effectively have access to all computer files.</p> <p>The owner-manager carefully reviews the computer generated financial reports, such as</p>			

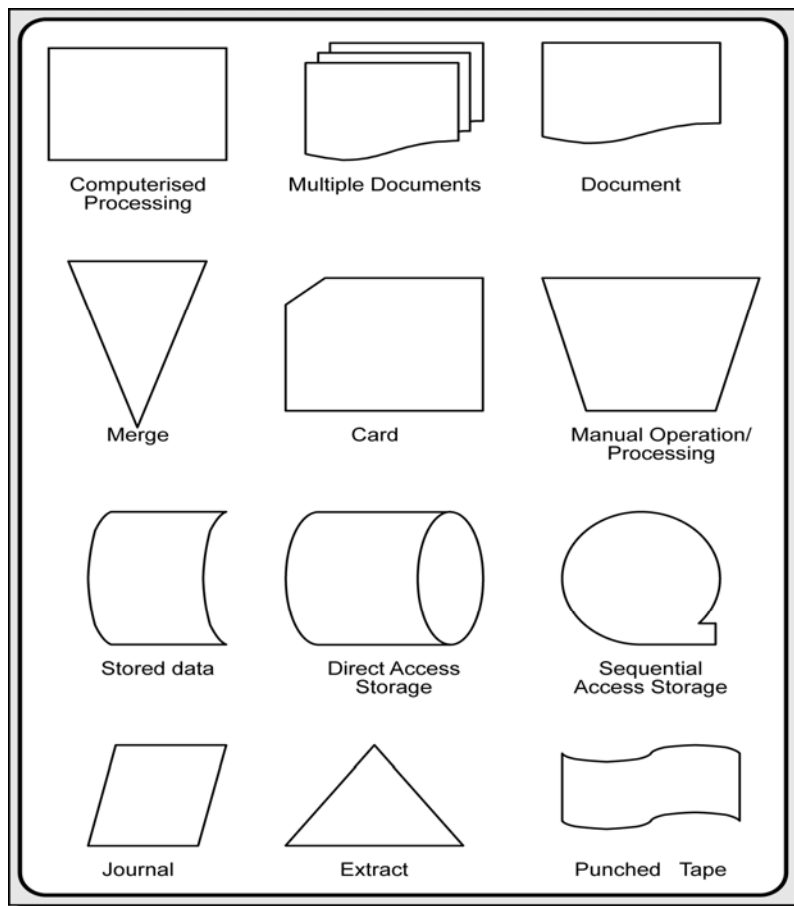
reports on receivable ageing, and compares revenues and expenses with the prior years' performance. He also monitors the terms of the long-term debt agreement that requires certain ratios and compensating balances.

**Source:** AICPA Audit Guide

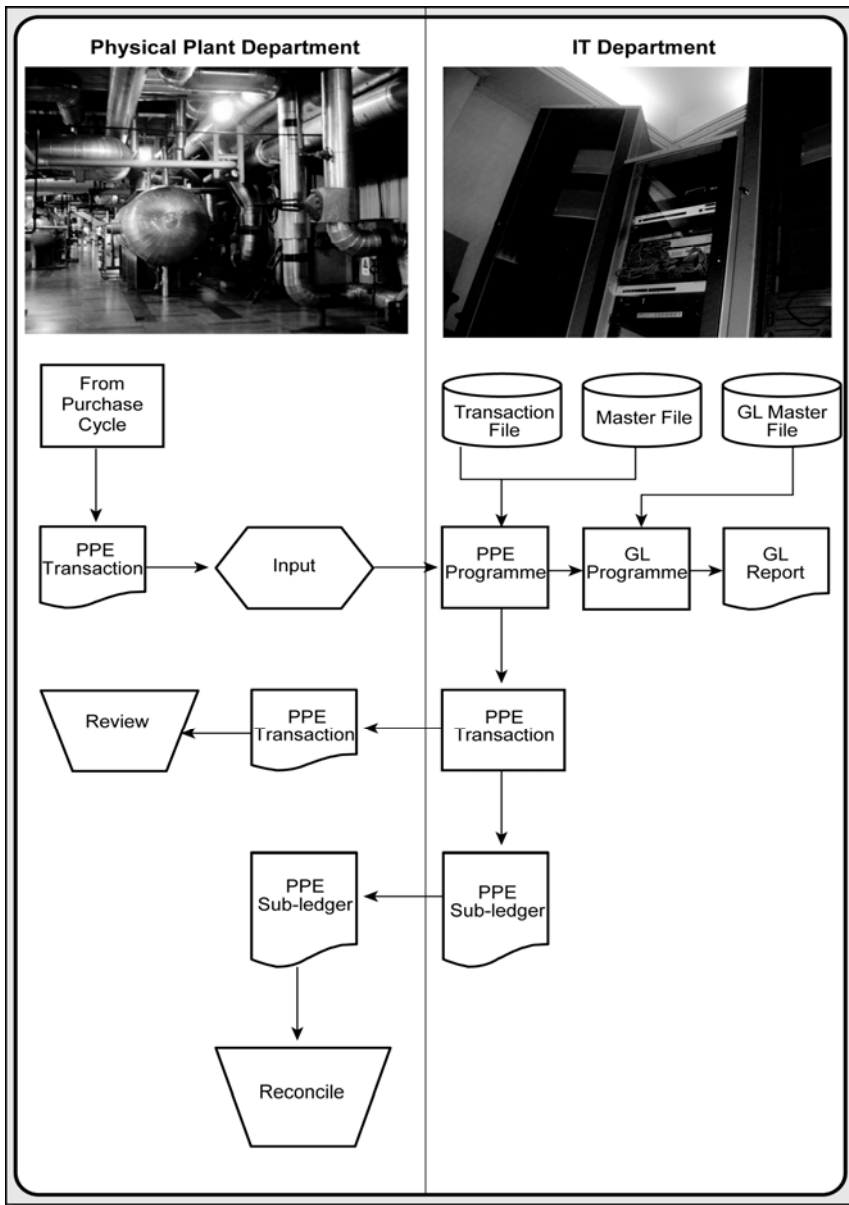
**Figure 4.4:** Narrative memorandum documenting understanding of control environment

(ii) **Flowchart**

Flowchart is a symbolic and diagrammatic representation of the client's documents and its sequential flow in the accounting system and internal controls. Symbols are used to represent documents, operations and checks carried out in the system. Figure 4.5 shows a standard flowchart used in understanding the entity's internal control. Figure 4.6 shows a flowchart depicting property, plant and equipment transaction.



**Figure 4.5:** Standard flowchart symbols



**Figure 4.6:** Flowchart of property plant and equipment (PPE) transactions internal control questionnaires (ICQs)

(iii) **Internal Control Questionnaires (ICQs)**

An ICQ is a pre-printed documents designed by audit firms. It is commonly used to assess the adequacy of the accounting systems. It consists of series of questions designed to establish which controls exist within the accounting system and to highlight any potential weakness in the system.

Each Question must be answered “Yes” or “No” or “N/A”. If answer is “No” attach an explanation.

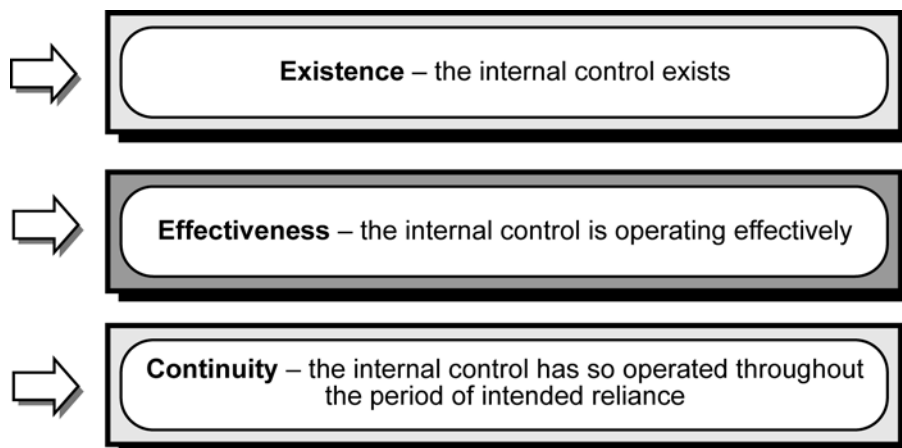
Sales

Answer	Questions
	<ol style="list-style-type: none"> <li>1. Are sales orders approved by the credit department before they are accepted?</li> <li>2. Is the credit function separated from other functions, particularly cash, sales, and accounting functions?</li> <li>3. Are shipping documents –                             <ul style="list-style-type: none"> <li>• used</li> <li>• used in all items leaving plant?</li> <li>• prenumbered?</li> </ul> </li> <li>4. Are shipping documents checked to customers’ orders for quantity and descriptions to determine that items shipped are those ordered?</li> <li>5. Are invoices –                             <ul style="list-style-type: none"> <li>• prepared on all sales?</li> <li>• pre-numbered?</li> </ul> </li> <li>6. Is a check made to to determine that there are notices of shipment for all invoices and invoices for all notices of shipments?</li> <li>7. Are invoices checked to notices of shipment for quantity and descriptions to determine that items shipped are being billed?</li> <li>8. Is a check made to determine that all invoices are recorded and all invoice numbers accounted for?</li> <li>9. Are invoices checked for –                             <ul style="list-style-type: none"> <li>• extensions?</li> <li>• footings?</li> <li>• terms?</li> <li>• prices?</li> </ul> </li> <li>10. Are partial shipments subject to the same procedures as regular sales?</li> <li>11. Do miscellaneous sales follow the same procedures as regular sales?</li> <li>12. Are sales summarise prepared, independent of the accounting department, which may be used as a check on recorded sales?</li> </ol>

**Figure 4.7:** Internal control questionnaires (ICQs)

## 4.8 TEST OF CONTROL (COMPLIANCE TEST)

Compliance tests or test of controls are those tests which seeks to provide reasonable evidence that internal control procedures are being applied as prescribed and intended. Test of controls provide evidence as to whether or not controls, on which the auditor wishes to rely, were functioning adequately during the audit period under review. Test of controls checks the functioning of a control, not the transaction itself. In obtaining audit evidence from test of controls, the auditor is concerned with the following assertions:



**Figure 4.8:** Assertions in obtaining audit evidence from test of controls

The auditor must obtain sufficient evidence to support the assessed level of control risk for an assertion. In assessing the control risk at less than maximum, the auditor has identified specified internal control structure policies and procedures that he or she believes will prevent or detect misstatements for the assertions. The evidence needed is to support those identified policies and procedures and to make sure they are effective. Some of the tests of control or audit procedures that will be conducted by auditors are as shown in Table 4.5:

**Table 4.5:** Common Auditing Procedures Used in Test of Controls

Auditing Procedures	Descriptions
<b>Observation</b>	Observation of personnel in the performance of their duties.
<b>Inquiries of client personnel</b>	Discussion or interview with client’s personnel regarding the performance of their duties.
<b>Walk-through Test</b>	A procedure that involves tracing a few transactions through the accounting system from initiation to final recording in the accounting records.
<b>Documentations</b>	Inspection and evaluation of documents for evidence that control procedures have been performed.
<b>Mechanical accuracy</b>	Reperforming calculations and bookkeeping procedures.

### 4.8.1 Effect on the Design of Substantive Tests

The result of the auditor’s consideration of the internal control structure is the assessment of control risk, which is then used in planning substantive tests for the various assertions within the transactions classes or account balances. If the auditor assessed the control risk at the maximum level, the result is that he or she must reduce the level of detection risk so that it is very low. Detection risk is reduced by performing substantive tests. The higher the level of assessed control risk, the more assurance the auditor must obtain from substantive tests.

An ineffective internal control structure results in the auditor having to increase the quantity and effectiveness of the substantive tests because there is general relationship between control objectives and audit objectives.



#### SELF-CHECK 4.2

Halim, a CPA, has been engaged in auditing financial statements of BCS Berhad. He is in the process of understanding the internal control structure. What do you think should be the considerations made by Halim when reviewing the effectiveness of any internal control structures? In addition, what are the inherent limitations that should be recognised?

## SUMMARY

- Internal controls are very important in ensuring reliable financial reporting through ensuring that transactions are processed correctly.
- Therefore, internal control is something that should be important for all companies regardless of their size.
- The management established adequate internal control to achieve efficient and effective operation of the entity the auditor is required to obtain an understanding of the controls relevant to the audit.
- This is when the auditor makes a preliminary assessment of control risk. When the preliminary assessment of control risk is less than high for a particular assertion, the auditor may decide to rely on these controls in performing the audit.
- Where reliance is placed on internal controls (reliance strategy) the auditor can reduce the required level of substantive tests that otherwise be performed to obtain the sufficient evidence needed to support audit opinion.
- To be able to do this, the auditor must perform test of control (compliance test) to evaluate effectiveness of operating controls. This is to provide evidence supporting the preliminary assessment of control risk.

## KEY TERMS

Authorisation	Internal auditors
Collusion	Internal control questionnaire
Control activities	Material weakness in internal control
Control environment	Monitoring
Control procedures	Monitoring of controls
Control risk	Narrative note
Flowchart	Segregation of duties
Independent checks	Walk-through test
Information and communication	Tests of controls

**SELF-TEST 1** .....

1. Internal control has become a very important focus for publicly-traded, and non-publicly traded companies alike. Internal control is intended to accomplish at least four objectives and consists of five components of internal control. List the four objectives and five components of internal control.
2. In terms of an audit, define 'substantive strategy' and 'reliance strategy'. How do the different strategies relate to internal control? Which strategy would best relate to a lower control risk?
3. Describe some limitations to internal control systems. Why do limitations on internal control exist?
4. What are the three potential tools available to the auditor for documenting their understanding of a client's system of internal control?

**SELF-TEST 2** .....

1. What are management's incentives for establishing and maintaining strong internal control?
2. Describe the five components of internal control.
3. What is meant by the concept of reasonable assurance in terms of internal control system?
4. What are some of the factors that affect the control environment?
5. Internal control system has become a very important focus for publicly-traded and non-public traded companies alike.

Required:

- (i) List the four objectives and five components of internal control.
- (ii) What are some typical types of procedures that is used in testing a client's internal controls?

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# Topic 5 ▶ Auditing Cash Balances and Inventory

## LEARNING OUTCOMES

By the end of this topic, you should be able to:

1. Explain the relationship between the cash-in-bank and transaction cycles;
2. Identify types of cash accounts;
3. Discuss the audit of general cash account and imprest petty cash;
4. Appraise the major parts of audit of inventory and the audit of cost accounting and
5. Describe the physical observation and substantive procedures involved in the audit of inventory.

## ▶ INTRODUCTION

This topic is divided into two parts; the first part will discuss on the audit of cash balances and followed by audit of inventory cycle. For every entity, proper cash and inventory management is crucial for its success. Because cash are susceptible to fraud and errors than other types of assets, so it normally represents critical audit area. As for the audit of inventory, especially test of year end inventory balance is often most complex and time-consuming part of the audit. It is also unique because of its close relationship to other transaction cycles.

Please refer to the following case scenario to have a picture of what auditing cash balances and inventory are.

Suzana, an audit assistant of Tan & Ahmad Firm is in the middle of an audit of a medium-sized construction company. She is discussing with her colleague on the explanation made by the controller of the company on preparation of bank reconciliation. The controller's remarks are as followed: "When I reconcile the bank account, the first thing I do is to sort the cheques in numerical order and find which numbers are missing. Then, I determine the amount of unpresented cheques by referring to the cash disbursements journal. If the bank account reconciles at that point, I am finished with the reconciliation. If it does not, I search for deposits in transit, cheques from the beginning outstanding cheque list that still have not cleared, other reconciling items, and bank errors until it reconciles. In most instances, I can do the reconciliation in less than 15 minutes."



### SELF-CHECK 5.1

1. What are the auditor's major concern in audit of cash balances?
2. How would the understanding of the relationship between cash in bank and other transactions cycle will help the auditor performs the audit effectively?

## 5.1 OVERVIEW OF CASH CYCLE

The scenario presented above is one of the typical examples found in the audit of cash balances. Usually the starting point for the verification of the bank balance in the general bank account is to obtain bank reconciliation from the client for inclusion in the auditor's documentation and most of the time it is regarded as the frame of reference for the audit tests. However, merely reconciling items to obtain the same book balance with balance in the bank as illustrated in the above scenario does not guarantee that the cash account is free from material misstatements. Hence a thorough understanding of transactions affecting the cash-in-bank will assist the auditor to determine appropriate type of audit evidence.

## 5.2 RELATIONSHIP OF CASH IN THE BANK AND OTHER TRANSACTION

A discussion of relationship between cash in the bank and the other transaction cycles serves a dual function: It clearly shows the importance of the tests of various transaction cycles to the audit of cash, and it aids in further understanding the integration of the different transaction cycles.

Figure 5.1 indicates why the general cash account is considered important in almost all audits even when the ending balance is immaterial. Figure 5.1 shows the relationship between cash in the bank and other transactions in capital acquisition and repayment cycle, acquisition and payment cycle, sales and collection cycle and payroll and personnel cycle. The amount of cash flowing into and out of the cash account is often larger than that for any other account in the financial statements. Additionally, the susceptibility of cash to defalcation is greater than for other types of assets because most other assets must be converted to cash to make them usable.

In the audit of cash, an important distinction should be made between verifying the client's reconciliation of the balance on the bank statement to the balance in the general ledger and verifying whether the recorded cash in the general ledger correctly reflects all cash transaction that took place during the year. For example, each of the following misstatements eventually results in the improper payment of or the failure to receive cash, but none will normally be discovered as a part of the audit of the bank reconciliation. They are:

- (a) Failure to bill a customer;
  - (b) Billing a customer at a lower price than called for by company policy;
  - (c) A defalcation of cash by interception of cash receipts from customers before they are recorded, with the account charged off as a bad debt;
  - (d) Duplicate payment of a supplier's invoice;
  - (e) Improper payments of officers' personal expenditures;
  - (f) Payment for raw materials that were not received;
  - (g) Payment to an employee for more hours than he or she worked; and
  - (h) Payment of interest to a related party for an amount in excess of the going rate.
- (i) All the above misstatements could be uncovered by conducting tests of controls and substantive tests of transactions.

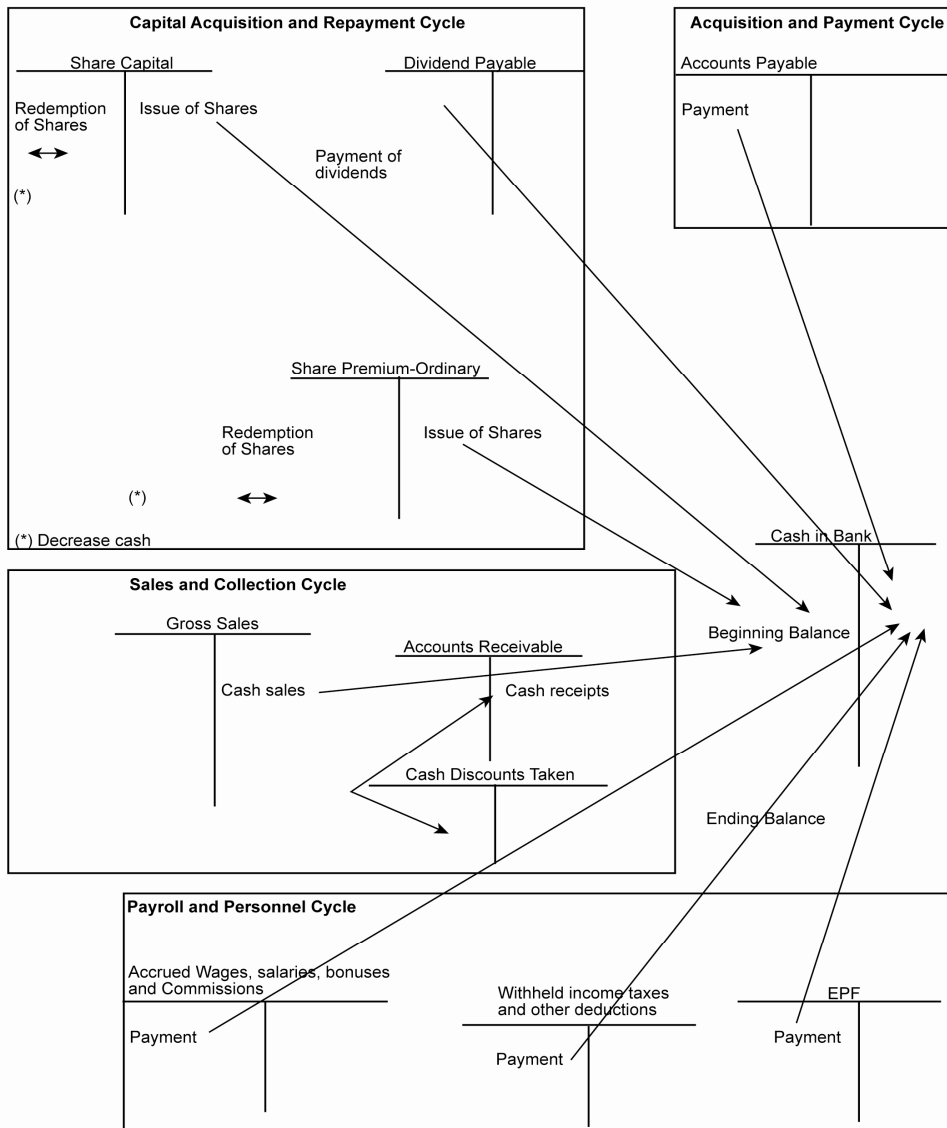


Figure 5.1: Relationship of cash in the bank and other transaction cycles

## 5.3 TYPES OF BANK ACCOUNTS

Cash is a very important asset in any type of organisation. Due to its importance and nature, the management of the company is concerned about its control and safekeeping. Also it is important to understand the different types of cash accounts because the auditing approach to each varies. The following types of bank accounts as shown in Figure 5.2 are usually found in an organisation.

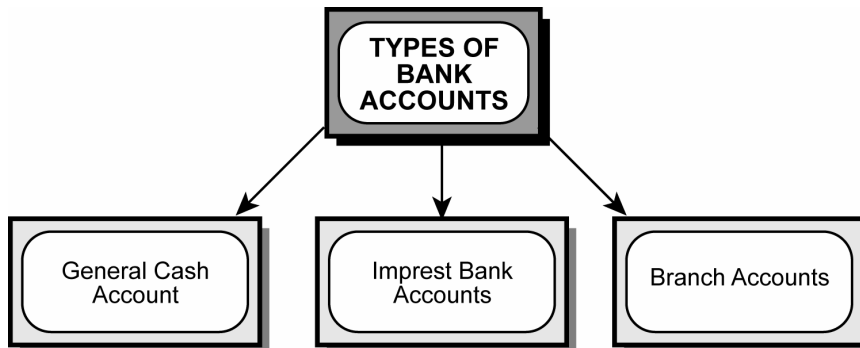


Figure 5.2: Types of bank accounts

### 5.3.1 General Cash Account

The general cash account is a principal cash account for most companies. It is because the general cash account is the central point of cash for most organisations since virtually all cash receipts and disbursements flow through this account. The major cash receipts for this accounts is from revenue cycle and the major cash disbursements are for purchasing and payroll cycle.

### 5.3.2 Imprest Bank Accounts

An imprest bank account contains a stipulated amount of money and the account is used for limited purposes. Imprest accounts are frequently used for disbursing payroll and dividend cheques. In the case of payroll, a separate bank account containing a minimum balance is established for disbursing payroll cheques. Prior to the disbursement of payroll cheques, a cheque is drawn or cash is transferred from general cash account to the payroll account for the amount of net payroll. The payroll cheques are then drawn on this imprest account. Thus, the payroll account serves as a clearing account for the payroll cheques and facilitates the disbursement of cash while also maintaining adequate control over cash. The use of imprest account also minimises the time needed to reconcile the general cash account and provides a better internal control to cash account.

