In this chapter we look at the way that audits are planned, how auditors assess audit risk and how they set materiality levels. We explain how auditors document their client’s financial systems, and how internal controls are identified. Finally we explain how the audit plan is put together.

The chapter covers:

- knowledge of the business
- planning the audit
- the audit process
- assessing audit risk
- materiality
- the Permanent File
- documenting the systems
- internal control
- control activities and procedures
- internal control questionnaires
KNOWLEDGE OF THE BUSINESS

Before beginning the planning process, the auditors should find out as much detailed information as they can about their new client, its management and staff, and the business environment in which it operates.

ISA 315 ‘Identifying and assessing the risks of material misstatement through understanding the entity and its environment’, states:

‘Obtaining an understanding of the entity and its environment, including the entity’s internal control (referred to hereafter as an ‘understanding of the entity’), is a continuous, dynamic process of gathering, updating and analysing information throughout the audit. The understanding establishes a frame of reference within which the auditor plans the audit and exercises professional judgment throughout the audit.’

the business environment

During the course of the relationship with the client, the auditor should constantly gather information about the business environment in which the client operates. This will include:

- information about the client’s position and reputation within its industry sector
- the general economic conditions within the industry sector, including the level of competitiveness and political or economic factors
- the possible effect of technological change or environmental factors
- any cyclical or seasonal aspects of the business or any vulnerability to factors such as changes in fashion
- any major legislative or regulatory impacts which might affect the client
- economic conditions such as interest rates or inflation

Information can be gathered from a variety of sources including:

- industry specific publications, trade journals and websites
- previous experience of other clients in the same industry
- discussions with previous auditors
- government publications, statistics, surveys
- financial journals
the business, its management and staff

Auditors cannot begin to carry out any work on verifying the financial statements unless they have a complete understanding of the following:

- the structure of the organisation – its divisions, departments or subsidiaries
- the management structure
- the products and processes
- the financial systems

This type of information can only be successfully obtained by direct contact with the client’s management and staff. They are the only real source of the detailed information that will allow the auditors to fully understand the ‘who’, ‘what’, ‘why’, ‘where’ and ‘when’ of the client’s day-to-day activities.

The auditors should have a clear understanding of:

- the client
- the client’s business activities
- the internal and external environments in which the client operates

The auditors will then be in a position to decide what audit work is required to ensure that the correct audit opinion is reached.

PLANNING THE AUDIT ASSIGNMENT

It is very important for auditors to properly plan the audit work to be carried out. Without proper planning the objectives of the audit will not be achieved and the auditor runs the risk of failing to detect a material misstatement. In addition to this, a lack of evidence of proper planning could lend support to a case for professional negligence, which we looked at in Chapter 2.

Poor audit work often arises because:

- there was no planning
- the audit started before the planning process was complete
- the audit was based on a plan which had not been updated for several years
- the auditors did not fully understand the business and how it operated

The key to proper planning is setting planning objectives. The planning objectives for an audit are:
deciding audit priorities and establishing the most cost-effective means of achieving audit objectives

- ensuring audit work generates sufficient evidence to support the audit opinion

- ensuring that there is clear direction and control of the day-to-day audit work

- ensuring sufficient attention is devoted to critical aspects of audit work where systems are complex or the audit risk is considered to be high

- ensuring audit work is completed within predetermined time and cost budgets

THE AUDIT PROCESS

We will now examine the way in which an audit process works.

The steps which an auditor will go through, from being asked to take up an appointment to signing the auditor’s report, are normally as follows:

- find out as much as possible about the potential client before accepting the assignment

- carry out detailed investigations and document the client’s structure, management, systems and accounting processes

- draft a programme of audit work

- carry out investigations and receive explanations necessary to support the audit opinion

- sign the auditor’s report

The separate elements of this process will be dealt with in more detail, step by step, in subsequent chapters in this book.
There is another important factor to consider and that is the **timescale** of this process.

There are deadlines for companies to file accounts with the Registrar of Companies, and there is also a deadline for sending accounts to shareholders. Shareholders must receive a copy of the final audited accounts not less than 21 days before the date of any Annual General Meeting, so once a date for that has been set, the timescale for the work has to be based on that deadline.

In reality, most companies will want to finalise their accounts within a few months of the year end, so in most cases final audits are carried out then. The Case Study that follows illustrates the way in which these timescales work.

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### TIMPANI LTD: TIMESCALE OF THE AUDIT

**situation**

Auditors Crash & Co have been approached to be the first auditors of Timpani Ltd and have accepted. The financial year end is 31 December and they have been told that the AGM will be held on 21 April.

It is now early September and the audit has to be completed in time to send the accounts to the shareholders.

**required**

You are the audit manager and have been told to draw up an outline plan of how the audit assignment will be arranged. This will form the basis of detailed planning later.

**solution**

Your approach is to identify the key tasks and decide how much time will be needed to carry out each one.

You know that the accounts have to be sent to the shareholders 21 days before the date of the AGM and so your real deadline is 31 March.

The duration of each task is based on your estimate of how much work there is to be done and how long you think it will take based on your experience.

As this is the first audit Timpani Ltd has had, the tasks may take more or less time and the plan should allow for this.