### 5.3.3 Branch Accounts

Companies which operate several branches in multiple locations may maintain separate accounts at local banks. This allows each branch to pay local expenditure and to maintain a banking relationship with the local community. The branch account can be operated in a number of ways. In some cases, branch account works similarly as an imprest account. In other cases, a branch account functions similarly to a general cash account by recording both cash receipts and cash payments. For controlling purposes, the branch should be required to submit periodic cash reports to head office and the entity's management should carefully monitor the cash balances in the branch accounts.

## 5.4 CASH EQUIVALENTS

According to Para 7, FRS 107, cash equivalents are held for the purpose of meeting short-term cash commitments rather than for investment or other purposes. For an investment to qualify as a cash equivalent it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only when it has a short maturity of, say, three months or less from the date of acquisition. Equity investments are therefore not cash equivalent unless they are, in substance, cash equivalents, for example in the case of preferred shares acquired within a short period of their maturity and with a specified redemption date.

## 5.5 TEST OF DETAILS BALANCE

The reliability of the client's control procedures over cash receipts and cash disbursements affects the nature and extent of the auditor's substantive procedures for cash balances. Internal controls over year-end cash balances in general account can be divided into two categories: controls over the transaction cycles affecting the recording of cash receipts and disbursements; and independent bank reconciliation. As shown in Figure 5.1 above, cash in the bank are related to the transaction in other cycles. Therefore control affecting the recording of cash transactions will be most affected by the control in place in other cycles. For example, in revenue and collection cycle, major controls include adequate separation of duties between the personnel involved in recording the cash receipts and handling the physical cash, cash received is prelisted and deposit of cash is done daily. In the acquisition and payment cycle, major controls involve adequate segregation of duties between the cheques signing and accounts payable functions, signing of cheque only by a properly authorised person, adequate control of blank and voided cheque as well as adequate internal verification.

A monthly bank reconciliation of the general bank account on a timely basis by someone independent of the handling or recording cash receipts and disbursements is an essential control over cash balance. The bank reconciliation is important to ensure that the books reflect the same cash balance as the actual amount of cash in the bank after considering reconciling items and provides opportunity for internal verification of cash receipts and disbursements transactions. Control can be improved further if an independent party such as the internal auditor reviews the bank reconciliation.

Table 5.1 summarises the audit objectives and common test of details of balances procedures in general cash in the bank. As in all audit areas, the actual audit procedures depend on the materiality and the risks the auditor has identified in other parts of the audit that are related to cash. Also, because of their close relationship in the audit of year-end cash, the existence of recorded cash in the bank, accuracy and inclusion of existing cash (completeness) are combined. These three objectives are the most important ones for cash and therefore receive the greatest attention.

A bank reconciliation by competent client personnel includes the following:

- (a) Compare cancelled cheques with the cash disbursements records for date, payee and amount;
- (b) Examine cancelled cheques for signature, endorsement, and cancellation;
- (c) Compare deposits in the bank with recorded cash receipts for date, customer, and amount;
- (d) Account for numerical sequence of cheques, and investigate missing ones;
- (e) Reconcile all items causing a difference between the book and bank balances and verify their propriety;
- (f) Reconcile total debits on the bank statement with the totals in the cash disbursements records;
- (g) Reconcile total credits on the bank statement with the totals in the cash receipts record;
- (h) Review month-end bank transfers for propriety and proper recording; and
- (i) Follow up on outstanding cheques and stop-payment notices.

**Table 5.1:** General Cash in the Bank - Audit Objectives and Tests of Details Balances

Audit Objective	Common Tests of Details of Balances Procedures
<p>Cash in the bank as stated on the reconciliation foots correctly and agrees with the general ledger (detail tie-in)</p>	<p>Foot the outstanding checklist and deposits in transit.                      Prove the bank reconciliation as to additions and subtractions, including all reconciling items.                      Trace the book balance on the reconciliation to the general ledger.</p>
<p>Cash in the bank as stated on the reconciliation exists (existence).                      Existing cash in the bank is recorded (completeness)                      Cash in the bank as stated on the reconciliation is accurate (accuracy)</p>	<p>Receipt and tests of a bank confirmation.                      Receipt and tests of a cut-off bank statements.                      Tests of the bank reconciliation.                      Extended tests of the bank reconciliation.                      Proof of cash.                      Tests for kitting.</p>
<p>Cash receipts and cash disbursements transactions are recorded in the proper period (cut-off)</p>	<p><b><u>Cash receipts:</u></b>                      Count the cash-on-hand on the last day of the year and subsequently trace to deposits in transit and the cash receipts journal.                      Trace deposits in transit to subsequent period bank statement (cut-off bank statement).  <b><u>Cash disbursements:</u></b>                      Record the last cheque number used on the last day of the year and subsequently trace to the outstanding cheques and the cash disbursements journal.                      Trace outstanding cheques to subsequent period bank statement.</p>
<p>Cash in the bank is properly presented and disclosed (presentation and disclosure)</p>	<p>(i) Examine minutes, loan agreements and obtain confirmation for restrictions on the use of cash and compensating balances.                      (ii) Review financial statements to make sure that:</p> <ul style="list-style-type: none"> <li>• material savings accounts and certificates of deposits are disclosed separately from cash in the bank,</li> <li>• cash restricted to certain uses and compensating balances are adequately disclosed, and</li> <li>• bank overdrafts are included as current liabilities.</li> </ul>

## 5.6 AUDITING THE GENERAL CASH ACCOUNT

To audit a cash account, the auditor should obtain the following documents:

- (a) A copy of bank reconciliation
- (b) A standard letter to request information from financial institutions
- (c) Subsequent bank statement(s).

### 5.6.1 Bank Reconciliation Working Paper

In most audits, the auditor obtains a copy of the bank reconciliation prepared by the client's personnel. The working paper reconciles the balance per the bank with the balance per the books. The major reconciling items are deposit in transit, outstanding cheques, and other adjustments such as bank service charges or client's errors or bank errors and non-sufficient fund cheques.

Example of a bank reconciliation working paper is shown in Figure 5.3.

	AMD	C2 6/3/07
XYZ Sdn Bhd		
Bank Reconciliation 31/12/06		
General Cash Account		
Balance per bank: C3		1,800,000C
Add:		
Deposit in transit:		
30/12/06	150,000v	
31/12/06	115,000v	265,000
Deduct:		
Outstanding cheques:		
25,000e		
12,000e		
5,678e		
24,000e		
15,000e		( 81,678 )
Balance per books, unadjusted		1,983,322
Adjustments to books:		
Bank service charges	RM200	
NSF cheque	5,000	(5,200)
Balance per books, adjusted		RM1,978,122 L
		K

- K** = Cast
- C** = Traced balance to bank confirmation
- L** = Agreed to cash lead schedule and general ledger
- v** = Traced amount to subsequent bank statement
- e** = Examined payment voucher for date, cheque number, amount, and approval.

Figure 5.3: Example of a bank reconciliation working paper

## 5.6.2 Standard Bank Confirmation Request

The auditor generally confirms the account balance and other financial information with every bank or financial institution that maintains an account for or has dealings with the client. As a convenience to auditors as well as to bankers who are requested to respond to bank confirmations, a standard bank confirmation letter is normally used. The importance of bank confirmations in the audit extends beyond the verification of the actual cash balance. It is typical for the bank to confirm loan information and bank balances on the same form. After the bank reconciliation has been received, the balance in the bank account confirmed by the bank should be traced to the amount stated on the bank reconciliation. Similarly, all other information on the reconciliation should be traced to the relevant audit schedules. In instances where the information is not in agreement, further investigation needs to be done.

## 5.6.3 Subsequent Bank Statements

These are bank statements for subsequent month(s), after year end. A major step in auditing a bank reconciliation is verifying the propriety of the reconciling items such as deposit in transit and outstanding cheques and the auditor should obtain the subsequent bank statement to test the reconciling items included in the bank reconciliation.

## 5.6.4 Test of the Bank Reconciliation

The auditor usually uses the following audit procedures to test the bank reconciliation:

- (a) Verify that the client's bank reconciliation is mathematically accurate.
- (b) Agreement between the bank balances on the bank reconciliation with the bank balance shown on the standard bank confirmation. The balance per bank in the bank reconciliation should agree with the balance shown in the bank confirmation for the particular bank account. The balance should also correspond to the balance per bank statement at the end of the period.

- (c) Trace the deposits in transit on the bank reconciliation to subsequent bank statement. Any deposit in transit shown on the bank reconciliation should be listed as a deposit shortly after the end of the period.
- (d) Compare the outstanding cheques on the bank reconciliation working paper with the cheques cleared contained in the subsequent bank statement for cheque number, date and amount. Investigate all significant cheques included in the outstanding cheque list that have not cleared the bank by tracing the amount to the cash disbursements journal.
- (e) Agreement between any charges included in the bank statement to the bank reconciliation. These included items such as bank error, stamp duty charges, interest debit or amount credited directly to the account by the bank. These need to be examined to determine that they have been treated properly by the client.



### ACTIVITY 5.1

Evaluate the following remarks by an auditor:

“In confirming bank accounts, I insist upon a response from every bank the client has done business with for the past 2 years even though the account may have been closed or less than RM10 balance at balance sheet date.”

## 5.7 FRAUD-RELATED AUDIT PROCEDURE

If the client does not have adequate control procedures over cash or the auditor suspects some type of fraud or defalcation involving cash, it may be necessary to extend the normal cash audit procedures.

### 5.7.1 Proof of Cash

A proof of cash is used to reconcile the cash receipts and disbursements recorded on the client’s books with cash deposited into and disbursed from the client’s bank account for a specific period of time. It is usually prepared when the client has material internal control weaknesses over cash. A proof of cash includes the following:

- (a) A reconciliation of the balance on the bank statement with the general ledger balance at the beginning of the proof-of-cash period;
- (b) A reconciliation of cash receipts deposited per the bank with the cash receipts journal for a given period;

- (c) A reconciliation of cleared cheques clearing the bank with the cash disbursements journal for a given period; and
- (d) A reconciliation of the balance on the bank statement with the general ledger balance at the end of the proof-of-cash period.

### 5.7.2 Extended Bank Reconciliation Procedures

In some instances, the year-end bank reconciliation can be used to cover cash defalcation. For example, suppose a client employee was able to steal RM10,000 from the client. The client's cash balance at the bank would then be RM10,000 less than reported on the client's book. The employee could hide the RM10,000 shortages in bank reconciliation by including a fictitious deposit in transit. Thus a possible approach to cover the fraud is to extend the bank reconciliation procedures to examine the disposition of the reconciling items included in the current bank reconciliation. For example if the auditor suspected that the fraud had been committed, the auditor will examine the November and December bank reconciliations by ensuring that all reconciling items had been properly handled.

For deposits in transit on the November bank reconciliation, the auditor would trace the deposits to the November cash receipts journal to verify that they were recorded. The deposits would also be traced to the December bank statement to verify that they were deposited in the bank. Cheques listed as outstanding on the November bank reconciliation would be traced to the November cash disbursements journal. Other reconciling items such as bank charges, NSF cheques and collections by the bank would be similarly traced to the accounting records for proper treatment.

### 5.7.3 Test for Kitting

When cash has been stolen by an employee, it is possible to cover the cash shortage by following a practice known as kitting. This involves an employee covering the cash shortage by transferring money from one bank account to another and recording the transactions improperly in the client's books. Concealing the cash shortage can be accomplished by preparing a cheque on one account before the year-end but not recording it as a cash disbursement in the account until the next period.

The cheque is deposited in a second account before year-end and recorded as a cash receipt in the current period. The deposit must occur close enough to year-end that it will not clear the first bank account before the end of the year.

One approach that auditors commonly use to test for kitting is the preparation of an inter-bank transfer schedule such as shown in Table 5.2. It provides few examples of the types of cash transfers an auditor might encounter.

**Table 5.2:** Example of an Interbank Transfer Schedule

Transfer No	Amount	Account No 1 Disbursement Dates		Account No 2 Receipts and Deposit Dates	
		Per Client Books	Per Bank Statement	Per Client Books	Per Bank Statement
1	RM16,000	28/12	30/12	28/12	29/12
2	8,000	30/12	2/1	30/12	31/12
3	9,000	31/12	2/1	31/12	2/1
4	10,000	2/1	2/1	30/12	31/12
5	4,000	3/1	3/1	3/1	30/12

Let us look at the table. For example transfer 1, the transfer was made on 28 December and recorded on the books as both a receipt and disbursement on the same date. The cheque written was deposited on 28 December in the receiving bank account and credited on the bank statement the next day. The cheque cleared account on 30 December. All dates are in the same accounting period, so there is no question as to the propriety of the cut-off. Transfer no 2 is considered as proper transfer, however the transfer cheque should appear as an outstanding cheque on the reconciliation of account 1. Similarly, transfer 3 is also proper. In this transfer, it should appear as a deposit in transit on the reconciliation of account 2 and as an outstanding cheque on the reconciliation of account 1. Transfer 4 represents kitting because the receipt was recorded on the books in the period prior to that in which the corresponding disbursement was recorded. Cash is overstated by RM10,000. Similarly, transfer 5 is also improper. In this case a deposit was made in the receiving bank, the transfer was apparently made to temporarily cover a shortage in that account. While the shortage will become apparent in the accounts as soon as the transfer is recorded in the following period, it will be covered by an unrecorded deposit on the balance sheet date.

## 5.8 AUDITING A BANK IMPREST ACCOUNT AND PETTY CASH FUND

The audit of any imprest cash account and petty cash fund follows the same basic audit steps discussed under the audit of general cash account. However, the audit testing is less extensive as the amount is generally immaterial and the types of disbursements from the account are homogeneous. Although the balance in the petty cash fund is not material, there is a potential for defalcation because a client's employee may be able to process numerous fraudulent transactions through the fund over the course of a year. Auditors seldom perform detailed substantive testing of the petty cash fund, except when fraud is suspected.

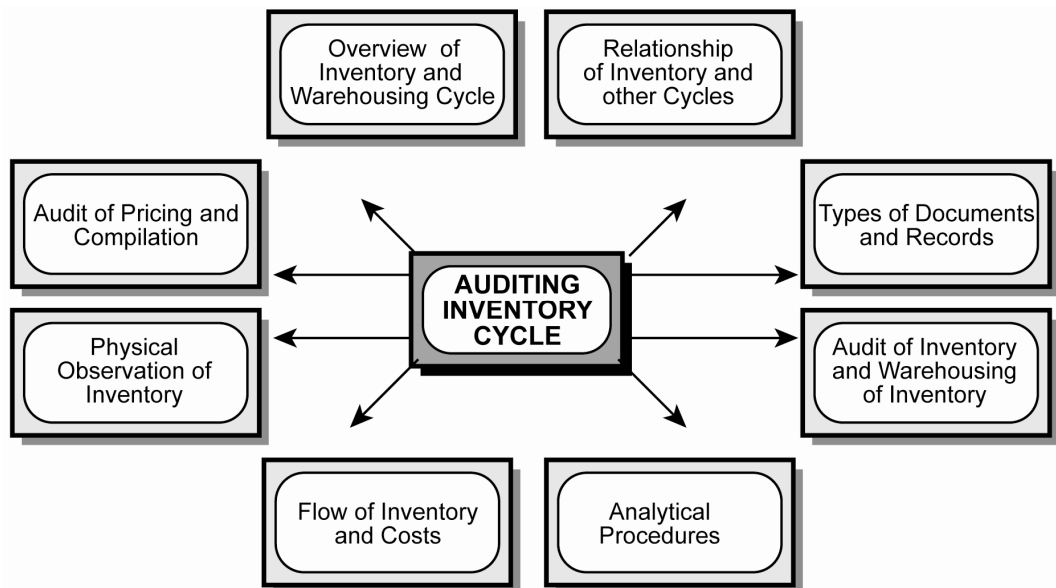


Figure 5.4: Audit of inventory cycle

The following shows a scenario of auditing inventory cycle.

Mr Ratnam, a senior manager of Ratnam & Co, reviews the stocktake instructions of a client attached with a working paper inside the audit file. The instructions are as follows:

1. Warehouse is to be tidied thoroughly the week before the stocktake and packing cases should be stacked as closely as possible, to allow staff to move freely. The warehouse is to be divided into clearly defined areas. Each area will be assigned to one of the warehouse staff, who will be responsible for counting the stock. However, the responsibility of identifying the obsolete stock lies with the manager.
2. A stocksheets will be given to each counter. Staff should return the completed sheets promptly to the warehouse manager. Each item should be marked with chalk when it has been counted. After completing the count, each staff is responsible to inspect the area to ensure that there are no unmarked items.
3. When all stocksheets has been returned, managers should review them and enquire into the reasons for any unexpectedly high or low stock figure. When this has been done, the sheets should be transcribed on the final sheets by a member of the clerical staff, to ensure that they are legible.

After reviewing the stocktake instructions and notes made by the audit supervisor in the working paper, he immediately called his audit team, who observed the physical stocktake for further explanation. On his remark to the audit team: "Having read the stocktake instructions, I found that many controls have been omitted. Did you perform any procedure other than physical observation of stocktake to justify the audit conclusion?"

## 5.9 OVERVIEW OF INVENTORY AND WAREHOUSING CYCLE

According to FRS 102, inventories are assets:

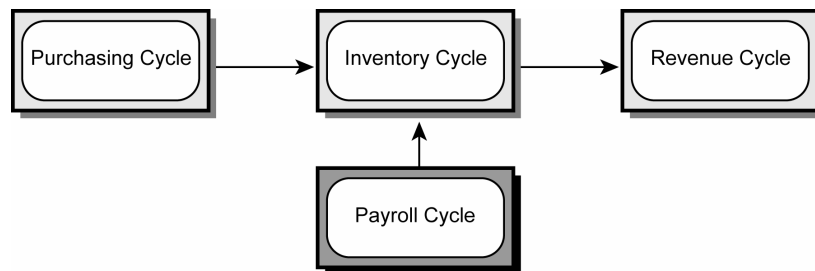
- (a) Held for sale in the ordinary course of business;
- (b) In the process of production for such sale; or
- (c) In the form of material or supplies to be consumed in the production process or in the rendering of services.

ISA 501 Audit Evidence Additional Consideration for Specific Item requires auditor to be present at the physical inventory count. The purpose of the attendance is to enable the auditor to obtain evidence as to the existence as well as ownership and valuation of the inventory. As physical observation of inventory count represents a significant portion of audit relating to inventory, the auditor needs to properly evaluate the client’s instruction of stock count. This is essential to ensure that the client’s personnel adhere to the instructions and whether significant control exists or has been omitted. If important controls are being omitted, the auditor should evaluate what effect might this omission have on the result of the stocktaking and how he should modify his audit work in order to draw a right conclusion. This is basically the issue raised by the senior manager to the audit team in the scenario described above.

Although, physical observation of stock count is fundamental in arriving at the conclusion as to the fairness of inventory presented in the financial statements, the auditor also should be aware of other audit tests and types of evidence available. Hence, the following sections merit considerable attention from the auditor in order to obtain a comprehensive understanding of inventory and warehousing cycle. We start off by explaining the relationship of inventory cycle to other business transaction cycles.

## 5.10 THE RELATIONSHIP OF THE INVENTORY CYCLE TO OTHER BUSINESS TRANSACTION CYCLES

As mentioned earlier in the introduction paragraph, the inventory and warehousing cycle is unique because of its close relationships to other transaction cycles. Inventory cycle is affected by the internal control procedures in revenue, purchasing, and payroll cycles. Figure 5.5 below shows how each of these cycles interacts with the inventory cycles. The acquisition of and payment for inventory are controlled via the purchasing cycle. The cost of both direct and indirect labour assigned to inventory is controlled through the payroll cycle. While, finished goods are sold and accounted for as part of the revenue cycle.



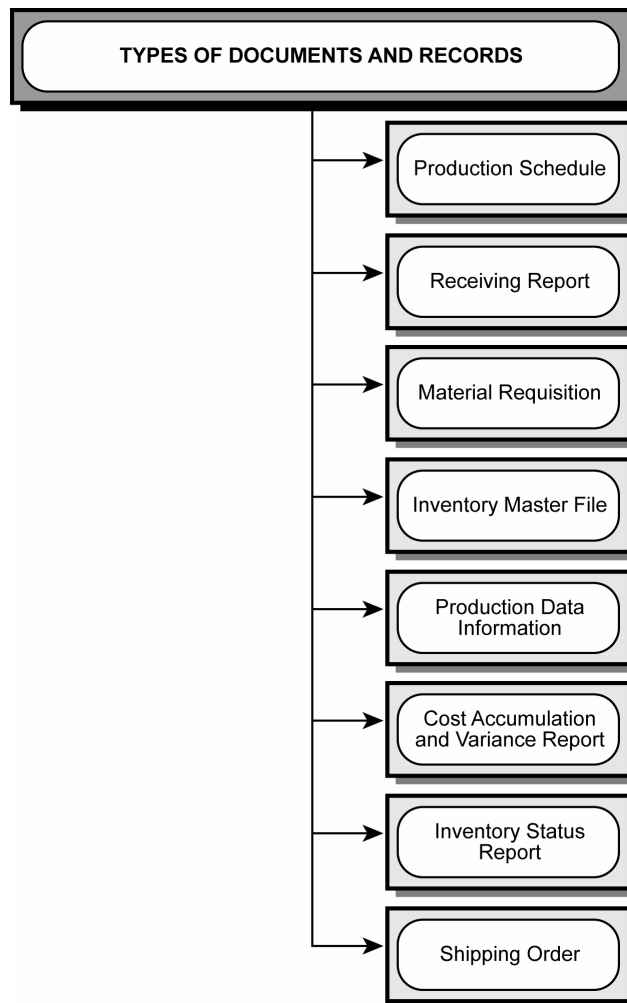
**Figure 5.5:** Interactions of inventory cycles to other business transaction cycles

**SELF-CHECK 5.2**

In the verification of the amount of the inventory, one of the auditor's concerns is that slow-moving and obsolete items be identified. What audit procedures could be used to determine whether slow-moving or obsolete items have been included in the inventory?

**5.11 TYPES OF DOCUMENTS AND RECORDS**

Figure 5.6 displays the important documents and records included in the inventory cycle.



**Figure 5.6:** Types of documents and records in inventory cycle

The types of documents and records included in the inventory cycle are explained as follows:

(a) **Production Schedule**

A production schedule is normally prepared periodically based on the expected demand for the entity's products. Production schedules determine the quantity of goods needed and the time at which they are ready in order to meet the production scheduling.

(b) **Receiving Report**

The receiving report records the receipt of goods from suppliers. This document is part of the purchasing cycle. It is also reconsidered in the inventory cycle because a copy of this document accompanies the goods to the inventory department and is used to update the client's perpetual inventory records.

(c) **Material Requisition**

Materials requisitions are normally used by manufacturing companies to track materials during the production process. Materials requisitions are normally prepared by department personnel as needed for production purposes. For example, the materials requisition is the document that authorises the release of raw materials from the raw materials department.

(d) **Inventory Master File**

The inventory master file contains all the important information related to the entity's inventory, including the perpetual inventory records.

(e) **Production Data Information**

In a manufacturing company, production information about the transfer of goods and related cost accumulation at each stage of production should be reported.

(f) **Cost Accumulation and Variance Report**

Most inventory control systems in a manufacturing setting produce reports similar to a cost accumulation and variance report. The cost accumulation report summarises the various costs charge to departments such as raw material, labour and overhead costs. Variance report shows the difference between the actual result and what have been budgeted.

(g) **Inventory Status Report**

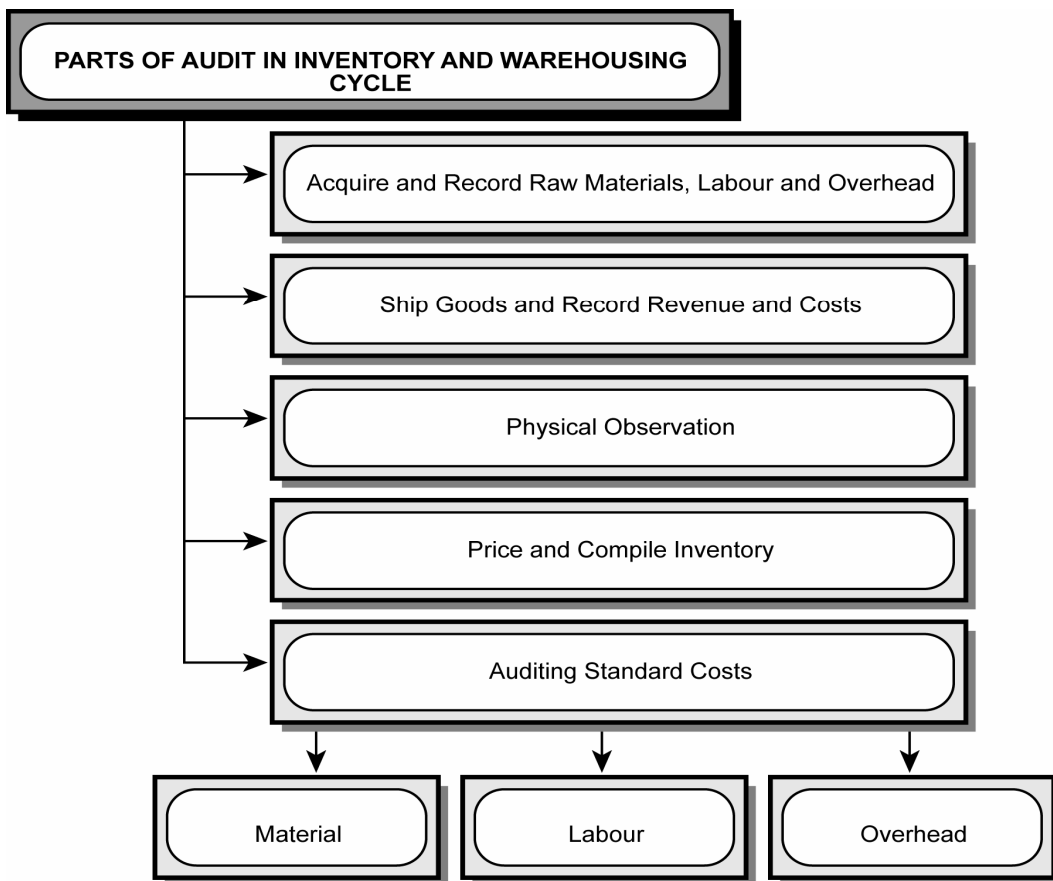
The inventory status report shows the type and amount of products on hand. Such a report is basically a summary of the perpetual inventory records. This report can also be used to determine the status of goods-in-process.

(h) **Shipping Order**

This document is used in the revenue cycle. It is reconsidered here because a copy of this document is used to remove goods from the client's perpetual inventory records.

## 5.12 AUDIT OF THE INVENTORY AND WAREHOUSING OF INVENTORY

The overall objective in the audit of the inventory and warehousing cycle is to determine the raw materials, work-in-process, finished goods inventory and cost of goods are fairly stated on the financial statements. However, because the inventory cycle interacts with the revenue, purchasing and payroll cycles, transactions involving the receipts of goods, shipment of goods and assignment of labour costs are normally tested as part of those cycles. Figure 5.7 shows a brief description of the parts of the audit in inventory and warehousing cycle.



**Figure 5.7:** Parts of the audit in inventory and warehousing cycle

### **5.12.1 Acquire and Record Raw Materials, Labour and Overhead**

The audit involves the three earlier functions in inventory and warehousing cycle: process purchase orders, receive raw materials and store raw materials. The internal controls over these three functions are first understood then tested as a part of performing tests of controls and substantive tests of transactions in the acquisition and payment cycle and personnel cycle. Similarly, when labour is a significant part of inventory processing, the payroll and personnel cycle tests should verify the proper accounting for these costs.

### **5.12.2 Ship Goods and Record Revenue and Costs**

Recording of shipments and related costs are part of the revenue and collection cycle. Test of controls and substantive tests of transactions should include procedures to verify the accuracy of the perpetual inventory master files.

### **5.12.3 Physical Observation**

Observing the client taking physical inventory count is necessary to determine whether the recorded inventory actually exists at the balance sheet date and is properly counted by the client. Inventory is one of the audit area for which physical examination is an essential type of evidence used to verify the balance in an account. Physical observation will be discussed in detail later in this topic.

### **5.12.4 Price and Compile Inventory**

Cost used to value the physical inventory must be tested to determine whether the client has correctly followed an inventory method that is in accordance with approved accounting standards and consistent with prior years method. Audit procedures used to verify these costs are called price tests. In addition, the auditor must verify whether the physical counts were correctly summarised, the inventory quantities and prices were correctly extended, and the extended inventory was correctly-footed. These tests are called compilation tests. Audit of pricing and compilation will be discussed in the last part of this topic.

### **5.12.5 Auditing Standard Costs**

Most manufacturing companies use standard cost system to measure performance and to value inventory. If a standard cost system is integrated with the general accounting records, cost accumulation and variance reports are direct

outputs of the client's inventory-accounting system. For proper valuation, standard costs should approximate actual costs. To test the standard costs, the auditor should first review the client's policies and procedures for constructing standard costs. Once the policies and procedures are understood, the auditor normally tests the component cost buildup for a representative sample of standard product costs. Three components make up the cost of producing a product: material, labour and overhead. Explanations are given below:

(a) **Material**

Determining the costs of materials requires testing the quantity and type of materials included in the product and the price of the materials. The quantity and type of materials are tested by reviewing the engineering specifications for the product. The auditor can compare the lists of materials with the standard cost card or other cost documentation used to support the cost accumulation. The prices used on the standard cost card can be traced to suppliers' invoices as a test of actual costs.

(b) **Labour**

The determination of labour costs requires evidence about the type and amount of labour needed for production and the labour rate.

(c) **Overhead**

The auditor tests overhead costs by reviewing the client's method of overhead allocation for reasonableness, compliance with accounting standards, and consistency. The auditor can examine the costs included in overhead to be sure that such costs can appropriately be assigned to the product. The inclusion or exclusion of such costs should be consistent from one period to the next.

## 5.13 ANALYTICAL PROCEDURES

Analytical procedures are as important in auditing inventory and warehousing as in any other cycle. In addition to performing analytical procedures that examine the relationship of inventory account balances with other financial statement accounts, auditors often use non-financial information to assess the reasonableness of inventory-related balances.

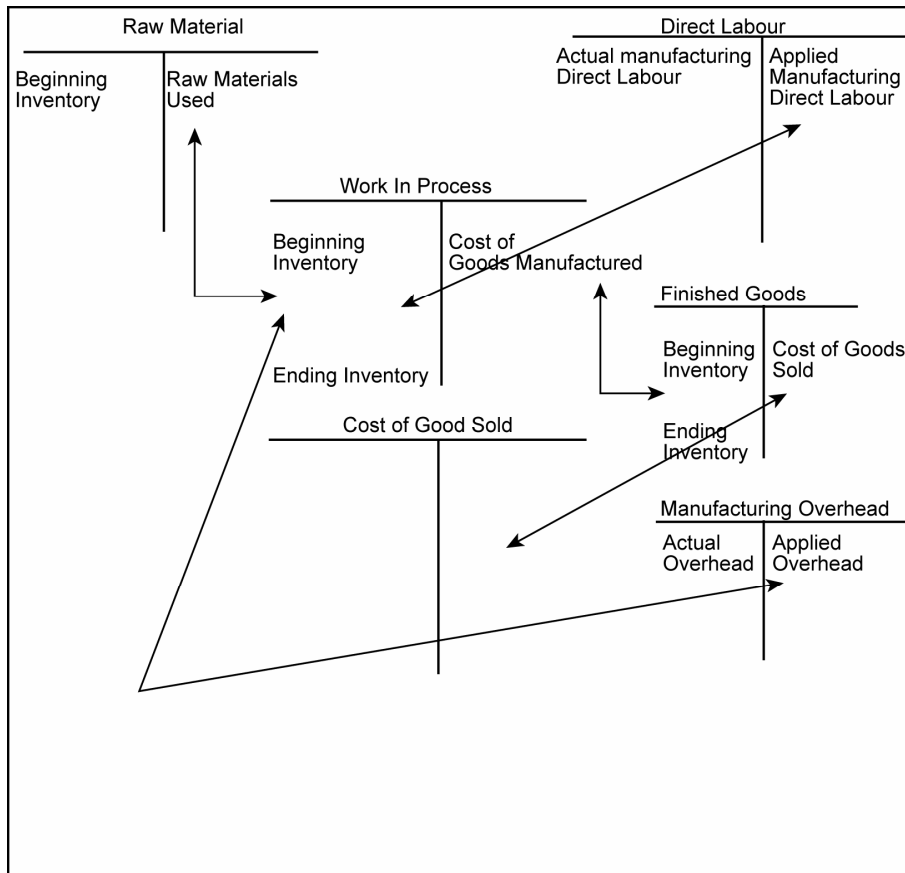
Table 5.3 below shows the common analytical procedures conducted in audit of inventory and warehousing cycle and possible misstatements that can be detected from those procedures.

**Table 5.3:** Analytical Procedures for the Inventory and Warehousing Cycle

Analytical Procedure	Possible Misstatement
Compare gross margin percentage with that of previous years.	Overstatement or understatement of inventory and cost of goods sold.
Compare inventory turnover (cost of goods sold divided by average inventory) with that of previous years.	Obsolete inventory which affects inventory and cost of goods sold. Overstatement or understatement of inventory.
Compare unit costs of inventory with those of previous years.	Overstatement or understatement of unit costs, which affect inventory and cost of goods sold.
Compare extended inventory value with that of previous years.	Misstatements in compilation, unit costs, or extensions, which affect inventory and cost goods sold.
Compare current year manufacturing costs with those of previous years (variable costs should be adjusted for changes in volume).	Misstatements of unit costs of inventory, especially direct labour and manufacturing overhead, which affect inventory and cost of goods sold.

## 5.14 FLOW OF INVENTORY AND COSTS

Figure 5.8 illustrates the physical flow of goods and the flow of costs in the inventory and warehousing cycle.



**Figure 5.8:** Physical flow of goods and the flow of costs in the inventory and warehousing cycle

## 5.15 PHYSICAL OBSERVATION OF INVENTORY

The auditor's attendance at physical inventory count is required by ISA 501 Audit Evidence Additional Consideration for Specific Items. The purpose of such attendance is to enable the auditor to obtain evidence regarding the existence of the inventory. It also could provide evidence of ownership and valuation audit objectives.

ISA 501 states that when inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at physical inventory counting unless impracticable. Where attendance is impracticable, due to factors such as the nature and location of the inventory, the auditor should consider whether alternative procedures provide sufficient appropriate audit evidence of existence and condition to conclude that the auditor need not make reference to a scope

limitation. For example, documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory count may provide sufficient appropriate audit evidence.

A distinction has to be made between the observation of the physical inventory count and the responsibility for taking the count. The client has the responsibility for setting up the procedures for taking an accurate physical inventory and actually making and recording the count. The auditor's responsibility is to evaluate and observe the client's physical procedures and draw conclusions about the adequacy of the physical inventory.

Based on the physical inventory count, the client compiles the physical inventory. While the form of compilation may differ among entities, it normally contains a list of the items by type and quantity, the assigned cost for each item, and a total for the inventory. Prior to the physical count of inventory, the auditor should be familiar with the inventory locations, the major items in inventory and the client's instruction for counting inventory. This is important to evaluate the effectiveness of the client's procedures but it also enables the auditor to make useful suggestions beforehand.

During the observation of the physical inventory count, the auditor should do the following:

- (a) Ensure that no production is scheduled. If the production is scheduled, ensure that proper controls are established for the movement between departments in order to prevent double counting.
- (b) Ensure that there is no movement of goods during the inventory count. If the movement is necessary, the auditor and client personnel must ensure that the goods are not double counted and that all goods are counted.
- (c) Make sure that the client's count teams are following the inventory count instructions. If they are not following the instructions, the auditor should notify the client representative in charge of the area.
- (d) Ensure that inventory tags are issued sequentially to individual departments. For many inventory counts, the goods are marked with multi-copy inventory tags. The count teams record the type and quantity of inventory in each tag and one copy of each tag is then used to compile the inventory.
- (e) Perform test counts and record a sample of counts in the working papers. This information will be used to test the accuracy and completeness of the client's inventory compilation.
- (f) Obtain tag control information for testing the client's inventory compilation. Tag control information includes documentation of the

numerical sequence of all inventory tags and accounting for all used and unused tags. If inventory listings are used by the client, copies of the listings will accomplish the objective of documenting the entire inventory count.

- (g) Observe the condition of the inventory for items that may be obsolete, slow moving, or carried in excess quantities.
- (h) Inquiry about goods held for others on consignment basis. Such items should not be included in the client's inventory. The auditor must also inquire about goods held on consignment by others for the client. These goods should be included in the inventory count.

### 5.15.1 Audit Decisions

The auditor's decisions in the physical observation of inventory are similar to those made for other audit areas and include selecting audit procedures, deciding on the timing of the procedures, determining sample size and selecting items for testing. This is shown in Figure 5.9.

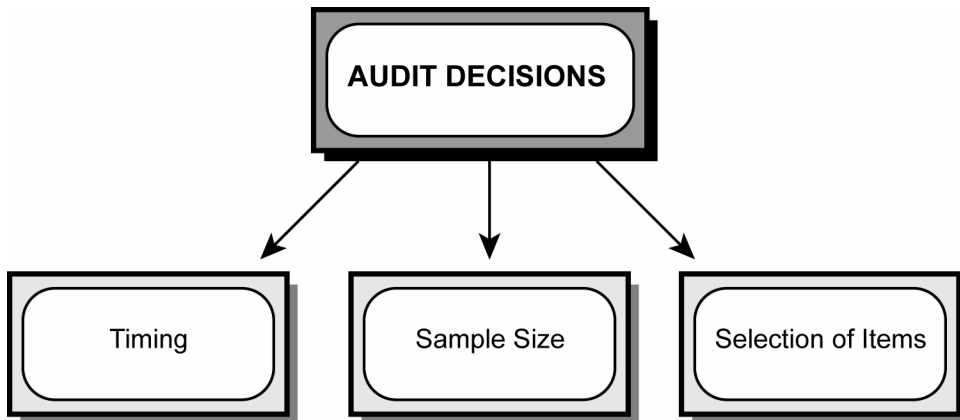


Figure 5.9: Audit decisions

#### (a) **Timing**

The auditor decides the suitable time to conduct the physical count of inventory either at interim period or before year-end. To decide on suitable timing to conduct physical count of inventory, the auditor will base his or her decision on the accuracy of the perpetual inventory master file. When perpetual inventory system is accurate, it may be unnecessary for the client to count the inventory every year. Instead, the auditor can compare the perpetual records with the actual inventory on a sample basis at a convenient time.

(b) **Sample Size**

Sample size in physical observation is usually difficult to specify in terms of the number of items because the emphasis during the tests is on observing the client’s procedures rather than on selecting items for testing. The auditor will normally decide on how many to observe based on the time needed to observe the physical count. Most of the time, the most important factor to consider is the reliability of client control procedure and auditor assessment of inherent risks.

(c) **Selection of Items**

The selection of items for testing is an important part of the audit decision in inventory observation. Care should be taken to observe the counting of the most significant items and a representative sample of typical inventory items, to inquire about items that are likely to be obsolete or damaged, and to discuss with management the reasons for excluding any material items.

## 5.15.2 Substantive Procedures for Account Balances

We can look at the substantive procedures for account balances in Table 5.4.

**Table 5.4:** Summarises Substantive Procedures for Inventory Account Balance for Each Audit Objective

<b>Inventory as recorded on tags exist (Existence)</b>	Select a random sample of tag numbers and identify the tag with that number attached to the actual inventory.
<b>Existing inventory is counted and tagged (Completeness)</b>	Trace test counts and tags controlled information to the inventory compilation. Inquire as to the inventory in other locations.
<b>Inventory is counted accurately (Accuracy)</b>	Obtain a copy of inventory compilation and agree totals to general ledger. Trace test counts and tags controlled information to the inventory compilation. Test mathematical accuracy of extensions and cast the inventory compilation.
<b>Inventory is classified correctly on the tags (Classification)</b>	Examine inventory descriptions on the tags and compare with the actual inventory for raw material, work-in-process and finished goods.

<b>Transactions are recorded in the proper period (Cut-off)</b>	Examine a sample of receiving documents for a few days before and after year-end for recording of inventory purchases in the proper period.  Examine a sample of shipping reports for a few days before and after year-end for recording of inventory shipments in proper period.
<b>Obsolete and unusable inventory items are excluded or noted (Realisable Value)</b>	Test for obsolete inventory by enquiring management about obsolete, slow-moving, damaged, rusty or dust-covered inventory items.
<b>The client has rights to inventory recorded on tags (Rights)</b>	Verify inventory held on consignment for others is not included in inventory.  Be alert for inventory that is set aside or specially-marked as indications of non-ownership.

## 5.16 AUDIT OF PRICING AND COMPILATION

Another important part of the audit of inventory is to perform all the procedures necessary to make certain that the physical counts or perpetual record quantities were properly priced and compiled. Inventory price tests include all the tests of the client's unit prices to determine whether they are correct. Inventory compilation tests include all the tests of the summarisation of the physical quantities, the extension of price times quantity, footing the inventory summary and tracing the totals to the general ledger. Table 5.5 shows common test of details balance for inventory pricing and compilation.

**Table 5.5:** Balance-Related Audit Objectives and Tests of Details of Balances for Inventory Pricing and Compilation

<b>Balance-Related Audit Objective</b>	<b>Common Inventory Pricing and Compilation Procedures.</b>
<b>Inventory in the inventory listing schedules agrees with the physical inventory counts, the extensions are correct, and the total is correctly added and agrees with the general ledger (Detail tie-in).</b>	Foot the inventory listing schedules for raw materials, work-in-process, and finished goods.  Trace the total to the general ledger.  Extend the quantity times the price on selected items.

<p><b>Inventory items in the inventory listing schedule exist (Existence).</b></p>	<p>Trace inventory listed in the schedule to inventory tags and auditor’s recorded counts for existence and description.</p>
<p><b>Existing inventory items are included in the inventory listing schedule (Completeness).</b></p>	<p>Account for unused tag numbers shown in the auditor’s documentation to make sure no tags have been added.</p> <p>Trace from inventory tags to the inventory listing schedules and make sure inventory on tags is included.</p>
<p><b>Inventory items in the inventory listing schedule are accurate (Accuracy).</b></p>	<p>Trace inventory listed in the schedule to inventory tags and auditor’s recorded counts for quantity and description.</p> <p>Perform price tests of inventory.</p>
<p><b>Inventory items in the inventory listing schedule are properly classified (Classification).</b></p>	<p>Verify the classification into raw materials, work-in process, and finished goods by comparing the descriptions on inventory tags and auditor’s recorded test counts with the inventory listing schedule.</p>
<p><b>Inventory items in the inventory listing are stated at realizable value (Realizable Value).</b></p>	<p>Perform test of lower of costs or market, selling price and obsolescence.</p>
<p><b>The client has rights to inventory items in the inventory listing schedule (Rights).</b></p>	<p>Trace inventory tags identified as non-owned goods during the physical observation to the inventory listing schedule to make sure these have not been included.</p>
<p><b>Inventory and related accounts in the inventory and warehousing cycle are properly presented and disclosed (Presentation and Disclosure).</b></p>	<p>Examine financial statements for proper presentation and disclosure such as separate disclosure of raw materials, work-in-process and finished goods.</p>



**ACTIVITY 5.2**

Try the following activity:

During the stock-taking, the Controller intentionally withheld several inventory tags from the employees responsible for physical count. After the auditor left the client’s premises at the completion of the inventory observation, the controller recorded non-existence inventory on the tags and thereby significantly overstated earnings. How could the auditor have uncovered the misstatement, assuming that there are no perpetual inventory records?

**SUMMARY** .....

- This topic discussed the audit of cash and inventory cycles.
- Cash usually represents significant amount of assets in any entities and its relationship with transactions in several cycles requires the auditor to assess the level of internal control in other cycles to help them accumulate sufficient appropriate evidence to support their conclusion on the fairness of the cash balance.
- For inventory cycle, common difficulties in audit is to determine its existence and valuation, for that reason it normally being considered as the most time-consuming and complex part of the audit.

**KEY TERMS** .....

Bank reconciliation	Inventory compilation tests
Branch bank accounts	Inventory price tests
Cash equivalents	Kitting
General cash account	Perpetual inventory master file
Imprest bank accounts	Standard cost records
Inventory and warehousing cycle	

**SELF-TEST 1** .....

1. What should be audited on an inter bank transfer schedule?
2. “Failure to bill a customer” is an example of an error that results in the failure to receive cash, but would not be discovered as part of the audit of the bank reconciliation. State three other examples of errors or irregularities that result in the improper payment of, or failure to receive cash but would not be discovered during the audit of the bank reconciliation. How are these types of misstatements normally uncovered in the audit?
3. The following are misstatements that an auditor might find through substantive tests of transactions or by tests of details of cash balances:
  - (a) The bookkeeper failed to record cheques in the cash disbursements journal that were written and mailed during the first month of the year.
  - (b) The bookkeeper failed to record or deposits a material amount of cash receipts during the last month of the year. Cash is prelisted by the president’s secretary.
  - (c) The cash disbursements journal was held open for 2 days after the end of the year.
  - (d) A cheque was paid to a supplier for a carload of raw materials that was never received by the client.
  - (e) A discount on an acquisition was not taken, even though the cheque was mailed before the discount period had expired.
  - (f) Cash receipts for the last 2 days of the year were recorded in the cash receipts journal for the subsequent period and listed as deposits in transit on the bank reconciliation.
    - (i) For each procedure above, state whether it is A test of details of cash balance or a substantive test of transactions.
    - (ii) List a substantive audit procedure to uncover each of the above misstatements.
4. Discuss the auditor’s responsibilities for inventory maintained in public warehouses or with other outside custodians.
5. Identify THREE analytical procedures commonly used when auditing accounts in the inventory and warehousing cycle.

6. The following are audit procedures commonly performed in the inventory and warehousing cycle:
  - (a) Compare the client's count of physical inventory at an interim date with perpetual inventory master file.
  - (b) Compare the unit price on the final inventory summary with suppliers' invoices.
  - (c) Read the client's physical inventory instructions and observe whether they are being followed by those responsible for counting the inventory.

**Required:**

- (i) Identify whether each of the procedures is primarily a test of control or substantive test.
- (ii) State the purpose (s) of each of the procedures.

## SELF-TEST 2

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1. The following are misstatements that might be found in the client's year-end cash balance:
  - (a) A cheque was omitted from the outstanding cheque list on 31 December bank reconciliation. It cleared the bank on 4 January.
  - (b) A cheque was omitted from the outstanding cheque list on the bank reconciliation. It cleared the bank 5 on February.
  - (c) Cash receipts collected on accounts receivable from 3 January to 5 January were included as cash receipts in the current year.
  - (d) A loan from the bank on 23 December was credited directly to the client's bank account. The loan was not entered as of 31 December as cash receipts.
  - (e) A cheque that was dated 24 December and disbursed in December was not recorded in the cash disbursements journal but it was included as an outstanding cheque on December 31.
    - (i) Assuming that each of these misstatements was intentionally (fraud), state the most likely motivation of the person responsible.
    - (ii) List an audit procedure that could be done to discover each fraud.

2. Why do most auditors verify petty cash even though it is generally immaterial?
3. Discuss how an auditor can test for kitting.
4. The design of tests of details of balances for inventory is affected by audit results from multiple cycles. Identify the cycles, other than inventory and warehousing cycle that affect the audit of inventory.
5. Discuss the key control procedures relating to the client's physical count of inventory.
6. The following are the misstatements found in auditing of inventory and warehousing cycle of a client.