You draw up a basic plan which is shown on the next page.

This plan depends upon Timpani’s accounts staff having the accounts and supporting schedules ready on time. This is why preliminary discussions with their staff are important so that everybody knows what they have to do, and by what date.
We have already identified that during the planning process the auditors must gain a good understanding of the client’s business and must consider the following factors:

- the environment in which the company operates, ie its market, its competitors, the way it is financed, the quality of its management, its current financial position etc and

- the company’s internal processes together with the internal controls in its accounting systems.

These factors will directly affect the possibility of a misstatement or fraud in the financial statements. For example, weak or ineffective controls could allow errors to slip through undetected.

The auditors must evaluate the company and its systems and decide whether there is a possibility that a serious misstatement could go undetected. This will directly affect the auditors’ decision as to the level of audit risk which we will now consider in the next section.
**ASSESSING AUDIT RISK**

The correct assessment of audit risk is vital, and is probably one of the most important aspects of audit that you have to study.

The whole approach that the auditors take to their audit work is based on how they assess the level of risk that their audit client represents. Basically, if the auditors think that the client represents a high level of risk they will need to carry out much more detailed audit work than if they assess it as being low risk.

We will now look at what we mean by risk in the context of auditing.

**what is audit risk?**

Audit risk is the risk that after carrying out all the audit work the auditors give an incorrect opinion of the client’s financial statements.

The auditors may certify that the financial statements give a true and fair view when they do not. In other words the financial statements contain a significant error or misstatement which the auditors have failed to detect.

**audit risk and fraud**

One thing that must be stressed is that audit risk has nothing directly to do with fraud. It is not the auditors’ job to set out to detect fraud. As we have seen, they are not ‘bloodhounds’ but ‘watchdogs’. Therefore, when auditors are assessing risk they are not assessing the risk that they might fail to detect a fraud.

Note, however, that ISA 240 ‘The Auditors’ responsibilities relating to fraud in an audit of financial statements’ requires auditors to approach any audit assignment with a degree of professional scepticism and says that they must bear the possibility of fraud in mind when planning audit work. This means that auditors should identify areas where the company’s assets are at greatest risk or where its controls are weakest.

**risk assessment**

ISA 315 ‘Identifying and assessing risks of material misstatement through understanding the entity and its environment’ requires auditors to identify and document areas of significant audit risk where they consider there could be a material misstatement, for example:

- in the financial statements as a whole
- for individual disclosures within the financial statements
Auditors have to understand and identify risk arising both out of the company’s operations and from its systems of internal control by carrying out a **risk assessment**.

This is done by a combination of:

- analytical review procedures, ie identifying inconsistencies in the figures being audited (see Chapter 4)
- discussions with management and other relevant people in the company
- observation and inspection of the company’s procedures and controls

A quick planning meeting with the financial director is not sufficient!

When the risks have been identified, the auditors have to design audit procedures so that these risks are reduced to an acceptable level. Auditors also have to identify whether there are risks which are so great that they deserve special audit consideration, ie so significant that normal audit testing processes will not be sufficient to validate the disclosures in the financial statements.

Auditors must fully document all the steps in their risk assessment.

One important point which ISA 315 stresses is that the risk assessment must be communicated and discussed with the whole audit team so that everyone on the assignment is aware of potential areas of risk.

**categories of risk**

Auditors will **measure** the levels of audit risk so that they can estimate how likely it is that they will give a wrong audit opinion.

Audit risk is defined in **ISA 200 ‘Overall objectives of the independent auditor and the conduct of an audit in accordance with International Standards on Auditing’** and comprises two things:

- the risks of a material misstatement in the financial statements as a whole or in the disclosure of individual transactions and balances
- detection risk – the risk that the auditor’s own procedures will fail to detect a material error or misstatement

We will look at materiality later. For the moment the word ‘significant’ is a good substitute. Therefore audit risk is concerned with the risk of a significant error or mistake not being detected.

Auditors assess audit risk using their professional judgement; this assessment is a key part of the planning process.

There are two components to the risk of material misstatement:

- Inherent risk
- Control risk

We will now look at each of these in turn, and then at detection risk.
**inherent risk**

Inherent risk is the risk that an item or items in the accounts will contain a material error or misstatement, simply because of the characteristics of the company or the characteristics of the particular item.

The following tables show the key signs of inherent risk that the auditors will look out for and the effect those factors may have.

### INHERENT RISK

**management & ownership of the business**

<table>
<thead>
<tr>
<th>potential risk areas</th>
<th>the effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>domineering owner or director</td>
<td>may influence the attitude of other directors and senior management towards disclosure in the financial statements or in the operation of the business</td>
</tr>
<tr>
<td>relationships between managers</td>
<td>direct relationships (eg in family companies) between managers or directors could reduce the effectiveness of the internal controls</td>
</tr>
<tr>
<td>level of management expertise</td>
<td>inexperienced or unqualified management may not appreciate the likelihood of error</td>
</tr>
<tr>
<td>expectations of stakeholders</td>
<td>expected levels of dividends by shareholders guarantees about profit levels given to lenders when applying for credit</td>
</tr>
</tbody>
</table>