**Required:**

- (a) An inventory item was priced at RM20 each instead of at the correct cost of RM20 per package of 10 items.
- (b) The clerk in charge of the perpetual inventory master file altered the quantity on an inventory tag to cover up the shortage of inventory caused by its theft during the year.
- (c) During the physical count, several obsolete items were included.
  - (i) For each misstatement, state the internal control that should have prevented it from occurring.
  - (ii) For each misstatement, state a substantive procedure that could be used to uncover it.

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# Topic ▶ Auditing 6 Revenue and Collection Cycle

## LEARNING OUTCOMES

By the end of this topic, you should be able to:

1. Explain the transactions and accounts affected by the revenue and collection cycle;
2. Identify documents and records involved in the revenue and collection cycle;
3. Discuss the audit objectives, test of control and substantive test for revenue and collection cycle;
4. Assess the audit confirmation process and type of audit confirmation in revenue and collection cycle; and
5. Describe the alternative procedures available when there is no response received from audit confirmation.

## ▶ INTRODUCTION

You have learned about auditing cash balances and inventory in Topic 5. Now you will learn about auditing revenue and collection cycle. The topic starts with the definition of revenue and the condition to be satisfied under FRS 118 for its recognition. It then describes the typical documents and records accounts and classes of transactions in revenue and collection cycles. The remaining of this topic will focus on determining audit objectives, test of control and substantive test of transactions affecting each class of transactions in the sales and collection cycle.

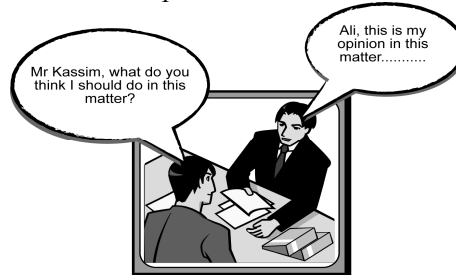
## 6.1 OVERVIEW OF REVENUE AND COLLECTION CYCLE

Let's consider the following scenario:

Ali, a new audit assistant of Heng and Goh Firm, have been assigned to send an account receivable confirmation for a client, namely Perwira Indera Sdn. Bhd. Ali has reviewed the ageing trial balance and selected the accounts for confirming. Before the confirmation requests are mailed, the controller will review the accounts to determine whether the confirmation is necessary. He reviews the list and informs Ali that he does not want him to send confirmation to five of the accounts on the list. One is a very material amount, two have zero balance, and another two have credit balance. The reason he gave is that he feels the confirmations will upset these customer as "they are kind of hard to get along with". He does not want the credit balances confirmed because it may encourages the customer to ask for a refund. Instead, he asked Ali to send confirmation to a list of 10 customers he believe would be happy to respond to the auditor.

Upon meeting with the controller, Ali decided to seek the opinion of an audit manager who he believes is more experienced than him, Mr. Kassim. Kassim expresses the following viewpoint:

"I always do not believe in sending confirmation as we hardly get a response from the customer. However, I also do not like to perform tests of controls and substantive test of transactions for revenue and collection cycle. As it is a requirement under ISA 500 to send confirmation on account receivable, what I used to do is I will send a lot of negative confirmations on every audit at interim date. If I find a lot of misstatements, I analyse them to determine their cause. If the internal control is inadequate, I will send positive confirmation at year end to evaluate the amount of misstatements. If the negative confirmations result in minimal misstatements, which is always the case, I will decide that internal control if effective without conducting tests of controls and substantive tests of transactions. Therefore confirmation is a means to avoid test of controls and substantive tests of transactions in revenue and collections cycle. With regards to your question of whom to send the confirmation, I always rely on the client to provide a list as they know their customer better than anyone else. In that way, we will not waste our time to send the confirmation and chase for the non-response customer."



**Figure 6.1:** Seeking the opinion of an audit manager

The scenario presented above is not peculiar in an audit, where the auditor needs to exercise reasonable care and avoid interference from the client in conducting his or her audit. One important message from the scenario is that the auditor needs to understand the whole activities and transaction involved in revenue and collection cycle as well as what type of audit tests could help them in determining the fairness of the accounts in the cycle. Additionally, the auditor should observe the guidelines provided by relevant auditing standards in performing his or her audit. Before we further discuss the accounts and classes of transaction involved in the revenue and collection cycle, let us look at the definition of the revenue under FRS 118.



### SELF-CHECK 6.1

1. What are the documents and records generally used in revenue and collection cycle?
2. How would the understanding of major classes of transaction in revenue and collection cycle help the auditor to perform the audit effectively?
3. The returns of positive confirmation requests for account receivable were very poor. In such circumstances, what should the auditor do to determine the fairness of the account receivable?

## 6.1.1 Revenue Recognition



Figure 6.2: Revenue

FRS 118 defines **revenue** as the **gross inflow** of **economic benefits** during the period arising in the course of ordinary activities of an entity when those inflows result in increases in equity, other than increases relating to contributions from equity participants. Para 15 further explain that revenue from the sales of goods shall be recognised when all the following conditions have been satisfied:

- (a) The entity has transferred to the buyer the significant risks and rewards of ownership of the goods;
- (b) The entity retains neither continuing managerial involvement to the degree usually associated with neither ownership nor effective control over the goods sold;
- (c) The amount of revenue can be measured reliably;
- (d) It is probable that the economic benefits associated with the transaction will flow to the entity; and
- (e) The costs incurred and to be incurred in respect of the transaction can be measured reliably.

## **6.2 TRANSACTIONS AND ACCOUNTS AFFECTED BY REVENUE AND COLLECTION CYCLE**

The overall audit objective of revenue and collection cycle is to evaluate whether the related account balances are fairly presented in accordance with generally accepted accounting principle. As shown in Figure 6.3, typical accounts included in revenue and collection cycle are sales, account receivables, cash discount taken, allowance for uncollectible account, sales returns and allowance and bad debt expense. The major deposits to cash-in-bank accounts are from cash sales and collection from the customers. For some companies, other types of transactions may occur as part of the revenue cycle such as inter-company sales, related party sales and scrap sales. As such, the auditor should be aware of how these transactions are processed and their related control especially when it represents a material amount in the financial statements.

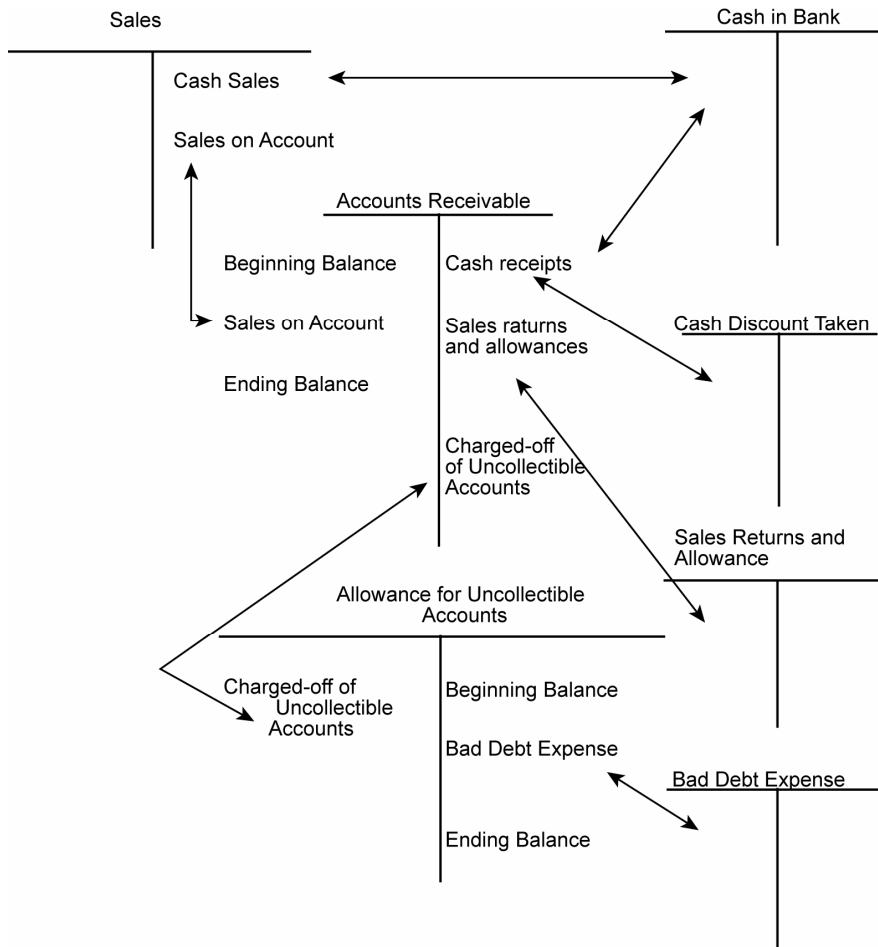
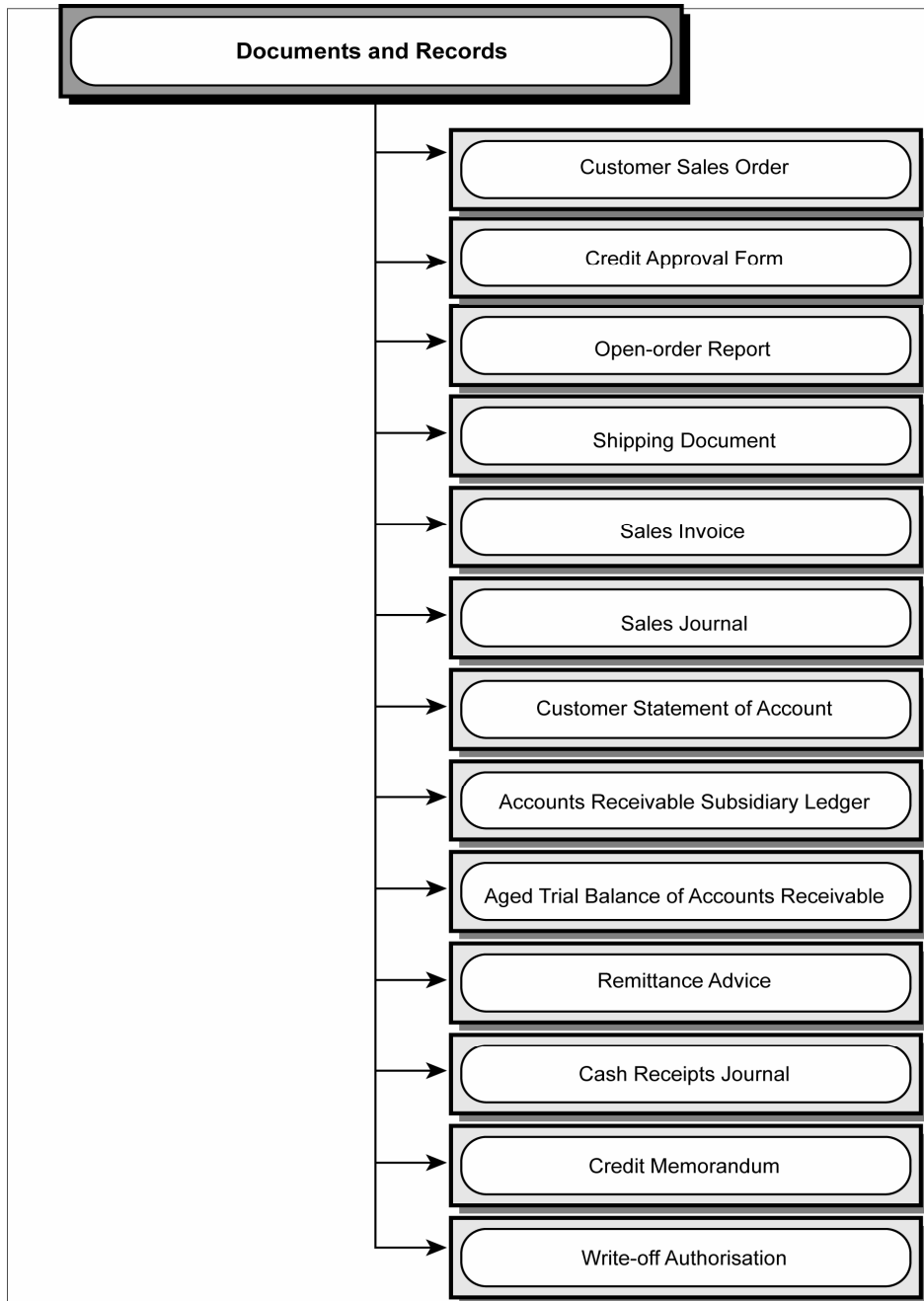


Figure 6.3: Transactions and accounts affected by revenue and collection cycle

### 6.3 DOCUMENTS AND RECORDS

Listed below are documents and records included in the revenue and collection cycle. Refer to Figure 6.4.



**Figure 6.4:** Documents and records included in the revenue and collection cycle

(a) **Customer Sales Order**

This document contains the details of the type and quantity of products or services ordered by customer. Customer sales orders may be prepared and forwarded by a sales person, mailed or faxed, or received over the Internet.

Item	Description	Quantity	Uom	Price	Total	Tax
17 78-343	soft paper towels	5	EA- Each	\$14.00	\$70.00	Non
Total					\$70.00	
Tax					0	
Total Tax					\$0.00	
Gross Total					\$70.00	

Figure 6.5: Sample of customer sales order

(b) **Credit Approval Form**

This is the form to show the approval from an appropriate level of management on the creditworthiness and credit limit of a customer.

**GENCO dtp**  
 275 Lake Hill Road  
 Philadelphia, PA 19127  
 Tel: (800) 336-2341

**Credit Card Holder Consent & Agreement Form**

BILLING/SHIPPING ADDRESS: \_\_\_\_\_  
 CREDIT CARD IMPRINT AREA: \_\_\_\_\_

I appreciate for any inconvenience that this form may cause you, but I thank you in advance for helping me fight credit card fraud. The requirements below are dictated by my credit card processor. Please print out this form, fill it in COMPLETELY and follow instructions on it.

**CREDIT CARD AUTHORIZATION AGREEMENT**

I, \_\_\_\_\_ hereby authorize: Mare Leskman, DBA Genco's DTP, to put through a charge to my credit card.

My credit card number is \_\_\_\_\_ CVV: \_\_\_\_\_  
 Expiration Date (mm/yyyy) \_\_\_\_\_

The amount to be charged to my credit card is \$ \_\_\_\_\_

Description of Items: \_\_\_\_\_ (signature must be legible)

**CARDHOLDER SIGNATURE** x \_\_\_\_\_ (signature must be legible)

To complete this transaction, you must completely fill out this form. Make an imprint of your credit card in the "Credit Card Imprint Area" above. To make an imprint, simply put this piece of paper over the raised credit card numbers and name, and with a pencil, lightly sketch where the credit card numbers and name are, and the raised numbers and name will appear on the paper. Start to legible. Fax this completed form to (800) 336-2341, or e-mail as an attachment to Secondstreet@aol.com.

**NOTE THAT I CANNOT PROCESS YOUR CARD WITHOUT THE CREDIT CARD IMPRINT.**  
 All transactions are subject to approval by your credit card company.

GENCO dtp  
 Mare Leskman

Figure 6.6: Sample of credit approval form

(c) **Open-order Report**

This is a report of all customer orders for which processing has not been completed. Examples are goods that might have been shipped-out but the customer has not been billed yet and the customer orders have yet to be delivered.

The screenshot shows a software interface for 'Employee Resources'. It features a header with navigation buttons and a main area with several data tables. The tables include:

- TRAVEL AND LODGING ADMINISTRATION:** Columns include Date, From, To, Rate, and Amount.
- MEALS AND ENTERTAINMENT ADMINISTRATION:** Columns include Date, Description, Rate, and Amount.
- HOUSING ADMINISTRATION:** Columns include Date, Description, Rate, and Amount.

Each table has a 'TOTALS' row at the bottom. The interface also includes a search bar and various filters.

Figure 6.7: Sample of open-order report

(d) **Shipping Document**

A shipping document is prepared every time goods are shipped to a customer. This document normally serves as bill of lading and contains information on the type of product shipped, the quantity shipped and other relevant information. In certain revenue system, the shipping document and bill of lading are separate documents.



Figure 6.8: Sample of shipping document

(e) **Sales Invoice**

This document is used to bill the customer. The sales invoice contains information on the type of product or service, the quantity, the price and the terms of the trade. The original sales invoice is usually forwarded to the customer and copies are distributed to other departments within the organisation. The sales invoice is typically the source document that signals the recognition of revenue.

<i>The Coffee Roasting Company</i>					
<b>Sales Invoice</b>		987 Campus Lane Corvallis, OR 9733		No: 95416	
Bill To: MonCaf Montreux Cafe 500 Perdue Avenue Portland, OR 97201			Corresponding Documents		
Date of Invoice: 14-Apr-95			Sales Order Number: 404	Shipment Number for S-O: 1	Bill of Lading Number: 405
Coffee Mix Name	Mix Code	Mix Type	Quantity Sold	Price per Pound	Extended Price
Columbian Dark	CD-3	Reg	400	\$6.10	\$2,440.00
House Special	HS-3	Decaf	350	\$7.40	\$2,590.00
Vienna Roast	VR-3	Reg	450	\$6.40	\$2,880.00
SubTotals:			<b>1200</b>		\$7,910.00
Freight:					\$395.50
Total Payment					<b>\$8,305.50</b>

Figure 6.9: Sample of sales invoice

(f) **Sales Journal**

The sales journal is used to record the necessary information for each sales transaction. The sales journal will contain columns for debiting account receivable and crediting various sales accounts.

Date	Entries	Total
08/18/2005	1	494.40
08/19/2005	1	838.05
08/26/2005	2	9,946.15
08/31/2005	1	494.40
09/08/2005	1	2,772.53
09/12/2005	2	168.95
09/13/2005	1	11.80
09/21/2005	1	10.72
09/28/2005	1	152.31
10/20/2005	1	4,211.69
10/25/2005	1	569.15
11/03/2005	1	15,750.93
11/10/2005	1	5,595.95
11/23/2005	1	1,927.96

Figure 6.10: Sample of sales journal

(g) **Customer Statement of Account**

This document is usually mailed to a customer monthly. It contains the details of all sales, cash receipts and credit memorandum transactions processed through the customer's account for the period.



This report, which is normally prepared monthly, summarises all the customer balances in the accounts receivable subsidiary ledger. Customers' balances are reported in categories based on the time expired since the date of the sales invoice (examples; less than 30 days, 30-60 days, 90 days old). The aged trial balance of accounts receivable is used to monitor the collection of receivables and to ensure that the details of the accounts receivable subsidiary ledger agree with the general ledger control account. The auditor uses this report for conducting much of the substantive audit work in accounts receivable.

(j) **Remittance Advice**

The document is usually mailed with the customer's invoice and returned with the customer's payment for goods or services. A remittance advice contains information regarding which invoices are being paid by the customer. Many entities use turnaround documents, where a portion of the sales invoice serves as a remittance advice that is returned with the customer's payment.


<b>Test and Trial Co Ltd</b> 6th Floor, Testco House North Test Lane Test Area Middles ex TE12 7ST  E-mail <a href="mailto:support@d-systems.co.uk">support@d-systems.co.uk</a> Web <a href="http://www.trcl-systems.co.uk">www.trcl-systems.co.uk</a>				Registered In <b>England</b> Number <b>12345678</b> VAT Number <b>GB 98765432</b>  Telephone Voice <b>01234 567890</b> Fax <b>01234 567891</b>													
<b>Remittance Advice</b>																	
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Figure 6.13: Sample of remittance advice

(k) **Cash Receipts Journal**

This journal is used to record the entity's cash receipts. The cash receipts journal contains columns for debiting cash, crediting accounts receivable, and crediting other accounts such as scrap sales or interest income.

CASH RECEIPTS JOURNAL							
DATE	NAME	DESCRIPTION	Product	Labor	Sales Tax (%)	Total	Bank Deposits
1-26-Jun	Joe Landscaper	Cash Equity				10,000	10,000
2-26-Jun	USA Bank	Loan Proceeds				25,000	25,000
3-Jul	Mrs. Johnson	Landscape grading & seeding	66	600	53	719	
4-Jul	Mrs. James	Construct berms	0	550	44	594	
8-Jul	bank deposit						1,312
10-Jul	Mr. Smith		574	375	76	1,025	
14-Jul	Mrs. James		372	250	50	672	
14-Jul	Mr. Jackson	Retainer		500		500	
18-Jul	Mr. Jackson	topsoil & grading for pool	1,319	600	184	2,113	
18-Jul	Mrs. Bing	install shrub row	399	200	46	647	
19-Jul	Mr. Grant	Retainer		500		500	
20-Jul	bank deposit						5,457
26-Jul	Mr. Grant	Landscape & perennial bed	1,609	600	217	2,426	
28-Jul	bank deposit						2,426
30-Jul	Mr. Wildove	Prepare garden beds	50	500	44	594	
31-Jul	Mr. Verbanic	install shrubs	100	300	32	432	
31-Jul	Mrs. Henderson	Grading & install landscape timbers	80	340	34	454	
31-Jul	bank deposit						1,480
		TOTALS THIS PAGE	4,568	5,315	792	45,674	45,674
		TOTALS PREVIOUS PAGE					
		TOTALS TO DATE					

Figure 6.14: Sample of cash receipts journal

(l) **Credit Memorandum**

This document is used to record credits for the return of goods in a customer’s account or to record allowances that will be issued to the customer. Its form is generally similar to that of a sales invoice, and it may be processed through the system in the same way as a sales invoice.

The form is titled "REQUISITION AND INVOICE/SHIPPING DOCUMENT". It contains several sections:
 

- ENTER UIC, NAME AND HULL NO. OF SHIP**
- ENTER NAME AND COMPLETE ADDRESS OF VENDOR**
- MATERIAL RETURNED FOR CREDIT MEMORANDUM**
- A table with columns: QUANTITY, UNIT, DESCRIPTION, TYPE, UNIT PRICE, TOTAL PRICE.
- VENDOR REPRESENTATIVE MUST SIGN** and **DATE**
- CREDIT MEMO. #2025 DATED IN THE AMOUNT OF \$100.00 RECEIVED AND APPLIED AGAINST PURCHASE ORDER NO. \_\_\_\_\_**
- RECORDS KEEPER COMPLETES**

Figure 6.15: Sample of credit memorandum

(m) **Write-off Authorisation**

This document authorises the write-off of an uncollectible account. It is normally initiated in the credit department, with the final approval for the write-off coming from the financial controller.

## 6.4 INHERENT RISK ASSESSMENT

The auditor should conduct inherent risk assessment in revenue and collection cycle to assess the susceptibility of transactions processed by the cycle and the financial statements accounts affected by those transactions to possible material misstatements. Specific inherent risk factors that may affect the revenue cycle include the following:

(a) **Industry Related Factors**

Auditor should realise that factors, such as the changes that occur in the industry, level of competition within the industry, profitability and health of the industry in which the entity operates may lead to potential misstatements in the revenue and collection cycle. For example the recent increase of fuel prices may affect many industries by increasing the cost of production hence reduce the profitability and poor cash flow. Similarly, the entity operates in the industry which is highly competitive may change its pricing policies, credit policies and products warranties. If such factors exist, there is a likelihood that management will embark in activities that can result in material misstatements.

(b) **The Complexity and Contentiousness Revenue Recognition Issues**

As mentioned earlier in the topic, FRS 118 has laid down the specific criteria that need to be observed in order to recognise the revenue from the sale of goods or services. For most entities, it is quite straightforward because the revenue is recognised when the product is shipped or a service is provided. However, for certain entities, the recognition of revenue may involve complex calculations and considerable estimates such as to determine revenue from the long-term construction contracts and property development, lease contract and instalment sales. In such situation, the auditor should assess the possibility of material misstatement to be high.

(c) **The Difficulty of Auditing Transactions and Account Balances**

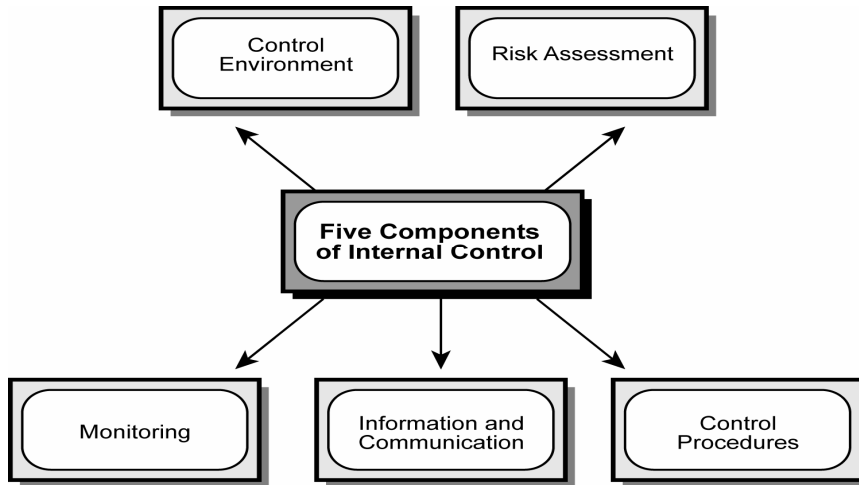
Accounts that are difficult to audit may influence the auditor to increase the inherent risk assessment to revenue and collection cycle. In addition to issues on revenue recognition discussed above, the provision for doubtful debt can also be difficult to audit because of the significant judgements and subjectivity involved in determining its value. The estimation of this account will affect the reliability of the account receivable value on the financial statements. The risk of the material misstatements in the estimate of the provision of doubtful debt is also a function of the complexity of customer base and the data available to test the provision. This is not simply available in the entities and the apparent evidence available to determine the collectibility of account receivable may be past payment history or referral from other companies. Such evidence may not be necessarily reliable in supporting the estimates.

(d) **Misstatements Detected in Prior Audits**

The presence of misstatements in previous audit may be a good indicator that misstatements will likely be present during the current audit. Experience from previous engagement will help the auditor to assess the potential misstatements in the financial statements.

## 6.5 CONTROL RISK ASSESSMENT

As discussed in Topic 3, control risk is the risk that client’s internal control fails to detect, prevent and rectify material misstatement. In this topic, we will discuss on how auditor assess the control risk for revenue cycle. In order to assess the control risk, the auditor must understand the five components of internal control as follows:



**Figure 6.16:** Five components of internal control

(a) **Control Environment**

The auditor should study the control environment to understand the management’s and board of directors’ attitude, awareness and action concerning the control environment. Factors such as integrity and ethical values of management and board of directors and their commitment to competence should be fully considered in assessing control environment. Because these factors have pervasive effect on all business cycles, understanding the control environment is generally completed on an overall entity basis. The auditor should however, consider how the various control environment factors may affect the individual accounting cycles.

(b) **Risk Assessment**

The auditor must understand how the management considers risks that are relevant to the revenue cycle, assesses the likelihood of their occurrence and

decides what actions to take to address those risks. Some of these risks include a new or revamped information systems, rapid growth and new technology. Each of these factors can represent serious risk to an entity's internal controls over revenue.

(c) **Control Procedures**

When reliance strategy is adopted for revenue cycle, the auditors need to understand the controls that exist to ensure that management's objectives and internal control objectives are being met. The auditor's understanding on revenue cycle can be documented using procedures manuals, narrative descriptions, internal control questionnaires and flowcharts.

(d) **Information and Communication**

For each major class of transactions in the revenue cycle, the auditor needs to understand the whole process involved in the revenue cycle from the point of the sales, cash receipts and related transactions are initiated, the documents involve and the relationship among the accounts as explained in the discussion on item 6.2 and 6.3 above. The auditor usually develops an understanding of an accounting (information) system such as revenue cycle by conducting a transaction walk-through. This involves the auditor's "walking" a transaction through the accounting system and documenting the various functions that process it.

(e) **Monitoring**

Besides understanding the process involved in the revenue and collection cycle, the auditor also needs to understand the client's monitoring processes over the revenue cycle. This includes understanding how management assesses the design and operation of controls in the revenue cycle. It also involves understanding how the supervisory personnel within the cycle review the personnel who perform the controls and also evaluate the performance of the entity's data processing system.

## 6.6 AUDIT OBJECTIVE, TESTS OF CONTROLS AND SUBSTANTIVE TESTS FOR REVENUE CYCLE

### 6.6.1 Audit Objectives

As for the other cycles, the auditor needs to satisfy that the transaction-related audit objective of existence, completeness, accuracy, classification, timing and posting and summarisation are being met in the audit of revenue cycle. The audit objectives, key internal control, example of test of control and substantive tests involved in the revenue cycle will be discussed at the end of this section.

### 6.6.2 Planning and Performing Test of Control

In performing this step, the auditor systematically examines the client’s revenue cycle to identify relevant controls that help to prevent, or detect and correct, material misstatements. The following are important control activities for a revenue cycle.

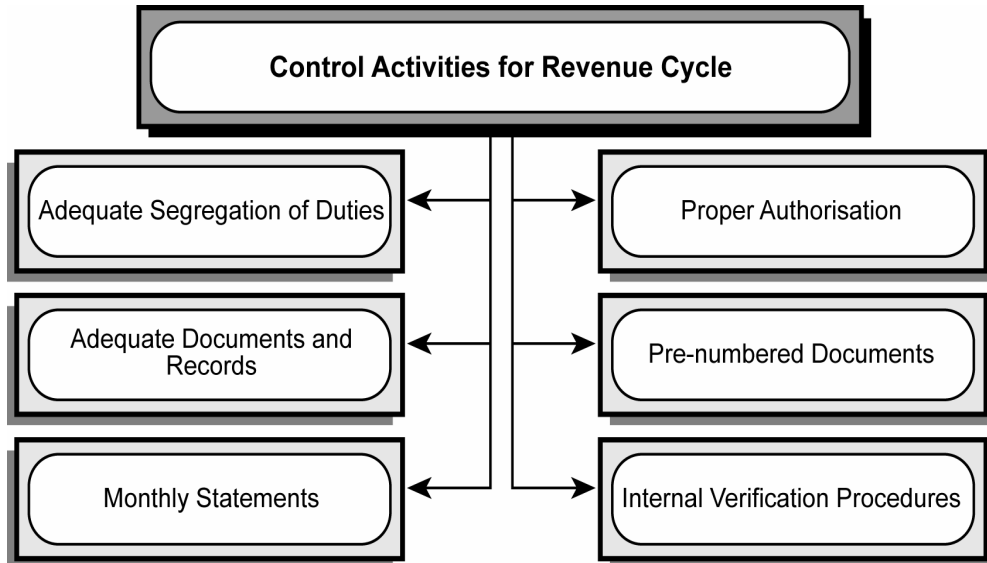


Figure 6.17: Important control activities for revenue cycle

- (a) **Adequate Segregation of Duties**  
Proper separation of duties is very important to prevent misstatements either intentional or unintentional. The basic concept in separation of duties is someone who has direct access to the assets will not be responsible for

record keeping of those assets such as anyone responsible for imputing sales and cash receipts transaction information into the computer be denied access to cash. It is also important to segregate the credit granting function from the sales function because credit checks are intended to offset the natural tendency of sales personnel to optimise volume even at the expense of high bad debt written off.

(b) **Proper Authorisation**

It is very important for the auditor to satisfy that; the sales are properly authorised; goods should be shipped only after proper authorisation; check on customer's creditworthiness, and the price, freight, discounts must also be authorised. Those mentioned controls are important to prevent loss of company assets by shipping to a fictitious customer or to a customer who have credit problem and to ensure that the sale is billed correctly according to company policy.

(c) **Adequate Documents and Records**

The auditor should evaluate the adequacy of client's record keeping. Adequate record keeping should exist before most of the transaction-related audit objective could be met. Different company may have different styles of record keeping procedures. Some may automatically produce a multicopy pre-numbered sales invoice at the time a customer order is received. Copies are then used for credit approval process, authorised shipment, update inventory record and billing. Under this system, it is less likely that client will fail to bill the customer if all invoices are accounted for periodically. Under a different system where the sales invoice is prepared after the goods has been shipped to the customer, there is high possibility of a failure to bill a customer unless alternative control exists.

(d) **Pre-numbered Documents**

It is very important for all documents used in the revenue cycle to be pre-numbered. It is essential to prevent failure to bill or record sales and occurrence of duplicate billings and recording. However, to be an effective control, those documents should be accounted for periodically and investigation should be done when there are missing documents without proper reason.

(e) **Monthly Statements**

Sending computer generated monthly statements to customer is a good control because it encourages a response from customers if the balance is improperly stated. To be effective it should be handled by a person who has no responsibility of record keeping of sales and account receivable.

(f) **Internal Verification Procedures**

The use of computer programs or independent persons for checking the processing and recording sales transactions is essential to fulfil the transaction-related audit objectives. Examples include accounting for numerical sequence of pre-numbered sales documents, checking the accuracy of the calculation, reviewing reports for unusual items.

### 6.6.3 Evaluate Cost-Benefit of Testing Controls

The auditor needs to identify key internal controls, strengths and weaknesses and eventually assess control risks. This is necessary in order to decide on the level or degree of substantive tests to be carried out. It is because the results of the auditor's testing of internal control for the revenue cycle directly impacts the detection risk and therefore the level of substantive testing that will be required for the accounts affected by the cycle. In evaluating the cost benefit factor of conducting audit test, it should be noted that the substantive test for detail balance is more costly as compared to test of control or substantive test of transaction. If the result is favourable, for example the internal controls are strong, then the auditor could apply reliance strategy. This means that the substantive tests could be reduced significantly without compromising the detection risks.

### 6.6.4 Test of Control

As described above, the auditor needs to understand that the relevant internal control exists in the client's revenue cycle in order to help him assess the level of control risks. Audit procedures used to test controls in the revenue cycle include enquiry of client personnel, inspection of documents and records, observation of operation of the control, and performance of the auditor on control procedures.

### 6.6.5 Substantive Test of Transactions

Substantive procedures for transactions are tests conducted to detect monetary misstatements in the individual transaction processed through all accounting cycles. Sometimes the auditor performs substantive test at the same time as tests of control. Also, it is often difficult to differentiate between tests of control and substantive tests for transactions because the specific audit procedure may both test the operation of an internal control procedure and a test for monetary misstatement or it serves as dual-purpose tests.

In deciding on substantive tests of transactions, some procedures are commonly used on every audit regardless of the circumstances, whereas others are dependent on the adequacy of the controls and the results of the tests of controls.

The substantive tests of transactions procedures are discussed below and summarised in the order of sales transaction-related audit objectives in Table 6.1.

(a) **Recorded Sales Exist (Existence)**

The auditor is concerned with the possibility of three types of misstatements: sales being included in the journals for which no shipment was made, sales recorded more than once, and shipments being made to non-existent customers and recorded as sales. The appropriate substantive tests of transactions for testing the existence objective depend on where the auditor believes the misstatements are likely to take place.

To verify whether recorded sale for which there was no shipment, the auditor can trace from selected entries in the sales journal to make sure that related copies of the shipping and other supporting documents exist. To check on possible misstatement of sale recorded more than once, the auditor could review numerically sorted list of recorded sales transactions for duplicate numbers. The auditor can also test for the proper cancellation of shipping documents. Proper cancellation decreases the likelihood that a shipping document will be used to record another sale.

To check on possible misstatement of shipment made to non-existent customer, the auditor can trace a sample of duplicate sales invoices to related shipping documents filed in the shipping department to make sure that a shipment was made. This type of fraud normally occurs when the person recording the sales is also the same person who authorises the shipments. It is important to understand that the starting point is the journal or accounting records and trace to the supporting documents.

(b) **Existing Sales Transactions are Recorded (Completeness)**

To test the completeness objectives, the auditor may trace pre-numbered shipping documents from a file in the shipping department to related duplicate sales invoices and the sales journal. Unlike testing for existence, the starting point to test for completeness is from the supporting documents to the sales journal.

(c) **Sales are Accurately Recorded (Accuracy)**

The auditor's concern is to verify whether sales are recorded at the correct amount, accurately billed to the customer and recorded based on the correct amount shipped to the customer. A common approach is to start with entries in the sales journal and compare the total of selected transaction with the accounts receivable master file entries and duplicate sales invoice. The auditor also will check the amount recorded by comparing the prices on the duplicate sales invoices with approved price list, extensions and footing are recomputed, and the details stated on invoices will be compared

with the information on shipping records such as descriptions, quantity and customer identification.

(d) **Recorded Sales are Properly Classified (Classification)**

This auditor's concern is to determine whether the correct general ledger account was charged for every sales transaction. It is common to test for proper classification as part of testing for accuracy. The auditor examines the supporting documents to determine the proper classification of a given transaction and compares this with actual account to which it is charged.

(e) **Sales are Recorded on the Correct Dates (Timeliness)**

Sales should be recorded and billed as soon as shipment takes place to prevent failure to record the transactions and to make sure that sales are recorded at the correct period. This is particularly crucial for the sales that take place near the year end, where failure to record the sales will result in an understatement of sales and account receivable for the year.

(f) **Sales Transactions are Properly Included in the Master File and Correctly Summarised**

The proper inclusion of all sales transactions in the accounts receivables master file is essential because the accuracy of these records affects the client's ability to collect the outstanding receivables. The sales journal also must be correctly totalled and posted to the general ledger to ensure the correctness of financial statement. The distinction between posting and summarisation and other transaction-related audit objectives is that posting and summarisation includes footing journals, master file records, and ledgers and tracing from one to the other among these three. When footing and comparisons are restricted to these three records, the process is known as posting and summarisation. In contrast, accuracy involves determining the monetary correctness of transactions and comparing amounts between documents or with journals and master file records.

**Table 6.1:** Sales-Audit Objectives, Key Internal Controls and Substantive Tests for Transaction

<b>Audit Objectives</b>	<b>Key Internal Control</b>	<b>Test of Control</b>	<b>Substantive Test For Transactions</b>
<b>Existence</b> Recorded sales are for shipments actually made to existing customers.	Recording of sales is supported by authorised shipping documents and approved customer orders.	Examine copies of sales invoices for supporting bills of lading and customers' orders.	Trace sales journal entries to copies of sales orders, sales invoices and shipping documents.
<b>Completeness</b> Existing sales transactions are recorded.	Shipping documents are pre-numbered and accounted for.	Account for integrity of numerical sequence of shipping documents.	Trace shipping documents to respective sales invoices and entry into sales journal and accounts receivable master file.
<b>Accuracy</b> Recorded sales are for the amount shipped and are correctly billed and recorded.	Internal verification of invoice preparation.	Examine indication of internal verification on affected documents.	Trace entries in sales journal to sales invoice.
<b>Classification</b> Sales transactions are properly classified.	Sales transactions are internally verified.	Examine documents for internal verification.	Examine duplicate sales invoice for proper account classification.
<b>Timing</b> Sales are recorded on the correct dates.	Shipping documents are pre-numbered and accounted for weekly by the accountant.	Account for a sequence of shipping documents.	Compare date of recording of sale in sales journal with duplicate sales invoice and bill of lading.
<b>Posting and Summarisation</b> Sales transactions are properly included in the accounts receivable master file and are correctly summarised.	Accounts receivable master file is reconciled to the general ledger on a monthly basis.	Examine evidence that accounts receivable master file is reconciled to the general ledger.	Trace selected sales invoices from the sales journal to the accounts receivable master file and test for amount, date and invoice number.

## **6.7** **AUDIT OBJECTIVE, TESTS OF CONTROL AND SUBSTANTIVE TESTS FOR ACCOUNTS RECEIVABLE AND CASH RECEIPTS**

Detail explanations on accounts receivable, cash receipts, audit tests for uncollectible accounts and lapping are given below.

### **6.7.1 Accounts Receivable**

In the case of account receivable, it is usually more efficient and effective to test audit objectives such as ownership, classification, and disclosure using substantive procedures for detail balances. The auditor also uses substantive procedures for details balance to detect material misstatements in accounts receivable and related accounts.

For most of the engagements, ownership is not a problem because the client owns all the receivables. However, there is situation whereby a client may sell its account receivable to third party. Such occurrence can be detected by examining minutes of board of director or management meeting, reviewing bank confirmations, cash receipts for payments from organisations that factor account receivable. The major issues related to classification objective are: identifying and reclassifying any material credits contained in accounts receivable, segregating short-term and long-term receivables and ensuring that different types of account receivables are properly classified. In many companies, when a customer pays in advance or a credit is issued, the amount is credited to customer's account receivable. The auditor should determine the amount of such credit and, if material, reclassify them as either a deposit or another type of liability. The separation between short-term and long-term receivables, trade and non-trade receivables should also be emphasised by the auditor. For instance, receivables from officers, employees, or related parties should not be included with trade account receivables because users might be misled if such receivables are combined. Disclosure is an important audit objective for account receivables and related accounts. Typical example items disclosed in revenue cycle and related accounts are basis for revenue recognition, revenue recognised under the percentage-of-completion method, long-term sales contracts, revenue by reportable segment of the business, revenue and receivables from related parties, receivables by type (trade, officer, staff, associates, etc), short-term and long-term receivables and pledged or discounted receivables.

## 6.7.2 Cash Receipts

An important part of the auditor's responsibility in auditing cash receipts is identification of weaknesses in internal control that increase the likelihood of fraud. The most difficult type of defalcation for the auditor to detect is that which occurs before the cash is recorded in the cash receipts journal or other cash listing, especially if the sale and cash receipt are recorded simultaneously. Therefore, controls such as sending monthly statements to the customer and preparation of pre-listing of cash receipts should be in place to reduce the likelihood of such fraud. Key internal controls, common test of controls and common substantive tests of transactions to satisfy each of the transaction-related audit objectives for cash receipts are listed in the Table 6.3. Since the summary follows the same format as presented in the Table 6.1, the detailed discussion of the internal controls, tests of control, and substantive tests of transactions that was included for the audit of sales is not repeated for cash receipts.

A useful audit procedure to test whether all recorded cash receipts have been deposited in the bank account is a proof of cash receipts. In this test, the total cash receipts recorded in the cash receipt journal for a given period, such as a month, are reconciled with the actual deposits made to the bank during the same period. There may be a difference in the two as a result of timing differences between the recording period and deposits clear in the bank, but the amount can be reconciled and compared. The procedure however is not useful in discovering cash receipts that have not been recorded in the journal but it could help to uncover recorded cash receipts that have not been deposited, unrecorded deposits, bank loans deposited directly into the bank account and similar misstatements.

## 6.7.3 Audit Tests for Uncollectible Accounts

The existence of recorded write-offs is the most important transaction related audit objective that the auditor should keep in mind in the verification of the write-off of an individual's uncollectible accounts. A major concern in testing accounts charged off as uncollectible is the possibility of the client covering up a defalcation by charging off accounts receivable that have already been collected. The major control for preventing this type of misstatement is proper authorisation of the write-off of uncollectible accounts by a designated level of management only after a thorough investigation of the reason the customer has not paid. A normal procedure is an examination of approvals by the appropriate persons and examination of correspondence in the client's files establishing their uncollectibility through the credit report from the financial institutions. After the auditor is satisfied that the accounts charged off are proper, the selected items should be traced to the accounts receivable master file as a test of the records.

### 6.7.4 Lapping

Lapping is an embezzlement scheme in which cash collections from customers are stolen and the shortage is concealed by delaying the recording of subsequent cash receipts. The fraudulent employee must continue to cover the shortage through repeated lapping, replace the stolen money, or find another way to conceal the shortage. It most frequently occurs when both record keeping and custody of cash is the responsibility of one individual.

It can be detected by comparing the name, amount and dates shown on remittance advices with cash receipts journal entries and related duplicate deposit slips. Lapping also could be detected by performing analytical procedures and debtor confirmation.

Example of simple lapping scheme can be explained in the following Table 6.2:

**Table 6.2:** Simple Lapping Scheme

Date	Situation	Book Keeping Entry
7/1	Ahmad pays RM500 on account	No entry, bookkeeper cashes cheque and keeps proceeds
8/1	Salina pays RM200 on account	Dr. Cash 500 Cr Accounts Receivable
	Zurina pays RM300 on account	-Ahmad 500
9/1	Burhan pays RM500 on account	Dr. Cash 500 Cr. Accounts Receivable - Salina 200 Accounts Receivable - Zurina 300
10/1	Bookkeeper determines Burhan is unlikely to purchase from the company in the future.	Dr. Provision for Bad Debt 500 Cr. Burhan 500

**Table 6.3:** Cash Receipts-Audit Objectives, Key Internal Controls and Substantive Tests for Transaction

<b>Audit Objectives</b>	<b>Key Internal Control</b>	<b>Test of Control</b>	<b>Substantive Test</b>
<b>Existence</b> Recorded cash receipts are for fund actually received by the company.	Separation of duties between handling cash and record keeping.	Observe separation of duties.	Trace from cash receipt journal to bank statement.
<b>Completeness</b> Cash received is recorded in the cash receipts journal.	Immediate endorsement of incoming cheques.	Observe immediate endorsement of incoming cheques.	Trace from remittance advice to cash receipt journal.
<b>Accuracy</b> Cash receipts are deposited and recorded at the amounts received.	Preparation of monthly bank reconciliations by independent person.	Review monthly bank reconciliations.	Trace deposit in transit in bank reconciliation to bank statements or deposit slips.
<b>Classification</b> Cash receipts transactions are properly classified.	Cash receipts transactions are internally verified.	Examine evidence of internal verification.	Examine pre-listing for proper account classification.
<b>Timing</b> Cash receipts are recorded on the correct dates.	Procedures require recording of cash on a daily basis.	Observe unrecorded cash at a point in time.	Compare date of deposit per bank statement to the dates in the cash receipts journal and prelisting of cash receipts.
<b>Posting and Summarisation</b> Cash receipts are properly included in the accounts receivable master file and are correctly summarised.	Accounts receivable master file is reconciled to the general ledger on a monthly basis.	Examine evidence that account receivable master file is reconciled to general ledger.	Trace selected credits from the accounts receivable master file to the cash receipts journal and test for dates and amounts.

## **6.8 EFFECTS OF RESULTS FROM TESTS OF CONTROLS AND SUBSTANTIVE TESTS OF TRANSACTIONS**

The result of the tests of controls and substantive tests of transactions will have significant effect on the remainder of the audit, particularly on substantive tests of details of balances. The parts of the audit most affected by the tests of controls and substantive tests of transactions for revenue and collection cycle are the balances in account receivables, cash, bad debts expense and allowance for doubtful accounts. Additionally, if the test results are unsatisfactory, it is necessary to do additional substantive testing for the propriety of sales, sales returns and allowances, charge-off of uncollectible accounts, and processing of cash receipts. The most significant effect of the results of the tests of controls and substantive tests of transactions in the revenue and collection cycle is on the confirmations of accounts receivable. The type of confirmation, the size of the sample, and the timing of the test are all affected. Audit confirmation process is discussed in the following section.

## **6.9 ANALYTICAL PROCEDURES**

Analytical procedures are useful audit test for examining the fairness of accounts such as sales, accounts receivable, provision for doubtful debts, bad debt expense, and sales returns and allowances because such tests provide sufficient evidence at low cost.

As discussed in topic 3, when performed as part of audit planning, analytical procedures can effectively identify accounts that may contain material misstatements. Analytical procedures are also useful as an overall review for the revenue-related accounts. Table 6.4 lists analytical procedures that are useful in auditing account receivable and related accounts either at the planning stage or as an overall review.