**the accounts of the business**

<table>
<thead>
<tr>
<th>potential risk areas</th>
<th>the effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>complex accounts</td>
<td>complex financial structures involving subsidiary or associated businesses</td>
</tr>
<tr>
<td></td>
<td>companies engaged in complex trade eg foreign currency or share trading, freight forwarding, high tech businesses</td>
</tr>
<tr>
<td>items relying on judgement the</td>
<td>this requires objectivity on the part of the client staff making judgements (eg high levels of provisions at the year end)</td>
</tr>
<tr>
<td>cash transactions</td>
<td>tracing cash transactions is always more difficult than tracing credit transactions</td>
</tr>
</tbody>
</table>
There are, of course, many more inherent risks unique to specific companies. As auditors it is important to remember that if some aspect of the business appears unusual or poses a significant inherent risk, then it must be considered when assessing the level of audit risk.

*If a company has several areas of inherent risk, the auditor is likely to grade the level of inherent risk as high.* Read the Case Study that follows.

### INHERENT RISK – MUCKERS LIMITED

#### situation

You have been approached to be the new auditors of Muckers Limited

Muckers Ltd is a construction company engaged in the construction of housing projects, small office complexes and factory units.

Its main trade is in acquiring disused or derelict land and buildings (‘brownfield’ sites) at a low cost and building developments which they then sell to businesses looking for premises. They have been quite successful as the Development Director, Roger
Random, has been able to find attractive sites which the company can acquire quite cheaply. They also build new housing developments, mostly on ‘greenfield’ sites in development areas on the edge of town.

The Development Director, Roger Random, has recently handed in his notice as he is leaving to join a larger construction firm.

Muckers is owned and run by the Mucker family. Cyril Mucker, Chairman and Chief Executive, owns 60% of the shares. The only other director, apart from Roger Random, is Cyril’s brother, Hugo Mucker, who is responsible for overseeing the building contracts.

The financial accounting section is run by Paula Poppett (who is not a qualified accountant) and produces a set of management accounts quarterly. There are no budgets or management accounts as Cyril Mucker believes that watching the bank balance is the way to run the business.

The company has recently had some difficulty with two of its sites. On the ‘brownfield’ site inspectors have discovered contamination from an old asbestos factory and have forbidden any further development until it is decontaminated by specialist contractors. Muckers will have to pay for this. On a ‘greenfield’ housing project Muckers built twelve houses but have only sold two, as there are rumours that the local authority have decided to put in plans to central government for a dual carriageway bypass next to the new development.

The company employs a large number of temporary casual staff who are paid weekly in cash.

**required**

Before you take on this client what would be your assessment of inherent risk?

**solution**

The inherent risk involved in this client is high for a number of reasons, including:

- The company is under the control of a very small group of shareholders all of whom are related. One of them, Cyril Mucker, is a major shareholder.
- Cyril is also the chairman and chief executive, so this makes him a dominant force in the company.
- There is a very weak finance function, with no representative at director level. It seems unlikely that Paula Poppett could stand up to Cyril Mucker if there was any dispute about the figures.
- There is no proper management accounting system or budgeting.
- They have recently lost a key employee, Roger Random, who was responsible for much of the company’s success in the past.
- They have problems with two of their building developments. It is not known what the financial effect might be, but it is likely to be substantial. The business might then come under financial pressure.
control risk

Control risk – the second element of audit risk – is the risk that the internal controls of the company being audited are not operating properly and so do not prevent or detect material errors or misstatements. This could mean:

- a significant error may pass through the system undetected
- transactions may be missed out completely
- transactions may be wrongly recorded

Internal controls are the safeguards that the client has built into the systems and processes to minimise risk or error. This will include procedures such as matching invoices to orders and delivery notes before the invoice is processed and authorising the invoice before it is paid.

A key part of the auditors’ preliminary work is to evaluate these internal controls. Later in this chapter we will see how auditors go about doing this.

If the auditors are satisfied that the internal controls are working well, then they may be able to assess the control risk as low.

Significant weaknesses in the internal controls will lead to the auditors assessing the control risk as high. If internal controls are assessed as being weak this will limit the reliance the auditors can place on the accounting systems.

detection risk

Detection risk is the risk that the auditors’ own tests will fail to detect material errors or misstatements in the financial statements.

If we think about inherent and control risk, neither of these can be influenced by the auditors. Detection risk is different in that it is the only element of audit risk which is within the auditors’ control.

Suppose that, after carrying out their assessment of the inherent risk and control risks, the auditors assess the risk of a material misstatement as high. Because audit risk is a combination of the risk of material misstatement and detection risk, in order to make the level of audit risk acceptable, the auditors will have to do a large amount of audit testing in order to make the detection risk low.
On the other hand, if, after carrying out their risk assessment, the auditors judge inherent and control risk to be low, and hence the risk of material misstatement as low, they will be able to reduce their audit work to a more reasonable level, making the detection risk higher, but still acceptable.

**Numerical Scoring of Risk**

As accountants you are used to attaching numerical values to things, so you may well look at this system of risk assessment and think it is a bit vague. Auditors sometimes use a **numerical scoring system** for each of the categories of risk in order to arrive at an overall estimate. Remember that in every case the evaluation of risk ultimately requires skill and judgement on the part of the auditor which is gained through training, qualification and experience.