**Table 6.4:** Analytical Procedures for Accounts Receivables and Related Accounts

Analytical Procedure	Possible Misstatement Detected
<p><b>Revenue</b></p> <p>Comparison of gross profit percentage by product line with previous years and industry data.</p> <p>Comparison of reported revenue to budgeted revenue.</p>	<p>Unrecorded (Understated) revenue.</p> <p>Fictitious (overstated) revenue.</p> <p>Changes in pricing policies.</p> <p>Product-pricing problems.</p>
<p><b>Account Receivable, Provision for Doubtful Debts, and Bad Debt Expense</b></p> <p>Comparison of receivables turnover and days outstanding in accounts receivable to previous years.</p> <p>Comparison of ageing categories on aged trial balance of accounts receivable to previous years.</p> <p>Comparison of bad debt expense as a percentage of revenue to previous years' and/or industry data.</p> <p>Comparison of provision for doubtful debts as a percentage of accounts receivable or credit sales to previous years' and/or industry data.</p> <p>Examination of large customer accounts individually and comparison to previous year.</p>	<p>Understatement or overstatement of provision for doubtful debts and bad-debt expense.</p>
<p><b>Sales Returns and Allowances and Sales Commissions</b></p> <p>Comparison of sales returns as a percentage of revenue to previous years' or industry data.</p> <p>Comparison of sales discounts as a percentage of revenue to previous years' or industry data.</p> <p>Estimation of sales commission expense by multiplying net revenue by average commission rate and comparison of recorded sales commission expense.</p>	<p>Understatement or overstatement of sales return.</p> <p>Understatement or overstatement of sales discounts.</p> <p>Understatement or overstatement of sales commission expense and related accrual.</p>

## 6.10 AUDIT CONFIRMATION PROCESS IN ACCOUNT RECEIVABLE

As mentioned above, sending confirmation to customers will help the auditor to detect occurrence of lapping. Confirmation can be defined as a process of obtaining and evaluating a direct communication from a third party in response to a request for information about a particular item affecting financial statement assertions. The auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence to support certain financial statement assertions. In making this determination, the auditor should consider materiality, the assessed level of inherent and control risk, and how the evidence from other planned audit procedures will reduce audit risk to an acceptably low level for the applicable financial statement assertions. ISA 501 states that external confirmation may be used in confirming accounts receivable balances and auditor should evaluate whether the results of the external confirmation process together with the results from any other procedures performed, provide sufficient appropriate audit evidence regarding the balance being audited.

However, the auditor may disregard confirmation of accounts receivable in the following circumstances:

- (a) The account receivables are immaterial to the financial statements.
- (b) The use of confirmations would not be effective as an audit procedure such as past response rate were low or the responses might not be reliable.
- (c) The auditor's assessment of inherent risk and control risk is low, and evidence gathered from other substantive procedures is sufficient to reduce audit risk to an acceptable low level.

Confirmations can address more than one audit objective. However, confirmations normally provide different levels of assurance for different audit objectives. Accounts receivable confirmation is a good source of evidence for testing the existence objective. Accounts receivable confirmation also may be used to provide evidence on completeness, cutoff, and valuation objectives.

However, a number of factors affect the reliability of accounts receivable confirmations such as listed as follows:

### (a) **Type of Confirmation Request**

There are two types of confirmation: positive and negative confirmation. A positive accounts receivable confirmation request that customers indicate whether they agree with the amount due to the client stated in the confirmation. Therefore, a response is required regardless of whether the

customer believes the amount is correct or incorrect. Sometimes the auditor may use a “blank” form of positive confirmation, in which the request requires the customer to provide the amount owed to the client. Positive confirmation is used when the year-end account balances are large and when the control risk has been assessed as high.

A negative confirmation only requires the customer to respond only if he or she disagrees with the amount stated in the confirmation letter. Therefore, a non-response to a negative confirmation will indicate a valid balance. This is a major disadvantage of negative confirmation. Hence, negative confirmation is usually sent to customer with small year-end account balances and when control risk is low. The auditor may choose to send accounts receivable confirmation either at the interim date or at year end. To maximise the response rate, most of the time the auditor will send confirmation soon after year end.

(b) **Prior Experience with the Client or Similar Engagements**

The auditor also should consider prior experience with the client in terms of confirmation response rates, misstatements identified and the accuracy of returned confirmation when assessing the reliability of accounts receivable confirmations. For example, based on experience certain companies may have a very low response rate and it will be very costly to do the follow up on that confirmation, the auditor might consider evidence from alternative procedures.

(c) **The Intended Respondent**

The auditor also should consider the respondent’s competence, knowledge, ability and objectivity when assessing the reliability of the response received. For example, a small enterprise may not have appropriate accounts department as compared to a medium or large company. For a small enterprise, there is a possibility that the respondent does not have necessary knowledge to respond to the confirmation appropriately. For a big company, this is usually not the case, as they have a well-defined accounting function in their organisation.

## 6.10.1 Confirmation Procedures

The auditor must maintain control over the accounts receivable confirmations to minimise the possibility that direct communication between the customers and the auditor is biased by interception or alteration of the receivable confirmation by the client. The auditor should ensure that there is no interference from the client on which account to send confirmation and timing of the confirmation. Direct mailing from the auditor’s office generally provides the best control as well as mailing the confirmation using the auditor’s envelopes. The auditor should maintain a record of the confirmations mailed and those returned. In

certain circumstances, the auditor may receive a respond from the electronic media such as e-mail or fax. In such cases, the auditor should verify the source and contents of the communication.

Each confirmation exception (the difference between the recorded balance and the balance confirmed by customer) should be properly evaluated by the auditor to determine the reason for the difference. In many cases, exceptions result from what are referred to as timing differences and such differences occur because of delays in recording transactions in either the client's or customer's records.

## 6.11 ALTERNATIVE PROCEDURES

The auditor usually conducts alternative procedures when no response is received, particularly after the second and third follow-up for positive confirmation or when the auditor does not obtain direct confirmation of accounts receivable that is expected from the debtors. ISA 501 requires the auditor to perform alternative procedures where no response is received to a positive external confirmation request. Alternative procedures are also performed when the auditor does not obtain direct confirmation of account receivable because it is expected that debtors will not respond. The types of alternative procedures performed should be such to provide the evidence that positive confirmation is intended to provide.

Typically, the auditor will perform the following alternative procedures for account receivable:

- (a) Examination of subsequent cash receipts involves checking the accounts receivable subsidiary ledger for payments of the specific sales invoice included in the customers' account receivable balances that were outstanding at the date of confirmation. If the client has strong controls for recording cash receipts, the auditor may stop at this point. If the client's controls are weak, the auditor may extend the testing by tracing the payment in the subsidiary ledger to the cash receipts journal and to the bank statement. If the customer has paid for the goods, the auditor has strong evidence concerning the existence and valuation of the account receivable.
- (b) Examination of customer orders, shipping documents, and duplicate sales invoices. If the customer has not paid the account receivable, the auditor can examine the underlying documentation that supports the sales transaction. This documentation includes the original customer order, shipping document and duplicate sales invoice. If this documentation indicates that the customer ordered the goods and the goods were shipped,

then the auditor would have evidence supporting the existence of the account receivable.

- (c) The auditor may need to examine other correspondence between the client and customer to obtain adequate evidence on the validity and valuation of the account receivable.



**ACTIVITY 6.1**

Do the following activity:

Recent discussion with a client personnel revealed that the same personnel handle the cash receipts as well as updating the accounts receivable subsidiary ledger. In this situation, discuss the type of audit test that should be emphasised by the auditor and justify your decision.

**SUMMARY** .....

- The auditor needs to obtain a thorough understanding of the major classes of transaction involved in the revenue and collection cycle to enable him or her to accumulate sufficient appropriate evidence to support his or her opinion on the fairness of the revenue and collection cycle.
- Similar to other cycles, the auditor needs to conduct an assessment of inherent and control risk and perform substantive procedures to meet the transaction and balance related audit objective.
- This topic also briefly explains the concept of lapping and the internal control and substantive procedures to uncover the act.
- The topic ends with discussion on the audit confirmation process of account receivable and the alternative procedures used if the response rate are low.

**KEY TERMS** .....

Classes of transaction	Positive confirmation
Collection cycle	Proof of cash receipts
Lapping of accounts receivable	Sales and collection cycle
Negative confirmation	Walk-through test

**SELF-TEST 1** .....

1. Assuming the client's internal controls are adequate, describe how the auditor can verify proper cut-off of sales transactions.
2. Describe how the auditor tests the right objective for accounts receivable.
3. The following are common audit procedures for tests of sales and cash receipts.
  - (a) Compare the quantity and description of items on duplicate sales invoices with related shipping documents.
  - (b) Trace recorded cash receipts in the accounts receivable master file to the cash receipts journal and compare the customer name, date and amount of each one.
  - (c) Examine duplicate sales invoices for an indication that unit selling prices were compared to the approved price list.
  - (d) Examine duplicate sales invoices to determine whether the account classification for sales has been included on the document.
  - (e) Examine the sales journal for related-party transactions, notes receivable, and other unusual items.
  - (f) Select a sample of customer orders and trace the document to related shipping documents, vendors' invoices and the accounts receivable master file for comparison of name, date and amount.
  - (g) Perform a proof of cash receipts.
  - (h) Examine a sample of remittance advices for approval of cash discounts.
  - (i) Account for a numerical sequence of remittance advices and determine whether there is a cross-reference mark for each one, indicating that it has been recorded in the cash receipts journal.

Required:

- (i) Identify whether each audit procedure is a test of control or substantive test of transaction.
- (ii) State which transaction-related audit objective(s) each of the audit procedures fulfils.
- (iii) For each test of control in part (1), state a substantive test that could be used to determine whether there was a monetary misstatement.

4. Discuss the circumstances in which it is acceptable to use negative confirmation requests.
5. What audit procedures are most likely to be used to verify accounts receivable charged off as uncollectible? State the purpose of each of these procedures.
6. List several audit procedures that the auditor can use to determine whether all cash received were recorded.

## SELF-TEST 2

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1. Which of the following most likely would be detected by an auditor's review of a client's sales cut-off?
  - (a) Excessive sales discounts
  - (b) Unrecorded sales for the year
  - (c) Unauthorised goods returned for credit
  - (d) Lapping for the year-end accounts receivable
2. Discuss the alternative procedures an auditor can perform to test the existence objective for account receivable when customers do not respond to confirmation requests.
3. Describe how the auditor tests the classification objective for accounts receivable.
4. The following are commonly performed tests of controls and substantive tests of transactions audit procedures in the sales and collection cycle:
  - (a) Examine sales returns for approval by an authorised official.
  - (b) Account for a sequence of shipping documents and examine each one to make sure that a duplicate sales invoice is attached.
  - (c) Account for a sequence of sales invoices and examine each one to make sure that a duplicate sales invoice is attached.
  - (d) Compare the quantity and description of items on shipping documents with the related duplicate sales invoices.
  - (e) Trace recorded sales in the sales journal to the related accounts receivable master file and compare the customer name, date, and amount for each one.

- (f) Review the pre-listing in the cash receipts book to determine whether cash is pre-listed daily.
- (g) Reconcile the recorded cash receipts on the pre-listing with the cash receipts journal and the bank statement for a 1-month period.

**Required:**

- (i) Identify whether each audit procedure is a test of control or a substantive test of transaction.
  - (ii) State which of the six transaction-related audit objectives each of the audit procedures fulfils.
  - (iii) Identify the type of evidence used for each audit procedure, such as confirmation and observation.
5. Please circle the correct answer:
- (a) The audit working papers often include a client-prepared, aged trial balance of accounts receivable as of the balance sheet date. This ageing is best use by the auditor to:
    - (i) Evaluate internal control over credit sales
    - (ii) Test the accuracy of recorded charge sales
    - (iii) Estimate credit losses
    - (iv) Verify the validity of the recorded receivables
6. When auditors use confirmations for the primary purpose of obtaining evidence related to accounts receivable, which balance-relate audit objectives are ordinarily satisfied?

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# Topic 7 ▶ Long-Term Assets and Obligations and Owners' Equity

## LEARNING OUTCOMES

By the end of this topic, you should be able to:

1. Discuss the auditor's objectives with regard to the examination of long-term assets, obligations and owners' equity;
2. Describe the essential elements of internal control over the assets, obligations and owners' equity; and
3. Explain the audit procedures used in testing these various account balances.

## ▶ INTRODUCTION

In this final topic, we are going to study about long-term assets and obligations, and owners' equity. It will discuss about the auditor's examination of the remaining assets which are often included on the balance sheets of most clients. These assets include property plant and equipment, investment and intangible assets. Fixed tangible assets are capital assets used in the operation of a business. They are not purchased with the intention of reselling them, and they normally have a useful business life expectancy of more than one year.

Long-term debt and equity are the major sources of financing for most entities. In the case of liabilities and owners' equity, the auditor is usually more concerned

with detecting any understatement or omission. Although the number of transactions is few, each transaction is normally material. This partly focuses on how auditor's work on collecting sufficient competent evidence in these items.

Refer to the following case scenario:

A client is a manufacturer of electronic equipment. The total fixed assets are RM20,000,000 and the total assets are RM75,000,000. During the audit for the current year, your analysis of the fixed assets showed total additions of RM600,000 and total deductions of RM200,000. You are supplied with an analysis of these additions and deductions. Some of the RM600,000 additions were purchased from outside sources and part of the work was performed by the employees of the client.

You vouched the fixed asset purchases for all amounts in excess of RM4,000, examined the liabilities for unpaid amounts, and tested small purchases; and found that all the fixed assets were reasonable and correct, and that all liabilities for unpaid amounts were correct. Next, you examined for authorisations and found that all assets purchased were correctly authorized and within the limits of the authorisations.

(AICPA Adapted)



### SELF-CHECK 7.1

1. What are the auditor's major concern in the audit of long-term assets balances?
2. Cite the major objectives on assessment of internal control over long-term assets balances.

## 7.1 OVERVIEW OF LONG-TERM ASSETS, LIABILITIES AND OWNERS' EQUITY

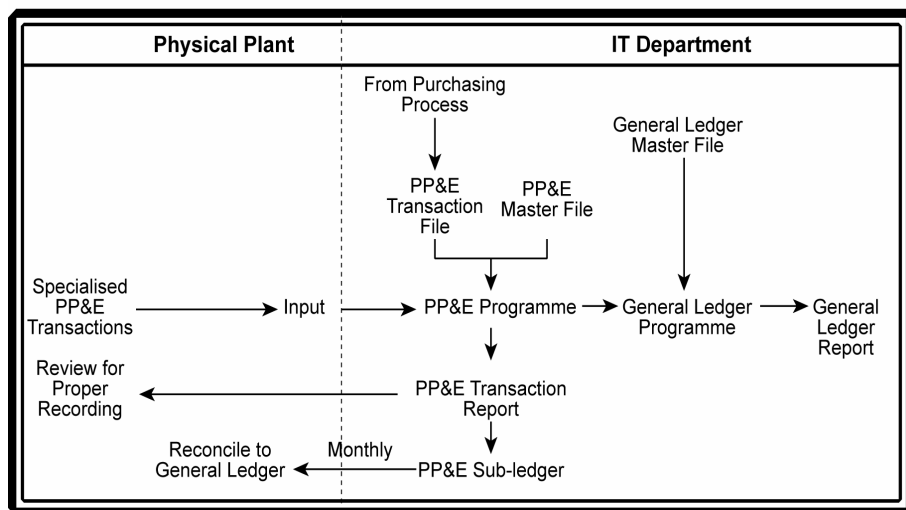
Property, plant and equipment (PP&E) usually represent a material amount in the financial statements. In the examination of long-term assets, the auditor has three broad objectives. The first is to determine whether the physical assets carried on the company's books do in fact exist, whether all existing assets are recorded and whether all assets are being used in the manner the company claims they are being used. Another of the auditor's objectives is to determine the company's ownership of these assets and the presence of any related *liens* or

other encumbrances. The third objective is to ascertain whether the company's methods of valuation confirm with generally accepted accounting principles and whether these principles have been consistently applied.

Figure 7.1 presents a flowchart of accounting system for property, plant and equipment. This transaction starts with acquisition of assets from purchasing process. Then, the master file of fixed assets is updated and a few reports are produced. The reports are reviewed for proper recording. For example, subsidiary ledger shows assets owned by the entity. Information such as cost, date acquired, depreciation method and accumulated depreciation of the respective assets. The general ledger reflected for any new addition of assets and its depreciation charges.

Four types of PP&E transactions may occur:

- Acquisition of capital assets for cash or other non-monetary considerations;
- Disposition of capital assets through sale, exchange, retirement, or abandonment;
- Depreciation of capital assets over their useful economic life; and
- Leasing of capital assets.



**Figure 7.1:** Property, plant and equipment transaction process

Since there is a tendency for assets to be overstated, the auditor is usually primarily concerned with detecting overstatement. However, in the case of liabilities or obligations, the focus of this subject, there is a tendency for them to be understated or omitted. Thus, in the examination of liabilities, the auditor is usually more

concerned with detecting understatement or omission. The proper valuation of recorded liabilities is usually not difficult for the auditor to determine.

In a capital acquisition and repayment cycle, there are a few transactions that affect the account balances, but each one is often highly material in amount. Therefore, the exclusion of a single transaction could be material in itself. There is a legal relationship between the client entity and the holder of the stock, bond or similar ownership document. Similarly, there is a direct relationship between the interest and dividends accounts and debt and equity.

## 7.2 PROPERTY, PLANT AND EQUIPMENT

Auditors must also know about property, plant and equipment. Property and equipment generally includes land, buildings and manufacturing equipment. It may also include office equipment, furniture and fixtures, and even when these non-current assets are classified separately, the audit approach generally is the same as for property and equipment. The essential features of direct tests of balances for property and equipment are emphasis on specific audit objectives related to **existence**, **ownership**, and **valuation** achieved primarily by substantiating **additions (purchase of new assets)** and identifying **retirements (disposal of old assets)** during the period and analytically testing or re-computing related expense and allowance accounts. Property, plant, and equipment usually represent a material amount in the financial statements.

Property, plant and equipment normally include only fixed tangible assets. Fixed tangible assets are capital assets with useful lives generally in excess of one year that are used in the operation of the business and that are not purchased for resale purposes. In connection with the examination of property, plant, and equipment (PP&E), the auditor must be satisfied that:

Internal controls over PP&E and PP&E acquisitions are adequate:

- (a) Assets included in PP&E exist and are being used in the normal operations of the business;
- (b) Assets included in PP&E are owned by the company whose financial statements are being examined;
- (c) Assets included in PP&E are not encumbered by *liens* or, if so, the facts are properly disclosed in the footnotes to the financial statements;
- (d) Depreciation and/or amortisation methods are proper;
- (e) Amounts in the financial statements are in substantial agreement with the supporting records;
- (f) Accounting for additions, disposals, and retirements is proper;

- (g) Maintenance accounts do not include items that should be capitalised;
- (h) The valuation and the disclosure of the method of evaluation are acceptable; and
- (i) Important information relating to the assets is properly disclosed.

For recurring engagement, the auditor is able to focus on additions and retirements in the current period because amounts from prior periods have been subject to audit procedures.

While for a new engagement, the auditor has to verify the assets that make up the beginning balance in property, plant, and equipment.

There are three inherent risk factors that must be considered by the auditor. They are as follows:

- (i) **Complex Accounting Issues**  
Lease accounting, self-constructed assets, and interest capitalization are vivid examples of some of the complex accounting issues faced by auditors.
- (ii) **Difficult-to-Audit Transactions**  
When assets are purchased directly from a vendor, the transaction is relatively easy to audit. However, transactions involving donated assets, non-monetary exchanges and self-constructed assets are more difficult to audit.
- (iii) **Misstatements Detected in Prior Audits**  
If misstatements in prior audits have been detected, the auditor should set inherent risk higher than if few or no misstatements have been found in the past.

Internal control features are applicable to long-term assets primarily involved control procedures for the occurrence and authorisation of property, plant and equipment. Most entities have some type of authorisation table for approving capital asset transactions. Control procedures should be present to ensure that the authorisation to purchase capital assets is consistent with the authorisation table. For example, the control procedures should specify dollar limits at each managerial level to ensure that larger projects are brought to the attention of higher levels of management for approval before commitments are made. The entity also needs to have control procedures for authorising the sale or other disposition of capital assets. This should include a level of authorisation above the department initiating the disposition. Control procedures should also identify assets that are no longer used in operations because they may require different accounting treatment. Finally, an appropriate level of management should properly authorise all major maintenance or improvement transactions.

The key segregation of duties for property, plant and equipment and possible errors or fraud that can occur, if they are not present are as explained in Table 7.1.

**Table 7.1:** Segregation of Duties and Possible Errors or Fraud

Segregation of Duties	Possible Errors or Fraud as a Result of Conflicts in Duties
The initiation function should be segregated from the final approval function.	Fictitious or unauthorised purchases of assets can occur, resulting in purchases of unnecessary assets, assets that do not meet the company's quality control standards, or illegal payments to suppliers or contractors.
The property, plant, and equipment records function should be segregated from the general ledger function.	Conceal a defalcation that would normally be detected by reconciling the subsidiary records with the general ledger control account.
The property, plant, and equipment records function should be segregated from the custodial function.	Tools and equipment can be stolen and the theft concealed by adjustment of the accounting records.
If a periodic physical inventory of property, plant, and equipment is taken, the individual responsible for the inventory should be independent of the custodial and record-keeping functions.	Theft of the entity's capital assets can be concealed.

### 7.2.1 Assertions, Objectives and Procedures

The financial statement assertions, specific audit objectives and the common audit procedures traditionally used to achieve the objectives for property and equipment and related account balances are summarised in Table 7.1. As applied in the property and equipment area, these procedures have the following features:

(a) **Vouching**

This procedure consists of inspecting the supporting documentation for additions and retirements during the period. For example, the auditor examines the vendor's invoice, cancelled cheque, and receiving report for equipment additions and considers the appropriateness of capitalisation in light of the company policy and generally accepted accounting principles.

(b) **Physical Examination**

The auditor obtains firsthand knowledge of additions and retirements by touring the plant. Often the tour of the plant is coordinated with the observations of physical inventory. The auditor notes whether new additions are recorded in the accounting records and whether items in the accounting records can be located in the plant.

(c) **Re-computation**

The auditor recomputed depreciation expense and considers whether the depreciation is calculated in accordance with an acceptable accounting method consistently applied. Consistency of application includes adherence to company policy on the portion of depreciation attributable to years of addition and retirement. Usually, the auditor does not need to make a detailed recomputation when depreciable assets are voluminous. Depreciable assets may be grouped in categories with similar lives and same depreciation method, and the calculation may be on an overall basis. Technically, this is an analytical procedure.

(d) **Analytical Procedure**

Several analytical procedures may be useful for detecting misclassified additions, unrecorded retirements, and miscalculation of depreciation expense. The auditor compares property and equipment balances with amounts of prior years and budgets, current additions to capital budget and depreciation expense to prior years budgets. Also, the auditor computes the ratio of depreciation expense and accumulates depreciation to equipment balances in the current and prior periods. The auditor also relates changes in property and equipment balances to expected related changes in insurance expense, property taxes, and repair and maintenance expense.

(e) **Inquiry and Scanning**

The auditor makes enquiries of operating management and personnel concerning actual additions and retirements and concerning decisions, such as adding or discounting a product or line of business, which would affect additions and retirements. The auditor also scans the accounting records for miscellaneous revenue resulting from sale of retired equipment.

(f) **Documentation Inspection**

The procedure relevant to property and equipment includes reading minutes, inspecting debt agreement and inquiry to management to identify significant changes in the composition of property and equipment and related *liens* and mortgages requiring disclosures. Table 7.2 summarises on assertions, objectives and procedures for property and equipment.

**Table 7.2:** Assertions, Objectives and Procedures for Property and Equipment

<b>Financial Statement Assertion</b>	<b>Specific Audit Objective</b>	<b>Audit Procedures to Achieve Objective</b>
Existence	Property and equipment included in the balance sheet physically exists. Additions include only the capitalise cost of assets purchased, constructed or leased and retirements (disposal) are removed.	Analytical Procedures. Vouching. Physical examination. Examine vendors' invoices and receiving reports. Physically examine assets.
Completeness	Property and equipment includes all capitalise costs and capitalise costs are not expensed.	Physical examination. Inquiry and scanning. Vouching. Examine vendors' invoices of closely related accounts to uncover items that should be manufacturing equipment. Review lease and rental agreements.
Rights and obligations	The company has a legal title or equivalent ownership rights to property and equipment included in the balance sheet and the related obligation of capitalised leased assets is recognised.	Inquiry to management. Documentation inspection. Re-computation. Examine vendors' invoices. Examine sale and purchase agreement, title documents or deeds.
Valuation	Property and equipment is stated at cost and allowances for depreciation or depletion are computed on the basis acceptable and consistent methods.	Re-computation. Analytical Procedures. Examine vendors' invoices.