Lastly, it is very important to remember that risk must be constantly reviewed during the course of the audit. Factors may come to light during audit testing that will change the level of risk, and this will have an immediate impact on the amount and focus of audit work.

**Materiality**

The concept of **materiality** is closely linked to the auditor’s consideration of the level of audit risk. Remember that part of the process of establishing the level of audit risk requires the auditor to review the risk of a **material** misstatement not being detected either by his/her own procedures or by the client’s internal controls.

**What do we mean by materiality?**

**ISA 320 ‘Materiality in planning and performing an audit’** states:

‘Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements’

and

‘The auditor’s determination of materiality is a matter of professional judgment, and is affected by the auditor’s perception of the financial information needs of users of the financial statements.’

Materiality is effectively a measurement of how important something is within the financial statements. ISA 320 states that something will be
considered to be material if leaving it out of the financial statements or getting it wrong would give the reader/user a misleading view of the state of the company’s affairs.

There are three key points to understand about materiality before we look at it in detail:

- the auditors will use their professional judgement to decide what is material
- it cannot be defined as one specific value
- the auditors’ decision about whether an error is material depends on how it fits in the context of the financial statements as a whole

misstatements

Before we look at materiality in detail there is another auditing standard which we must consider when reviewing materiality, and that is **ISA 450 ‘Evaluation of misstatements identified during the audit’**.

ISA 450 defines misstatement as:

‘the difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.’

In other words a misstatement is the difference between:

- the size of a figure as shown in the financial statements or how it has been disclosed or presented
  
  and
  
- the size it should be if it had been properly calculated, or what its correct disclosure or presentation should be if the relevant accounting standards had been applied correctly

Misstatements can include:

- amounts incorrectly taken from the accounting records and included in the financial statements, for example calculation error or simple mistakes in posting figures

- amounts or statutory disclosures omitted, for example failing to fully disclose directors’ emoluments

- incorrect estimates arising from misinterpreting facts or overlooking something which is relevant to the calculation of the estimate, for example understating an allowance for doubtful debts by ignoring some overdue amounts
estimates based on judgements which are clearly excessive or unreasonable in the circumstances. This includes the use of accounting policies which are unreasonable or inappropriate, for example depreciating computer equipment over 10 years where its useful life is considerably less.

The auditors must consider all the misstatements, or errors, they detect during the course of their audit work and make a judgement about how they could affect the financial statements. This will involve discussion with the management about amending the financial statements where individual misstatements are material. If the misstatements are individually small this will involve deciding whether, collectively, they are significant enough to affect the presentation of the accounts; lots of small errors can add up to a large one!

**performance materiality**

During the planning process the auditors will review the information they have obtained about the client’s financial results for the period and make a preliminary estimate of materiality for the financial statements as a whole.

They will also look at particular classes of transactions, for example inventories, where these are important figures in the accounts, and make an estimate of what they would consider to be a material misstatement for that class of transaction.

However, during the actual audit work the auditors will set performance materiality at a lower level of materiality than they had during the planning stage, ie smaller items now become material.

ISA 320 defines performance materiality as:

> ‘the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. If applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.’

The intention behind setting this lower level of materiality when the audit work is carried out is to minimise the risk that the sum of amounts that are individually immaterial plus any possible undetected misstatements exceeds the planned materiality limit set before the audit began.

The discovery of a huge error which is obviously significant will result in the auditors asking the management to amend the financial statements. Performance materiality aims to ensure that smaller errors, which on their own would not require the financial statements to be altered, added to an
allowance for any misstatements the auditors have not detected, do not collectively add up to something which would also require the financial statements to be altered.

The levels of planned materiality and performance materiality should be constantly reviewed during the audit and revised as appropriate.

Something can be material to the financial statements for qualitative or quantitative reasons.

**Qualitative Aspects**

Qualitative means that an error or omission that the auditors have discovered is material because of the nature of the item, regardless of its financial value. In this case the error or omission is unacceptable and the auditor must highlight this to the client management for adjustment.

Examples of items that are measured for qualitative reasons include:

- a disclosure required by the Companies Act or Accounting Standards which has been omitted completely or partially from the accounts, eg director’s emoluments
- an item which is misstated, eg a short-term loan shown as a long-term loan
- an item which might affect the accounts but which has not been included because it cannot be quantified with a reasonable degree of certainty, eg the outcome of a significant court case

It is the responsibility of the auditors to remind the directors of their duty to comply with legislation and with relevant Accounting Standards and to rectify errors and omissions.

**Quantitative Aspects**

Whereas ‘qualitative’ refers to the nature of errors and omissions, quantitative refers to quantity, ie to the size (value in £) of any errors found during the audit.

The auditors must take a view as to whether the value of errors found, individually, or taken all together, is sufficiently significant (material) for the auditors to request the management to adjust the financial statements. Remember that, as we saw above, for the purposes of the audit work the level of performance materiality will be lower than the level set at the planning stage.

In order to determine a numerical value for materiality, the auditors will often use percentages of some of the key numbers in the draft financial statements, for example:

- 5% - 10% of pre-tax profits
1% of turnover
5% of net asset value

Alternatively, they may decide to calculate these figures and then to use a combination of all three. The figures on which the auditors will base their calculation of materiality will depend on the nature of the client being audited.

It is important to understand that these figures are given as examples only and that you should not see them as a definitive guide to setting materiality.

It is also important for materiality levels to be constantly reviewed during the course of the audit where the level of inherent or control risk changes or where errors are found in audit testing.

When, during the audit, the auditors find errors in the accounts, these should be noted on a schedule of errors and misstatements. At the end of the audit all errors and misstatements that have been found should be aggregated and considered together.

The auditors must then assess whether they have a material impact on the financial statements and also whether they affect the truth and fairness of the financial statements.

In most cases the directors will be happy to adjust the financial statements for errors found by the auditors because they are keen for the accounts to be as accurate as possible. However, if the directors refuse to amend the accounts, the auditors will have to consider whether the error or mistake is serious enough that they should highlight it in their final audit report. This issue will be covered in detail in Chapter 7.

MATERIALITY: LEMON LTD

situation
You are the audit manager covering the year-end audit of Lemon Ltd. You are reviewing the audit files before sending them to the audit partner for final review. Two specific points have been drawn to your attention by the audit staff.

(a) The draft financial statements currently do not include any reference to the fact that the client’s Sales Director owns 15% of Tonic Ltd, a major supplier to Lemon Ltd.

(b) One of the company’s major customers has gone into liquidation, owing them £40,000 which is unlikely to be recovered. Profits for the year are £200,000 and receivables are shown in the Statement of Financial Position at £650,000.

Audit materiality on the audit has been set at 10% of the pre-tax profit. However, the client’s management say they have not provided for this, as it is not material and if necessary they will write it off next year.

required
What recommendations will you make to the audit partner regarding these two issues?
solution

(a) This is automatically material (for qualitative reasons) and must be disclosed. The director has an interest in a major supplier to the business and the Companies Act requires that this type of information is disclosed in the Financial Statements.

(b) This is not automatically material as there is no requirement on the company to disclose this item simply due to its nature. The auditor must look at the issue in the context of the accounts as a whole. Would failure to amend the accounts for this item mean that the financial statements were misleading to the reader?

In this case the profits would be reduced by 20% to £160,000 and receivables by about 6% to £610,000. Whilst the effect on the Statement of Financial Position may not be considered material the reduction in profit is large. The materiality here is clearly quantitative. The audit partner should therefore encourage the directors of Lemon Ltd to provide for this debt in the Financial Statements for the current year.

THE AUDITORS’ PERMANENT FILE

Before the auditors can decide on the nature and volume of audit work they have to carry out, they need to gain a clear understanding of the way in which the client operates. This will include an understanding of the client’s business, its management and its financial systems. Much of this information will remain unchanged from one year to the next, and once recorded by the auditor, will require only minimal updating each year.

Information that remains ‘permanent’ for the business is recorded in the Permanent Audit File.

the permanent file

As its name suggests, the permanent file is used to document those aspects of the client’s business which are expected to remain more or less unchanged from year to year.

The permanent file should contain sufficient information so that any member of the audit team who has no previous knowledge of the client can pick it up and gain a clear picture of the client company, its ownership, management, activities, and very importantly, its financial systems.

The information included in the permanent file will be obtained largely from the client’s management and staff. Before recording any information in the permanent file, the auditors must satisfy themselves that all information to be included is accurate. Consequently, at the planning stage of each annual audit visit, the permanent file must be reviewed to ensure that it continues to be relevant, up-to-date and accurate.
gathering information for the permanent file

Auditors can obtain information about their client by:

- touring the client’s premises and asking questions about what is going on
- talking to the employees
- interviewing directors, managers and other key personnel
- reviewing original documentation such as minutes of meetings, internal reports and management accounts
- approaching banks and other lenders for details of finance arrangements – always with permission from the client

It is important that, wherever possible, the auditors obtain information from as wide a range of sources as possible and obtain independent evidence to support the information included on the permanent file. Any copies of documents to be included in the file should be taken directly by the auditors from the original documents. These copies should then be initialled and dated to evidence that the original of the document has been inspected.

contents of the permanent file

The permanent file should include:

- a description of the client’s business activities
- details of ownership, including lists of shareholders, if relevant
- details of group structure, divisions or branches where appropriate
- management structure including relationships between the client’s owners/directors and other senior executives
- financial structure, including details of loan and overdraft arrangements
- significant stakeholders other than owners and lenders who might influence business activities, eg a major customer or supplier
- the auditors’ view of the business approach adopted, eg risk-taking and unplanned, or conservative and planned
- relationships with other auditors or specialists involved in the audit
- an overall risk assessment
- an assessment of the control environment
- the signed engagement letter
- detailed descriptions of the financial systems

A typical index to a permanent file is shown in the Appendix on page 272.

DOCUMENTING THE CLIENT’S FINANCIAL SYSTEMS

The final point on the list of items included in the permanent file is probably the most important. In order for the auditors to plan their audit work they
must have a thorough understanding of the client’s financial systems. To that end the auditors must prepare detailed descriptions of these systems.