Presentation and disclosure	Property and equipment is properly described and classified in the balance sheet and related disclosures are adequate.	Inquiry to management. Documentation inspection.
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## 7.3 INVESTMENT AND INTANGIBLE ASSETS

The audit approach and the audit problems for investment and for intangibles are similar to those for property and equipment. The auditor focuses on directly testing the transactions that affect the balances during the period and consideration of conformity with generally accepted accounting principles is very important. However, investments in the ending balance are normally substantiated directly.

### 7.3.1 Investment

The form of investments can vary considerably. The investment may be in debt or equity securities; the securities may be marketable or non-marketable; the companies whose securities are held may be affiliated or non-affiliated. Also, the investment may be a loan or an advance rather than security. This discussion focuses only on long-term investments. However, the primary distinction between long-term investments and investments classified as current assets is the management's intention and ability to hold the investment for longer than one year. Thus, the discussion is generally applicable to most investments.

Accounting for certain investments in Debt and Equity Securities, requires that investments be classified into three categories and accounted for as follows:

- (a) Debt securities that the entity has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and reported at amortised cost.
- (b) Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealised gains and losses included in earnings.
- (c) Debt or equity securities not classified as either held-to-maturity or trading securities are classified as available for sale and are reported at fair value, with unrealised gains and losses excluded from earnings and reported in a separate component of shareholders' equity.

The two presentation classification issues that are important for the audit of investments are:

- (a) Marketable securities need to be properly classified either as held to maturity, trading, or available for sale.
- (b) The financial statement classification requires that all trading securities be reported as current assets and held-to-maturity securities and individual available-for-sale securities be classified as current or non-current assets based on whether management expects to convert them to cash within the next twelve months.

### 7.3.2 Assertions, Objectives and Procedures

The financial statements assertions, specific audit objectives and the common audit procedure traditionally used to achieve the objectives for investments are summarised in Table 7.3.

**Table 7.3:** Assertions, Objectives and Procedure for Investments

<b>Financial Statement Assertion</b>	<b>Specific Audit Objective</b>	<b>Common Audit Procedures to Achieve Objectives</b>
<b>Existence</b>	Investments in securities (stock, bonds, notes) physically exist and loans and advances exist.	Physical examination. Confirmation.
<b>Completeness</b>	Investments are all included in the balance sheet.	Documentation inspection.
<b>Rights and obligations</b>	The company owns or has ownership rights to all investments included in the balance sheet.	Vouching. Physical examination. Confirmation.
<b>Valuation</b>	Investments are valued properly with respect to:  Marketable securities are reduced to market price if lower than cost.  Debt securities are properly classified as for trading, investment, or held for sale.  Equity investments are adjusted to recognise proportionate share of income or loss.	Recomputation, vouching, and tracing.  Inspection of market quotations or financial statements.

<b>Presentation and disclosure</b>	Investments are properly described and classified in the balance sheet and related disclosures are adequate.	Documentation inspection. Inquiry and scanning.
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### 7.3.3 Intangible Assets

A variety of items fall in this asset category. Intangibles include patents, copyrights, organisational costs, franchise fees and goodwill acquired in a business combination.

The essential features of direct tests of balances for intangibles are emphasis on specific audit objectives related to existence and valuation achieved primarily by vouching, inspection of legal documents and re-computation or analytical procedures. The primary risk of misstatements arises from misapplication of generally accepted accounting principles.

The accounting issues generally relate to whether a cost may properly be deferred and the amortisation period is appropriate. For example research and development costs generally must be charged as expense, in the period incurred. However, some costs, such as start-up costs or pre-opening costs, are not dealt with specifically in authoritative accounting pronouncements, and the appropriateness of the deferral depends on the specific circumstances. In some cases, the useful life of intangible may be determinable by reference to a law or contract. However, for goodwill, the basic guideline is that amortisation should be by the straight line method over a period not exceeding 40 years unless there is evidence of a loss of value.

## 7.4 LONG-TERM OBLIGATIONS

Generally, long-term obligations include loans, bonds and notes payable due after one year from the balance sheet date. The current portions of long-term obligations are classified as current liabilities but are examined in conjunction with long-term obligations. Also, interest expense and related account balances are examined in conjunction with long-term obligations.

The auditor must be assured that the amounts shown on the balance sheet for the various types of long-term debt are not materially misstated. This assurance extends to the recognition of interest expense. For the vast majority of entities, it is more efficient to follow a strategy of conducting substantive testing.

The auditor must be assured that the amounts shown on the balance sheet for the various types of long-term debt are not materially misstated. This assurance

extends to the recognition of interest expense. For the vast majority of entities, it is more efficient to follow a strategy of conducting substantive testing. When a substantive strategy is followed, the auditor still needs a sufficient understanding of the entity's internal control system over debt.

When a substantive strategy is followed, the auditor still needs a sufficient understanding of the entity's internal control system over debt. For instance, adequate documentation must verify that a note or bond was properly authorised. Any significant debt commitments should be approved by the board of directors or by executives who have been delegated this authority. When the entity has proper controls for issuing debt transactions, it is generally easy for the auditor to test those transactions for validity and authorisation at the end of the period.

### 7.4.1 Assertions, Objectives and Procedures

The financial statements assertions, specific audit objectives and the common audit procedures that are traditionally used to achieve those objectives for long-term obligations are summarised in Table 7.3. As applied in the long-term obligations area, these procedures have the following features:

(a) **Confirmation**

Normally, the auditor confirms the balance and related details, such as interest rate and terms, directly with all significant debt holders. The form of confirmation is similar to that for accounts payable. In some cases, a trustee keeps the detailed records of debt holders and makes interest payments to them. In those circumstances, the confirmation request is sent to the trustee. The standard bank confirmation form can be used for banks that are holders of debt. However, the standard confirmations forms confirms only direct loans. Details of compensating balances, lines of credit and contingent liabilities should be separately confirmed with the bank. Care should be given to achieve the specific audit objectives related to completeness as well as those related to existence.

(b) **Analytical Procedure**

Analytical procedures in the long-term obligations area include comparisons of balances with the prior period and comparisons of new debt proceeds and principal repayments with cash flow projections. Also, the auditor considers the reasonableness of the company's average cost of capital. An unreasonably high average cost of capital might indicate unrecorded debt.

(c) **Inquiry**

The classification of debt as short term or long term may depend on the intent and ability of management to refinance obligations. The auditor substantiates ability by examining evidence of actual refinancing in the

subsequent period or non-cancellable financing agreement. However, inquiries of management to corroborate intent are also made. Also, some obligations, such as obligations that arise when decision is made to dispose of a segment of a business, are recognised under generally accepted accounting principles before a liability is legally incurred.

(d) **Recomputation, Vouching and Tracing**

The auditor tests interest expense by recomputing the amount based on the outstanding balance, interest rate and fraction of the year outstanding. Interest payments are vouched to cancel cheques and the proceeds of new issue are traced to cash receipts records. The volume of debt transactions is generally low and all items are tested. If volume is high, an analytical procedure may be used, or audit software may be used to reperform all the computations.

## 7.5 OWNERS' EQUITY

The equity accounts differ depending on the form of organisation. This discussion focuses on stockholders' equity of a corporation. The specific audit objectives and common audit procedures for stockholders' equity are substantially the same as for long-term obligations. The particular procedures are as follows:

The following three types of transactions are important to the auditor:

- (a) Issuance of stock including transactions such as sale of stock for cash; the exchange of stock for assets; and issuance of stock for stock splits.
- (b) Repurchase of stock including both the reacquisition of stock and retirement of stock.
- (c) Payment of dividends including cash and stock dividends.

A substantive strategy is often used to audit stockholders' equity because the number of transactions is usually small. The auditor must still be aware of the types of controls that are in place to prevent the misstatement of equity transactions. For example, the following duties should be segregated:

- (i) The individuals responsible for issuing, transferring, and canceling stock certificates should not have any accounting responsibilities.
- (ii) The individual responsible for maintaining the detailed stockholders' records should be independent of the maintenance of the general ledger control accounts.
- (iii) The individual responsible for maintaining the detailed stockholders' records should not also process cash receipts or disbursements.

- (iv) Appropriate segregation of duties should be established among the preparation, recording, signing and mailing of dividend cheques.

Other control procedures that should be established includes stock and dividend transactions comply with corporate charter, dividend transactions have been properly posted and summarised in the accounting records, stock and dividend transactions have been properly approved and dividend transactions have been properly valued.

Large, publicly-traded companies use a registrar and transfer agent to process and record equity transaction. Relevant information about equity transactions may be confirmed with the register and transfer agent.

When outside agents are *not* used the auditor should:

- Trace the transfers of shares between stockholders to the stock register and/or stock certificate book.
- Foot the shares outstanding in the stock register and/or stock certificate book and agree them to total shares outstanding in the general ledger.
- Examine any cancelled stock certificates.
- Account for and inspect any unissued stock certificates in the stock certificate book.

Look at the following case scenario:

You were engaged on 1 April, 2006, by a committee of stockholders to perform a special audit as of 31 December 31, 2005, of the stockholders' equity of the Major Corporation, whose stock is actively traded on a stock exchange. The group of stockholders who engaged you believe that the information contained in the stockholders' equity section of the published annual report for the year ended 31 December, 2005, is not correct. If your examination confirms their suspicious, they intend to use the report in a proxy fight.

Management agrees to permit your audit but refuses to permit any direct confirmation with stockholders. To secure cooperation in the audit, the committee of stockholders has agreed to this limitation and you have been instructed to limit your audit in this respect. You have been instructed also to exclude that audit of revenue and expense accounts for the year.

(AICPA adapted)

**SELF-CHECK 7.2**

What are audit procedures for the usual examination of the stockholders' equity section of a corporation's balance sheet, assuming no limitation of the scope of your examination?

### 7.5.1 Assertions, Objectives and Procedure for Owners' Equity

**Assertions include the following:**

- (a) **Occurrence**  
Verify that stock and dividend transactions comply with the corporate charter.
- (b) **Accuracy**  
Verify that stock and dividend transactions have been properly posted and summarised in the accounting records.
- (c) **Authorisation**  
Verify that stock and dividend transactions have been properly approved.
- (d) **Valuation**  
Verify that stock and dividend transactions have been properly valued.

**Audit Procedure includes the following:**

- (i) **Confirmation**  
Many corporations use the services of independent registers and transfer agents to maintain detailed stockholder records in the confirmation requests sent to those agents. If the corporation keeps its own stock records, the auditor would examine the stock certificate book rather than send confirmations to stockholders. The auditor examines the stock certificate book and observes company procedures to ensure that all issued shares are recorded and that all authorised and un-issued shares are safeguarded.
- (ii) **Re-computation, Vouching and Tracing**  
The auditor's procedures for cash dividends are similar to those for interest payments. Additional audit procedures are necessary when there are treasury stock transactions, stock options, sale of stock rights or warrants and stock dividends or stock splits.

The following duties should be segregated:

- The individuals responsible for issuing, transferring, and canceling stock certificates should not have any accounting responsibilities.
- The individual responsible for maintaining the detailed stockholders' records should be independent of the maintenance of the general ledger control accounts.
- The individual responsible for maintaining the detailed stockholders' records should not also process cash receipts or disbursements.
- Appropriate segregation of duties should be established among the preparation, recording, signing, and mailing of dividend checks.

When an independent dividend-disbursing agent is used, the auditor can confirm the amount disbursed with the agent. This amount is agreed with the amount authorised by the board of directors.

When an independent agent is not used, the auditor can re-compute the amount of the dividend authorised by the board of directors and trace the amount to cash disbursements or dividends payable.



### ACTIVITY 7.1

Please try the following activity in your tutorial class:

A corporation employs a registrar for its capital stock. In your annual audit of the records of the company, you requested that a confirmation be obtained from the registrar, stating the number of shares of each class of capital stock outstanding at the balance sheet date. Does the registrar's confirmation constitute final evidence of the correctness of the outstanding shares? If it does, or it does not, would you perform additional work on the capital stock accounts in the records of the corporation?

## SUMMARY

- This topic discussed the audit of long-term assets, obligations and owners' equity.
- The cycle in long-term assets is important because it has unique characteristics that affect the auditor's accumulation of evidence about the

related account balances and transactions such as accounts payable and depreciation expenses.

- For capital acquisition and repayment cycle, this cycle is important as it is the primary source of financing for most entity.
- Normally, the cycle often involves a few transactions but the individual transactions are often material which can affect design and performance of audit procedures.

## KEY TERMS

Allocation	Long-term loan
Capital acquisition	Share capital certificate
Confirmation	Share registrar
Fixed asset master file	Substantive strategy

## SELF-TEST 1

1. You have been assigned the duty of auditing the long-term debt and retained earnings for your client, Kobei, Inc. Describe the tests you would use to support management's assertions regarding disclosure for these accounts.
2. Match each of the following controls with the assertion for the long-term debt that it supports.
  - (a) Premiums and discounts on bond and notes payables are properly amortised using the effective interest rate method.
  - (b) Any significant debt commitments are approved by the board of directors or delegated executives.
  - (c) The portion of long-term debt due in the next year is classified as a short-term liability.
  - (d) A subsidiary ledger is maintained that contains information about all the long-term debt and the amount recorded in this ledger is reconciled to the general ledger.
    - (i) Occurrence and Authorisation
    - (ii) Completeness

- (iii) Valuation
- (iv) Disclosure – Classification

3. The following information was provided by your client, the GRA Group, regarding their long-term debt:

Interest expense for the year 2005	\$2,000
Balance of Long-term Debt @ Jan 31, 2005	100,000
Balance of Long-term Debt @ Feb 28, 2005	90,000
Balance of Long-term Debt @ Mar 31, 2005	80,000
Balance of Long-term Debt @ Apr 30, 2005	70,000
Balance of Long-term Debt @ May 31, 2005	90,000
Balance of Long-term Debt @ June 30, 2005	85,000
Balance of Long-term Debt @ July 31, 2005	80,000
Balance of Long-term Debt @ Aug 31, 2005	70,000
Balance of Long-term Debt @ Sept 30, 2005	60,000
Balance of Long-term Debt @ Oct 31, 2005	65,000
Balance of Long-term Debt @ Nov 30, 2005	75,000
Balance of Long-term Debt @ Dec 31, 2005	50,000
Annual stated interest rate for all debt	6%

Make a conclusion regarding the reasonableness of the amount of reported interest expense for this client.

4. For each of the following substantive tests, first note whether it is a test of details of transactions or a test of details of account balances. Then decide for which assertion the test provides the best evidence.
- (a) Trace large cash receipts and payments to the source documents and the general ledger.
  - (b) Examine copies of note and bond agreements.
  - (c) Recompute accrued interest payable.
  - (d) Review debt activity for a few days before and after year end to determine whether transactions are included in the proper period.

- (e) Examine due dates on notes and bonds for proper classification between current and long term debt.
5. Identify the three major types of transactions that occur in stockholders' equity.
  6. Identify the four major assertions made regarding stockholders' equity and describe one control procedure for each.

## SELF-TEST 2

1. Mark each statement as either True or False.
  - (a) When auditing capital stock accounts, the cut-off assertion is the most important to consider.
  - (b) Examining cancelled stock certificates can provide evidence supporting the occurrence assertion.
  - (c) There are typically only two disclosure items that need to be considered for stockholders' equity.
  - (d) Generally, all dividends that are declared and paid will be audited.
  - (e) The auditor typically begins an audit of retained earnings by obtaining a schedule of account activity for the period.
2. Give an example of how the audit of income statement accounts could be affected by results of audit work done in other areas of the audit.
3. Match the balance sheet account with the income statement account that is typically audited at the same time.
 

(a) Investments	(i) Interest expense
(b) Bonds Payable	(ii) Bad debt expense
(c) Prepaid Insurance	(iii) Insurance expense
(d) Accounts Receivable	(iv) Depreciation expense
(e) Property, Plant and Equipment	(v) Investment income
4. What kind of information would typically be found on an account analysis work paper? What kind of tests can an auditor do using this information? Why would an auditor conduct additional analysis on an income statement account?

5. Match the segregation of duties for investments with the misstatement (due to error or fraud) it can help prevent.
- |   |   |
|---|---|
| (a) The initiation function is separate from the final approval function.                 | (i) An individual can conceal any defalcation that would normally be detected by reconciliation of subsidiary records with general ledger control accounts. |
| (b) The valuation-monitoring function is separate from the acquisition function.          | (ii) An individual can make fictitious transactions.  |
| (c) The maintenance of the securities ledger is separate from that of the general ledger. | (iii) An individual can conceal a theft of securities.  |
| (d) Custody of the securities is separate from accounting for the securities.             | (iv) An individual can improperly record securities values or not report the values to management.  |
6. For each test of transactions and each test of account balances for investments listed below, identify the assertion for which the test provides evidence.
- (a) Determine whether there has been any permanent impairment in the value of the cost basis of an individual security.
  - (b) Inspect securities if they are maintained by the client or obtain a confirmation from an independent custodian.
  - (c) Search for purchases of securities by examining transactions for a few days after year-end.
  - (d) Examine brokers' advices for a sample of securities purchased during the year.
7. What should an auditor look for when testing for proper classification of securities?

# Answers

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## TOPIC 1: INTRODUCTION TO AUDITING

### Self-Test 1

1. **Auditing** is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria.

**Accounting** is the recording, classifying and summarising of economic events for the purpose of providing financial information used in decision making.

2. The four types of audits may be classified as follows:

- (a) **Financial Statement Audits**

The audit is conducted to determine whether the overall financial statements and the quantifiable information are being verified and stated in accordance with specific criteria: approved accounting standards which are consistently applied and in accordance with the requirements of legislation and regulation. It is more efficient to have one independent (external auditor from certified public accounting firm) to perform audit and draw conclusions on that financial statements that can be relied upon by the different groups of users for the different purposes.

- (b) **Compliance Audits**

The purpose of compliance audit is to determine whether the management is following specific procedures, regulations or rules set down by some higher authority. A compliance audit may be required to check whether the organisation has complied with prescribed policies, contractual agreement or legal requirements. Results of compliance audit are generally reported to someone within the organisational unit being audited rather than a broad group of users (creditors, investors, etc).

- (c) **Operational Audits**

An operational audit is a review of any party of an organisation's operating procedures and methods (such as accounting, organisation structure, computer operations, production methods) for the purpose of evaluating efficiency and effectiveness of management itself.

Recommendations to management for improving the operations are normally expected at the completion of an operational audit.

(d) **Forensic Audits**

Forensic auditing requires the use of critical analyses and investigative skills, integrated with accounting knowledge and business experience. Examples of forensic audit include business or employee fraud, criminal investigations and shareholder and partnership disputes.

**The four types of auditors are:**

(a) **External Auditors**

An approved company auditor under Section 8 of the Company Act 1965 to audit every company incorporated under the Act. The primary responsibility is to provide a true and fair view or opinion on the financial statements.

(b) **Internal Auditors**

An employee of the company who carries out an appraisal on the accounting and other operations and the results are reported to management (operational audit and compliance audit).

(c) **Government Auditors**

A government employee reporting to the Auditor General Department. He would carry out audits of government department and government agencies. Audit duties include both the audit of financial statements and compliance audits. The final reports are to be reported to the responsible Ministry and Parliament.

(d) **Forensic Auditors**

Forensic auditors are trained to detect, investigate and deter fraud and white-collar crime. Forensic auditors may be employed by corporations, government agencies and investigative services firm.

3. **Accounting:**

Is a process of recording, classifying and summarising economic events in a logical manner for the purpose of providing financial information for decision making by the various users of financial statements.

**Auditing:**

Is a process of enhancing the credibility of financial information. The auditor in auditing accounting data must thoroughly understand the accounting principles and rules as the criteria for evaluating whether the accounting information is properly recorded and properly reflects the economic events that occurred during the accounting period.

4. Three fundamental concepts in auditing:

(a) **Materiality**

The magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgement of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

(b) **Audit Risk**

The risk that the auditor may unknowingly fail to appropriately modify the opinion on financial statements that are materiality misstated.

(c) **Evidence**

Evidential matter supporting the financial statements consists of the underlying accounting data and all corroborating information available to the auditor. Relevance refers to whether the evidence relates to the specific audit objective being tested. Reliability refers to the diagnosticity of the evidence; whether the evidence signal the true state of the assertion or audit objective.

5. Auditor's responsibilities:

- To state an opinion on the financial statements in auditor's report based on his independent examination.
- To provide reasonable assurance that the financial statements are free from material misstatements.
- To ensure audit exercise be performed with due care and professional competence.
- To ensure the auditor have extensive knowledge about the nature of the client's business and industry in order to determine whether financial statements assertions are valid.

Management's responsibilities:

- Preparation of yearly financial statements.
- Maintaining adequate accounting records and internal control systems.
- Safeguarding of company's assets
- Prevention and detection of errors, irregularities and fraud

## Self-Test 2

1. You should explain to En. Hilmy that an independent audit is an examination of the financial statements in accordance with approved auditing standards. The objective of such an examination is to render an opinion on whether the financial statements present a true and fair view of the financial position, results of the operations, and cash flows in conformity with approved accounting standards. The auditor after an objective evidence gathering examination, expresses a professional opinion as to the fair presentation of financial statements. It would not be meaningful for a company to report on itself without the attestation of an independent party because the company itself might not be objective.
  - (a) You should inform En. Hilmy of the following benefits derived from audit:
    - (i) By serving as a basis for the extension of credit
    - (ii) By supplying credit rating agencies with required information.
    - (iii) By serving as a basis for preparation of tax returns.
    - (iv) By providing industry wide comparisons.
    - (v) By establishing and/or improving systems of internal control.
    - (vi) By serving as a basis for action in bankruptcy and insolvency cases.
    - (vii) By serving as a basis for changes in accounting and recording.
    - (viii) By discouraging employees from planning errors, fraud and so forth, by making them aware of the auditor's presence.
  - (b) The agency relationship between an owner and manager produces a natural conflict of interest because of the information asymmetry that exists between an absentee owner and manager. That is, the manager generally has more information about the "true" financial position and results of operations of the entity than the absentee owner does. If both parties seek to maximise their own self-interest, it is likely that the manager will not act in the best interest of the owner.

There is a demand for auditing services because the agency relationship produces a natural conflict of interest. As a result, the agent agrees to be monitored as part of his/her employment contract. Auditing appears to be the most cost-effective form of monitoring.

- (c) The absentee owner is in no position to attest personally the credibility of the accounting information contained in the company's annual report. Nevertheless, it is of great importance for him or her to be given information that is relevant, reliable, consistent and comparable. Credibility is quality added to information to make it more believable. Information provided by the management can be relied upon with confidence by different users of the financial statements (e.g. shareholders, creditors and government agencies).
- (d) Management assertions define as explicit or implicit representations by management that are embodied in the financial statements. Assertions are generally classified in five broad categories:
- (i) Existence or occurrence
  - (ii) Completeness
  - (iii) Rights and obligations
  - (iv) Valuation or allocation, and
  - (v) Presentations and disclosures

## TOPIC 2: AUDITOR'S REPORTS

### Self-Test 1

1. Since the auditor's report is the end product of an audit, it serves as a message to the users of the financial statement on the state of affairs of the company as at the year end. Provided that the users understand the terms being used in the auditors report, it will serve as an important communication document to the users.
2. The basic elements of the standard unqualified auditor's report are:
  - Title
  - Addressee
  - Introductory
  - Scope
  - Opinion
  - Name of auditor
  - Date

3. Purpose of:  
**Scope paragraph** - a factual statement about the things undertaken by the auditor in the audit. The paragraph mentioned the fact that the auditors followed approved standards on auditing before describing the pertinent aspects of the financial statements audit.