The main client systems that need to be documented are:

- revenue
- purchases
- wages and salaries
- non-current assets
- inventory
- investments

Documentation of the systems should include as much information as possible relating to:

- all documents involved including where they are kept
- the way in which transactions are verified
- the personnel involved in the various systems and their roles
- levels of responsibility of staff
- reporting schedules
- the books of accounts maintained and where they are located

There are two main methods of documenting the client’s systems:

- narrative notes
- flowcharts

**narrative notes**

Compiling a series of narrative notes is the simplest way of recording the client’s systems. It is best to record the final version on computer file, as it makes them easier to update. A set of handwritten notes prepared on previous audit visits can be time-consuming to revise and is not recommended.

Auditors must ensure that the notes that they produce describing the client systems contain sufficient detail for the user to gain a good understanding of how the system operates.

**flowcharting**

The danger of using complex narrative notes to document a financial system is that they can become extremely detailed and ultimately may become confusing to the reader, who gets ‘lost in the detail’.

It is much easier for the reader to have a diagram showing how the financial system operates. With this in mind, auditors will often use flowcharts, together with brief narrative notes, where necessary, to describe and explain the system.
Flowcharts show the systems in picture form with common symbols used to represent particular documents, and their physical movement. Flowcharts can be used to show the flow of information as well as documents.

As with narrative notes, the auditors will review these charts each year and update for changes and developments in the systems.

The basic flowcharting symbols commonly used are shown below.

**Flowcharting Rules**

There are some key rules for flowcharting:

- use standard flowcharting symbols wherever possible
- keep the charts simple – unless the system is very simple do not try to get it all on one sheet; break the chart up into a series of sub-systems and link them together
- document flows should start at the top left of the sheet and finish at the bottom right
- chart all documents from ‘cradle to grave’ – ie from their origination to their final filing, and do not leave any loose ends
- connecting lines should not cross unless this is unavoidable

A simple flowchart of a goods received and invoice processing system is shown on the next page.
You should notice three things when you look at this flowchart:

- each operation within the flowchart is separately numbered with a brief narrative where required
- the chart is divided by functional departments, making it easier to see which department is responsible for which function, and where responsibility for checking transactions lies
- the chart does not attempt to describe the whole system at once, for example it does not deal with payments which would be included in a different chart; this simplifies reporting and makes identification of internal controls easier

---

### Flowchart for Receipt of Documentation from Supplier

<table>
<thead>
<tr>
<th>Narrative</th>
<th>No.</th>
<th>Goods Inward</th>
<th>Purchase Ledger</th>
</tr>
</thead>
<tbody>
<tr>
<td>Goods received note (GRN) raised by Goods Inwards Department</td>
<td>1</td>
<td><img src="image1" alt="Diagram Image" /></td>
<td></td>
</tr>
<tr>
<td>Copy filed in Goods Inwards Department</td>
<td>2</td>
<td><img src="image2" alt="Diagram Image" /></td>
<td></td>
</tr>
<tr>
<td>Supplier’s invoice given sequential number and checked for arithmetical accuracy.</td>
<td>3</td>
<td><img src="image3" alt="Diagram Image" /></td>
<td></td>
</tr>
<tr>
<td>Invoice matched and attached to GRN</td>
<td>4</td>
<td><img src="image4" alt="Diagram Image" /></td>
<td></td>
</tr>
<tr>
<td>If not all goods received, file in temporary file</td>
<td>5</td>
<td><img src="image5" alt="Diagram Image" /></td>
<td></td>
</tr>
<tr>
<td>Documents checked to see that all items have been checked and initialled.</td>
<td>6</td>
<td><img src="image6" alt="Diagram Image" /></td>
<td></td>
</tr>
<tr>
<td>Passed to purchasing manager for authorisation</td>
<td>7</td>
<td><img src="image7" alt="Diagram Image" /></td>
<td></td>
</tr>
</tbody>
</table>
advantages and disadvantages of flow charts

The advantages of flowcharts are:
- they can be prepared relatively quickly
- by linking flowcharts even quite complex systems can be described relatively clearly
- as standard symbols are used they can be easily followed by anyone familiar with flowcharting procedures
- flowcharts make any weaknesses or gaps in the system or sub-system being described relatively easy to spot
- there are a number of computerised flowcharting software packages available

The disadvantages of flowcharts are:
- they have to be redrawn if systems change, even to a limited extent
- they are fine for standard systems but for non-standard transactions they may become unwieldy and require too many narrative notes
- they are fine for describing accounting processes where documents are moving through the system, but once the documents stop moving they cannot describe controls – for example, flowcharts can describe procedures for controlling goods inward and goods outward but not the controls over inventory in the stores

walk through tests

When the flowcharts and accompanying narrative descriptions have been drafted, the auditors should test out the systems to ensure that they work as documented. These tests are known as walk through tests. To carry out a walk through test you should:
- choose a small sample of transactions, two or three, from the part of the system being verified
- follow them through the system, using the flowcharts as a guide
- ensure that the flowchart and any notes accurately record the system as it operates in practice

A walk through test should be performed each year before any audit testing begins to ensure that there have been no changes since the preceding audit.