**Opinion paragraph** - The opinion report in the standard paragraph states the auditor's conclusion based on the results of the audit. It should contain the auditor's opinion as to whether the accounts give a true and fair view in accordance with approved accounting standards and whether the accounts comply with the Companies Act. This part of the report is so important that frequently the entire audit report is referred to as the *auditor's opinion*. The opinion paragraph is stated as the as an opinion rather than an absolute fact or a guarantee. The intent is to indicate that the conclusions are based on professional judgment. Hence there may be some information risk associated with the financial statements, even though the statements have been audited.

4. **Standard unqualified** - the most common type of auditor's report normally issued by the auditors when the management assertions with regards to the financial statement are usually found to conform to the requirements of the reporting framework. The standard unqualified audit report will be issued by the auditors when there is affirmation of the requirements of each aspect of the reporting framework which means that the auditor is satisfied that the financial statements presents a true and fair view in accordance with the provision of the Companies Act, 1965 as well as the audit has been performed in accordance with the approved standards of auditing in Malaysia.

**Unqualified with explanatory paragraph auditor's report** - reports normally meet the criteria of a complete audit with satisfactory results and financial statements that give a true and fair view, but the auditor believes it is important, or is required, to provide additional information. It is therefore necessary for the audit to draw the reader's attention to the matter which being explained in the notes to the financial statement. In this type of report, an emphasis of matter paragraph is included after the opinion paragraph which would reflect the auditor's opinion. It is important to remember that the additional paragraph *does not affect* the auditor's opinion; hence the auditor's report issued is still unqualified.

5. Limitation normally arises when the auditor is not able to obtain for any reason, all the information and explanation which he considers necessary for the audit. This would include the inability to carry out procedures

considered necessary or the absence of proper documents or accounting records. There are two major categories of scope limitations:

- (a) Caused by restrictions imposed by clients – for example, management’s refusal to permit the auditor to obtain direct confirmation for material receivables or to physically examine inventory.
  - (b) Caused by circumstances beyond either the client’s or auditor’s control such as when the engagement has not been agreed upon until after the client’s year end and as a consequence, was unable to attend the previous year’s stock take or confirm receivables or perform other important procedures after the balance sheet date.
6. Situations:
- (a) Unqualified with explanatory paragraph
  - (b) Going concern issue – qualified due to material disagreement
  - (c) Significant uncertainty that is material and pervasive - disclaimer

## Self-Test 2

1. The company’s ability to continue as a going concern is in doubt as it has violated the loan agreement requirement. This can result in withdrawal of loan facility by the bank and will have an adverse effect on the company’s financing facilities. Provided that sufficient disclosure of the matters have been made in the notes to the financial statement, an unqualified with explanatory paragraph opinion will be the most appropriate.
2. The change in accounting policy must be agreed by the auditors and have been sufficiently disclosed in the notes to the financial statement. Provided that the change in the depreciation method is to provide true and fair presentation of the financial statement, the appropriate audit opinion would be standard unqualified.
3. This is an example of scope limitation imposed by the client. Since there is no alternative procedures available and assuming that the scope limitation is material but not pervasive, the suitable audit opinion is qualified.
4. Failure to disclose a major related party transaction is not complying with approved accounting standard and normally will not be agreed by the

auditors. This is therefore a disagreement which must be material but not pervasive. Hence the appropriate audit opinion is an adverse audit opinion.

5. A scope limitation – circumstances imposed. Should be material but not pervasive; therefore renders a qualified audit opinion.
6. Failure to disclose such matters in the financial statement will result in disagreement between the auditors and the client. A material but not pervasive disagreement will result in an adverse audit opinion.
7. The accounting treatment is consistent with approved accounting standards which renders a standard unqualified opinion.

### **TOPIC 3: AUDIT PLANNING AND EVIDENCE**

#### **Self-Test 1**

1. Factors that auditor need to consider before accepting any engagement:
  - (a) Client's reputations
  - (b) Client's financial standing
  - (c) Acceptable audit risk
  - (d) If it is new client, the results of the communication with predecessor auditor
  - (e) If existing client-integrity of management, audit fees, disputes over accounting practices, scope limitations
2. Auditors need to understand about the client's industry to help them in obtaining sufficient appropriate audit evidence and also to assess the risk associated with accepting or continuing to audit a client. Common sources of knowledge are industry publications, local banks, attorneys and suppliers.
3. An Engagement Letter is an agreement between the accounting firm and the client as to the terms of the engagement for the conduct of the audit and related services. It normally contains agreement between client and auditor regarding the type of service to be provided, audit fees, scope and limitation of the engagement, responsibility of the auditor and management, timing of the engagement.

4. (a) Physical examination  
(b) Documentation  
(c) Confirmation  
(d) Observation  
(e) Inquiry  
(f) Reperformance  
(g) Analytical Procedures
5. (a) and (f) because it is the auditor's direct personal knowledge and is more objective.
6. (a) Advantages of analytical procedures  
(i) Direct the auditor's attention to the area that needs more consideration in audit  
(ii) As a substantive procedure  
(iii) Reduce the amount of detailed testing  
(iv) At the completion stage to help the auditor justify the audit conclusion
- (b) (i) Long-term debt to interest expense – Relationship between interest expense and long term debt  
(ii) Return on equity – Relationship between net income to owners equity  
(iii) Return on investment – Relationship between net income to investment
- (c) (i) Reduction in sales amount, increase in inventory quantities, incorrect computation of physical inventory or incorrect pricing  
(ii) Inclusion of slow moving inventory-obsolete inventory  
– change in inventory valuation method  
– unrecorded purchase  
– erroneous in purchase or sales cut-off

## Self-Test 2

1. Major steps in audit planning are as follows:
  - (a) Pre-planning
  - (b) Obtain client's background information
  - (c) Assess materiality and risks
  - (d) Conduct preliminary analytical procedures
  - (e) Developed overall audit plan
2. To distinguish between obsolete and current inventory requires the auditor's judgement. Often the auditor is not an expert in these areas especially those involving knowledge of marketability of technical products. However knowledge about client's background such as client's industry may help the auditor in making such judgement. The tour of client facilities and result of analytical procedures such as inventory turnover ratio may indicate possible obsolescence.
3. Client's minutes of the board of director are relevant to the auditor for many reasons. Two important reasons are to gain understanding about the client's strategies and business operations and to inquire knowledge about important decision made by the client. It is important to read minutes early in the engagement to help the auditor determine sufficient appropriate audit evidence.
4. Responsibility of successor to initiate communication with predecessor auditor. Predecessor to ask client's permission to respond honestly to the successor auditor.
5.
  - (a) Commission expense may have been overstated in current year or understated in previous year or sales may have been understated in current year or overstated in previous year.
  - (b) Obsolete inventory may be present.
  - (c) Obsolete inventory may be present. The inventory is maintained at higher level than necessary.
  - (d) Problem in collections of account receivables. Additional provisions may be necessary.
  - (e) The allowance may be understated.
  - (f) Depreciation may be understated.

6. (a) Observation and physical examination
- (b) Documentation and inquiry of client personnel
- (c) Confirmation and reperformance
- (d) Confirmation and documentation
- (e) Documentation and confirmation with company secretary
- (f) Confirmation with attorney and inquiry of client personnel
- (g) Documentation and analytical procedures

## TOPIC 4: UNDERSTANDING INTERNAL CONTROL

### Self-Test 1

1. Objectives of internal control include reliability of financial reporting, effectiveness and efficiency of operations, compliance with applicable laws and regulations, and safeguarding of assets. The five components of internal control are the control environment, the entity's risk assessment process, the information system and related business processes relevant to financial reporting and communication, control procedures and monitoring of controls.
2. A substantive strategy means that the auditor has decided not to rely on the entity's controls to reduce audit risk, but rather to reduce audit risk solely by obtaining sufficient evidence from substantive tests and procedures. The reliance strategy requires a more detailed understanding of internal control than the substantive strategy does because the auditor intends to rely on the controls. Further, tests of controls are necessary to implement the reliance strategy.
3. The effectiveness of any internal control system is limited by potential for any of the following: management override of internal control, personnel errors or mistake, and collusion. Further, internal control effectiveness is limited by cost. The cost of the control system must be balanced with the related benefits.

Auditors can use copies of the entity's procedures manuals and organisational charts. In addition, they can use a narrative description of internal control, which is often in the form of a memorandum and is most appropriate with a simple internal control system. The auditor can also use internal control questionnaires and flowcharts.

4. Applicable procedures include inquiry of appropriate entity personnel and inspection of documents, reports, or electronic files indicating the performance of the control. The auditor might also observe application of the control, re-perform the application of the control or perform a walkthrough. A walkthrough involves tracing a transaction from its origination to its inclusion in the financial statements through a combination of audit procedures including inquiry, observation and inspection.

## Self-Test 2

1. From the management's perspective, the internal control provides a way to meet its stewardship or agency responsibilities. Management also needs a control system that generates reliable information for decision-making purposes. The importance of internal control to the auditor is rooted in the second standard of fieldwork. The controls that are relevant to the entity's ability to initiate, record, process, and report financial data consistent with management's assertions are the auditor's main concern. The auditor needs assurances about the reliability of the data generated within the entity's internal control system in terms of how it affects the fairness of the financial statements and how well the assets and records of the entity are safeguarded.
2. Internal control structure is composed of five components:
  - (a) **Control Environment:**

The control environment sets the tone of the organisation, influencing the control consciousness of its people. It is the foundation of all other components of internal control, providing discipline and structure.
  - (b) **The Entity's Risk Assessment Process:**

The process for identifying and responding to business risks and the results thereof. For financial reporting purposes, the entity's risk assessment process includes how management identifies risks relevant to the preparation of financial statements that are fairly presented in conformity with generally accepted accounting principles, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to manage them.
  - (c) **The Entity's Information System and Related Business Processes Relevant to Financial Reporting and Communication:**

The information system relevant to financial reporting objectives, which includes the accounting system, consists of the procedures,

whether automated or manual, and records established to initiate, record, process and report entity transactions and to maintain accountability for the related assets, liabilities and equity. Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting.

(d) **Control Procedures:**

Control procedures are the policies and procedures that help ensure that management directives are carried out, for example, that necessary actions are taken to address risks to achieve the entity's objectives. Control procedures, whether automated or manual, have various objectives and are applied at various organisational and functional levels.

(e) **Monitoring of Controls:**

It is a process to assess the quality of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions.

3. The concept of reasonable assurance recognises that the cost of an entity's internal control system should not exceed the benefits that are expected to be derived. Thus, an internal control system will not detect every error that might occur because it would be too costly to design such a system. Management override of internal control, personnel errors or mistakes and collusion are inherent limitations of internal control.
4. Factors that affect the control environment include:
  - Communication and enforcement of integrity and ethical values.
  - A commitment to competence.
  - Participation of the board of directors or audit committee.
  - Management's philosophy and operating style.
  - Organisational structure.
  - Assignment of authority and responsibility.
  - Human resource policies and practices.

5. (i) The four objectives of ICS:
- Orderly and efficient running of business.
  - Adherence to management policies.
  - Safeguarding of assets.
  - Preventing fraud and error.
  - Ensure completeness and accuracy of accounting records.

The five components of internal control:

- Control environment.
- Risk assessment
- Control procedures activities
- Monitoring
- Information and communication

- (ii) Typical types of evidence:
- Inspecting records and documentations
  - Inquiry to management.
  - Re-performing.
  - Observations.
  - Walk-through test.

## **TOPIC 5: AUDITING CASH BALANCES AND INVENTORY**

### **Self-Test 1**

1. Audit of interbank schedule:
- (a) The accuracy of the information on the interbank transfer schedule should be verified.
  - (b) The interbank transfers must be recorded in both the receiving and disbursing banks.
  - (c) The date of the recording of the disbursements and receipts for each transfer must be in the same fiscal year.

- (d) Disbursement on the interbank transfer schedule should be correctly included in or excluded from the year-end bank reconciliations as outstanding cheques.
  - (e) Receipts on the interbank transfer schedule should be correctly included in or excluded from the year-end bank reconciliations as deposits in transit.
2. Examples of misstatements that could not be uncovered by test of bank reconciliation:
- (a) Billing a customer at a lower price than called for by company policy.
  - (b) A defalcation of cash by interception of cash receipts from customers before they are recorded; the account is charged off as a bad debt.
  - (c) Duplicate payment of a vendor's invoice.
  - (d) Improper payments of officers' personal expenditures.
  - (e) Payment of raw materials that were not received.
- 3.
- (a) (i) Substantive test of transactions  
(ii) Prepare an interim period proof of cash
  - (b) (i) Substantive test of transactions  
(ii) Trace pre-listing of cash receipts to cash receipts journal
  - (c) (i) Test of details of cash balance  
(ii) Obtain the last cheque number issued from the client
  - (d) (i) Substantive test of transactions  
(ii) Compare recorded cash disbursement to receiving report
  - (e) (i) Substantive test of transactions  
(ii) Examine invoice for discount not taken.
  - (f) (i) Test of details of cash balances  
(ii) Trace deposit in transit to cash receipts journal.
4. Ordinarily the auditor will confirm inventory held by outside custodians. However, the auditor may perform additional procedure if the amounts involved are significant. These additional procedures may include: an investigation of the custodian's performance, requesting an independent accountant's report on the custodian's control procedures over the custody of goods and observing the physical count of goods held by custodian.

5. Common analytical procedures for auditing accounts in the inventory and warehousing cycles;
  - Compare gross margin percentage with previous years’.
  - Compare inventory turnover ratio with previous years’.
  - Compare unit costs of inventory with previous years’.
6. (a) (i) Substantive test  
(ii) To test for existence, completeness and accuracy
- (b) (i) Substantive test  
(ii) Accuracy
- (c) (i) Test of control  
(ii) Existence, completeness, accuracy, classification

## Self-Test 2

1. (a) (i) To cover shortage  
(ii) Trace all cheques dated on or before 31 December that were cleared in the subsequent balance sheet to the December 31 bank statement.
- (b) (i) To cover shortage.  
(ii) Verify the bank reconciliation by tracing any cheque dated on or before 31 December in the cash disbursements journal to bank statement. Any cheque not clear should be included in the outstanding cheque list.
- (c) (i) To improve cash position  
(ii) Trace deposit in transit to bank statement to determine deposit date and trace to remittance advice
- (d) (i) To cover cash shortage  
(ii) Obtain bank confirmation
- (e) (i) Cheque was not authorised, the outstanding cheque make the bank reconcile.  
(ii) Trace from outstanding cheque to cash disbursement journal

2. Petty cash is generally verified because of the potential for defalcation and the client's expectation of auditor consideration even when the amount is immaterial.
3. To test for kiting, the auditors obtains a schedule of interbank transfers that lists all bank transfers made a few days before and after the balance sheet date and traces each to the accounting records for proper recording.
  - (a) The accuracy of the information on the bank transfer schedule should be verified by reference to the cash disbursements and cash receipts records.
  - (b) The date of the recording of the disbursements and receipts for each transfer must be in the same fiscal year.
  - (c) Disbursements on the bank transfer schedule should be correctly included in or excluded from year-end bank reconciliation as outstanding cheque.
  - (d) Receipts on the bank transfer schedule should be correctly included in or excluded from year-end bank reconciliations as deposit in transit.
4. Tests of details of balances for inventory are affected by the results of tests of controls and substantive tests of transactions in the revenue and collection cycle, acquisition and payment cycle, and payroll and personnel cycle, as well as the inventory and warehousing cycle.
5. The key control procedures relating to the client's physical count of inventory include proper instructions for the physical count, supervision by responsible personnel, independent internal verification of the counts, independent reconciliations of the physical counts with perpetual inventory master files, and adequate control over count sheets or tags.
6.
  - (a)
    - (i) Internal verification by other person
    - (ii) Examine vendor's invoices in support of prices used.
  - (b)
    - (i) All people responsible for inventory tags and compilations should independent of custody of perpetual inventory record
    - (ii) Record test count and trace to compiled inventory.
  - (c)
    - (i) Segregation of obsolete inventory
    - (ii) Perform net realisable value or lower of cost or market value test of inventory, including test of perpetual inventory.

## TOPIC 6: AUDITING REVENUE AND COLLECTION CYCLE

### Self-Test 1

1. Assuming the client's internal controls are adequate, the auditor can verify proper cut-off of sales transactions by obtaining the shipping document number for the last shipment made at the end of the period and comparing this number with the current and subsequent period recorded sales.
2. The auditor can test the rights objective for accounts receivable through reviewing the client's minutes, discussions with the client, confirmation with banks, and the examination of correspondence files to determine whether receivables may have been pledged as collateral, assigned to someone else, factored or sold.

3.

Test of Control or Substantive Test of Transactions	Transaction-Related Audit Objective(s)	Substantive Test
(a) ST of T	Accuracy	Not applicable
(b) ST of T	Posting and summarisation	Not applicable
(c) T of C	Accuracy	Compare unit selling prices on duplicate sales invoices to the approved price list.
(d) T of C	Classification	Examine a sample of sales transactions to determine if each one is correctly classified in the sales journal.
(e) ST of T	Classification	Not applicable
(f) ST of T	Completeness Accuracy Timing Posting and Summarisation	Not applicable

(g) ST of T	Existence Completeness Accuracy Timing	Not applicable
(h) T of C	Accuracy	Recalculate the cash discounts for a sample of remittances and determine whether each one was consistent with company policy.
(i) T of C	Completeness	Trace from a sample of remittance advices to the cash receipts journal to determine if the related cash is recorded.

4. It is acceptable to use negative confirmation requests only when all of the following circumstances are present:
- Accounts receivable is made up of a large number of small accounts.
  - Combined assessed control risk and inherent risk is low.
  - There is no reason to believe that the recipients of the confirmations are unlikely to give them consideration.
5. The audit procedures most likely to be used to verify accounts receivable charged off as uncollectible and the purpose of each procedure are as follows:
- Examine approvals by the appropriate persons of individual accounts charged off. The purpose is to determine that charge-offs are approved.
  - Examine correspondence in client's files that indicates the uncollectibility of the accounts for a selected number of charge-offs. The purpose is to determine that the account appears to be uncollectible.
  - Examine the customer credit records as an indication of the uncollectibility of an account.
  - Consider the reason for the charge-off compared to the company policy for writing-off uncollectible accounts. The purpose is to determine whether or not company policy is being followed.

6. Audit procedures that the auditor can use to determine whether all cash receipts were recorded are:
  - (a) Discussion with personnel and observation of the separation of the separation of duties between handling cash and record keeping.
  - (b) Account for numerical sequence of remittance advices or examine pre-listing of cash receipts.
  - (c) Observe immediate endorsement of incoming cheques.
  - (d) Examine indication of internal verification of the recording of cash receipts.
  - (e) Observe whether monthly statements are being sent to customers.
  - (f) Trace from remittance advices or prelisting to cash receipts journal.

## Self-Test 2

1. (b)
2. For any positive confirmation not returned, the auditor can examine the following to verify the existence of individual sales transactions making up the ending balance in accounts receivable:
  - (a) Subsequent cash receipts: evidence of the receipts of cash after the confirmation date includes by examining remittance advices and entries in the cash receipts records.
  - (b) Duplicate sales invoices.
  - (c) Shipping documents.
  - (d) Correspondence between customer and the client.
3. The classification objective is tested by reviewing the aged trial balance for material receivables from affiliates, officers, directors or other related parties. If notes receivable or accounts that should not be classified as a current asset are included with the regular accounts, these should also be segregated. Finally, if credit balances in accounts receivable are significant, it is appropriate to reclassify them as accounts payable.
4. (a)
  - (i) Test of Control
  - (ii) Recorded sales returns are for returns from existing customers (existence).
  - (iii) Documentation

- (b) (i) Test of Control  
(ii) Existing transactions are recorded (completeness)  
(iii) Documentation
  - (c) (i) Test of Control  
(ii) Recorded sales are for shipments actually made to existing customers (existence)  
(iii) Documentation
  - (d) (i) Substantive test of transactions  
(ii) Recorded sales are for the amount of goods shipped (accuracy)  
(iii) Documentation
  - (e) (i) Substantive test of transactions  
(ii) Sales transactions are properly included in the accounts receivable master file and are correctly summarised (posting and summarisation)  
(iii) Reperformance
  - (f) (i) Test of control  
(ii) Cash received is recorded in the cash receipts journal (completeness)  
Cash receipts are recorded on the correct dates (timing)  
(iii) Observation and documentation
  - (g) (i) Substantive test of transactions  
(ii) – Recorded receipts are for funds actually received by the company (Existence)  
– Cash received is recorded in the cash receipts journal (Completeness)  
– Cash receipts are deposited at the amount received (Accuracy)  
– Cash receipts are recorded on the correct dates (Timing)  
(iii) Documentation
5. (a) (iii)
6. Existence, valuation and completeness

## TOPIC 7: LONG-TERM ASSETS AND OBLIGATIONS AND OWNERS' EQUITY

### Self-Test 1

1. Proper classification between long-term and current portions of long-term debt is an important part of disclosure. The auditor should verify the payment dates of the debt to ensure proper classification. To test for other long-term debt disclosure items, the auditor could inspect loan agreements for any restrictive covenants that should be disclosed in the financial statement footnotes. The auditor should also look for any applicable restrictions on retained earnings, which could arise from loan agreements or state law.
2. (a) iii (b) i (c) iv (d) ii
3. To test the reasonableness of the amount of reported interest expense, the auditor could multiply (6% / 12) by each of the monthly balances for long-term debt and add them together to estimate interest expense for the year. This estimate equals \$4,575, which is a lot higher than the reported amount of \$2,000. The auditor should do more testing to ensure the amount is not misstated.
4. (a) Test of details of transactions - Completeness  
 (b) Test of details of account balances – Rights and Obligations  
 (c) Test of details of account balances – Valuation and Allocation  
 (d) Test of details of transactions – Cutoff  
 (e) Test of details of transactions – Classification
5. Issuance of stock, repurchase of stock and payment of dividends
6. Occurrence – An officer of the entity ensures that every stock or dividend transaction complies with the corporate charter.

Accuracy – Stockholders' records are reconciled with the number of shares outstanding. Dividends paid is reconciled with the total shares outstanding on the dividend record date.

Authorisation – Stock and dividend transactions are approved by the board of directors.

Valuation – Stock issuances and repurchases and dividends are recorded by the treasurer's department at an amount that conforms to GAAP.

**Self-Test 2**

1. (a) False (b) True (c) False (d) True (e) True
2. The results of testing for controls of the various business processes can affect the audit of the income statement accounts because any weakness in controls discovered will also have an effect on the amount of substantive testing done for the income statement accounts. Also, misstatements found while completing tests of details of balance sheet accounts and their related income statement accounts could imply that there are misstatements elsewhere in the income statement. Due to the relationship between the balance sheet and the income statement, results from the audit work done on balance sheet accounts has meaning for the related income statement accounts as well.
3. (a) v (b) i (c) iii (d) ii (e) iv
4. The workpaper includes dates, amounts, descriptions and explanations of the account's transactions. The auditor can vouch this information to supporting documentation and scan the work paper for unusual amounts. These tests provide additional evidence about the reasonableness of income statement accounts that are not verified while auditing other business processes or accounts that contain sensitive information or unusual transactions. Additional analysis is also done on accounts used to complete the tax return.
5. (a) ii (b) iv (c) i (d) iii
6. (a) Valuation and allocation;  
(b) Existence;  
(c) Completeness;  
(d) Rights and obligations
7. First, the securities need to be properly classified as trading, available-for-sale or held-to-maturity. Then, those securities that are classified as trading must be listed as current assets. Proper classification of the available-for-sale and held-to-maturity securities as current or long-term should also be considered.

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<b>MODULE FEEDBACK</b>
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<b><i>MAKLUM BALAS MODUL</i></b>
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1. E-mail your comment or feedback to [modulefeedback@oum.edu.my](mailto:modulefeedback@oum.edu.my)

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2. Fill in the Print Module online evaluation form available on myINSPIRE.

Thank you.

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