Auditors must document their walk through tests, recording details of the transactions they have chosen to follow through the system, and keep the details on their permanent file.

As soon as the auditors consider that they have a sufficient understanding of the client’s systems they can create a programme of audit work to test the internal controls within the system.
The way in which the auditors produce the audit programme will be covered in detail in Chapter 4 but at this point we must ensure that you have clear understanding of what is meant by internal control.

**INTERNAL CONTROL**

ISA 315 – ‘Identifying and assessing the risks of material misstatement through understanding the entity and its environment’ separates internal control into five component parts. The ISA states:

‘The division of internal control into the following five components provides a useful framework for auditors to consider how different aspects of an entity’s internal control may affect the audit:

(a) the control environment

(b) the entity’s risk assessment process

(c) the information system, including the related business processes, relevant to financial reporting, and communication

(d) control activities; and

(e) monitoring of controls.’

As you will appreciate, at some time or another, everybody makes mistakes. A good financial system has within it a series of checks and procedures designed to prevent, detect and correct mistakes or errors that could occur during the processing of transactions. The prime aim of these checks is to ensure that as many errors as possible are picked up so that there are no material errors in the financial statements.

In all but the very smallest companies there will be a number of layers of management, each with their own role in supervising and directing areas of the business and its workforce. The managers will therefore be the key to the effective operation of these controls within the company’s systems. They will be the individuals responsible for the checks, authorisations and approvals that will make up the internal controls of the business.

It is important for you to understand that internal controls are not there primarily to detect fraud.

The purpose of internal control is to provide assurance to managers that:

- the risk of serious error or misstatement in the financial records is minimised
- the assets of the business are safeguarded
all liabilities are identified and properly recorded
financial records are kept up-to-date and as accurately as possible

Internal control is made up of two elements:
- the control environment
- control activities and procedures

---

**INTERNAL CONTROL**

- control environment
- control activities/procedures

---

**the control environment**

ISA 315 – ‘Identifying and assessing the risks of material misstatement through understanding the entity and its environment’ states:

*The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity’s internal control and its importance in the entity. The control environment sets the tone of an organisation, influencing the control consciousness of its people.*

The **control environment** is, fundamentally, the philosophy and operating style of the organisation as set by its directors and senior management, ie the managerial attitude to, and awareness of, internal controls.

In order to assess the internal controls, auditors must to able to understand the culture of an organisation and the way it is reflected in:
- the attitude of its management and staff, and
- the effect this attitude has on the organisation’s procedures

What makes a good internal control environment?

It should have the following characteristics:
- clear communication to staff of the ethical values of the organisation reinforcing a commitment to integrity in business dealings. This commitment is seen as an essential element in influencing the effectiveness of the design, administration and monitoring of controls
- competent, reliable staff who demonstrate a high level of integrity and commitment in their attitude to work
a clear, well-understood management structure with defined authority limits
involvement by the management in the day-to-day activities of the business
operating procedures which are understood and accepted by the employees who have to implement them

It is important that you understand key aspects of evaluating a control environment.
The following Case Study will illustrate these main points.

COUNTIT & CO: THE CONTROL ENVIRONMENT

situation
You are an audit manager for Countit & Co, a firm that has recently gained two new audit clients of a similar size.

Your audit staff have completed their preliminary investigations of the two clients. You are reviewing their notes which can be summarised as follows:

Client 1 - Floggers Ltd
Floggers Ltd is an old-fashioned family company which has been in business for over a hundred years and trades as wholesalers of fruit and vegetables.

Its management structure is divided into five layers ranging from supervisor, deputy manager, manager, senior manager and director. The senior managers and directors have been with the company for many years.

Each level of management has clear authority limits set down in the company manual, which also sets out detailed written procedures for every job.

Management at all levels generally has an unforgiving attitude to errors and inefficiencies.

Most of the systems are paper-based, although the accounting ledgers are maintained on a computer and there are rigid systems of authorisation before transactions can be processed.

Staff turnover in clerical posts and at supervisor and deputy manager level is high.

Client 2 - Creatit Ltd
Creatit Ltd is a new company set up six months ago. It trades as a website design business and as an advertising agency.

Creatit Ltd is run by two brothers who manage the business jointly.
Creatit Ltd mostly employs creative people but it does have a small clerical staff to deal with billing and time recording.

The approach to work is casual, spontaneous and rather uncontrolled.

Error detection is not seen as a priority. The management’s view is that they will deal with errors and problems when they arise.

Staff are happy and so staff turnover is low.

**required**

In your review of the control environment for each of these clients, what conclusions would you draw about the risk of error arising in the accounts?

**solution**

**Floggers Ltd**

The key points are as follows:

- Floggers has very rigid systems with a high level of internal control where error detection is seen as a priority and mistakes are not tolerated
- the senior management of Floggers is separated from the day-to-day activities of the business by several layers of administrative hierarchy
- Floggers has a high level of staff turnover which may indicate that staff have a low level of commitment to the company
- following on from the point above – there is a higher risk that frequent mistakes could be made by new, untrained staff
- there may be a temptation for staff to hide mistakes because of the attitude of the management
- Floggers management may take a negative approach to the audit and see it as an intrusion into their business

**Creatit Ltd**

The key points are as follows:

- Creatit has a much more ‘hands on’ approach to management and a more forgiving attitude to errors; their priority is the product rather than the accounts
- Creatit’s financial systems will contain little in the way of formal internal control checks, but managers are much more aware of what is happening on a day-to-day basis as they are actively involved in the company
- the low level of staff turnover indicates that the employees are loyal to the business and have a strong commitment to the company
Your conclusions from an audit point of view are:

1. Providing the systems at Floggers are working correctly there would be very little likelihood of mistakes being made when recording transactions in the financial systems. The risk is more likely to be transactions which are not being recorded at all. Consequently the audit approach would focus on omissions rather than errors.

2. The business that Floggers operates involves processing large numbers of transactions of easily identifiable goods. Their systems have been in existence for years which means that the risk of posting errors can be assessed as low.

3. As far as Creatit is concerned, the financial statements may well contain errors or omissions and the lack of formal procedures might give cause for concern. However, the close involvement of the management and the commitment of the staff to the organisation would indicate that they will take a positive approach to the audit rather than see it as an intrusion.

4. The trade of Creatit is project work which carries a higher level of audit risk.

Your estimate is that the control environment in both companies is generally good, although the focus of your audit work in each business will differ.

CONTROL ACTIVITIES AND PROCEDURES

ISA 315 ‘Identifying and assessing the risks of material misstatement through understanding the entity and its environment’ states:

‘Control activities are the policies and procedures that help to ensure management directives are carried out … Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels’.

These are the detailed policies and procedures which are designed to:

- minimise the possibility of mistakes or fraud
- detect errors within the accounting system

When documenting the systems of internal control, the auditors will need to highlight these control activities as they become apparent. It is important to remember that, in order for these control activities to operate effectively, there must also be a good internal control environment.

In practice, if the management and staff of the client company do not have a positive attitude towards the control environment, they will not be carrying out the relevant internal checks effectively, even if good control procedures are in place. This will lead to an increased risk of error or fraud.
**forms of internal control**

The internal controls that are present in the client’s systems will take a number of different forms.

Examples are shown in the table below.

<table>
<thead>
<tr>
<th>FORMS OF INTERNAL CONTROL</th>
<th>what they involve</th>
</tr>
</thead>
<tbody>
<tr>
<td>Organisational controls</td>
<td>Defined management structure</td>
</tr>
<tr>
<td></td>
<td>Clear responsibilities for supervision</td>
</tr>
<tr>
<td></td>
<td>Authority limits for expenditure</td>
</tr>
<tr>
<td></td>
<td>Written procedures</td>
</tr>
<tr>
<td>Segregation of duties</td>
<td>The involvement of a number of different people or departments in recording a</td>
</tr>
<tr>
<td></td>
<td>transaction to minimise the risk of error or fraud</td>
</tr>
<tr>
<td>Physical controls</td>
<td>Restricting access to information or assets</td>
</tr>
<tr>
<td>Authorisation and approval of documents</td>
<td>Fixed levels of authority to authorise specific transactions or sign cheques to</td>
</tr>
<tr>
<td></td>
<td>specified levels</td>
</tr>
<tr>
<td></td>
<td>Documented procedures</td>
</tr>
<tr>
<td></td>
<td>Evidence of authorisation</td>
</tr>
<tr>
<td>Competency and reliability of staff</td>
<td>Staff training based on identified training need</td>
</tr>
<tr>
<td></td>
<td>Clear Human Resources policies about recruitment and retention of staff</td>
</tr>
<tr>
<td>Arithmetical and accounting checks</td>
<td>Month-end routines to balance and reconcile accounts</td>
</tr>
<tr>
<td></td>
<td>Checks of calculations on documents generated and received</td>
</tr>
</tbody>
</table>

Internal controls can be described as being:

1. **Preventative**: most internal controls are preventative (ie they are designed to prevent an error from occurring or fraud taking place). Thus all the controls in the table shown above are preventative **except** the arithmetical and accounting checks which are

2. **Detective**: detective control activities identify unusual occurrences or events after they have taken place, ie they are designed to detect errors. The most obvious detective control activities are reconciliations, balancing of accounts and ratio analysis.

**Examples of control activities and procedures**

Examples of specific control activities and procedures that relate to the forms of internal control listed above are set out in the table opposite.
<table>
<thead>
<tr>
<th>INTERNAL CONTROL</th>
<th>CONTROL ACTIVITIES AND PROCEDURES</th>
</tr>
</thead>
<tbody>
<tr>
<td>Organisational controls</td>
<td>Company Procedures Manual</td>
</tr>
<tr>
<td></td>
<td>Company registered under a quality standard eg ISO 9001 with documented procedures</td>
</tr>
<tr>
<td></td>
<td>Internal auditors operating as part of the internal control environment</td>
</tr>
<tr>
<td>Segregation of duties</td>
<td>Staff responsible for sales invoices are not responsible for recording cash received</td>
</tr>
<tr>
<td></td>
<td>Staff responsible for purchase ordering are not responsible for checking delivery notes or purchase invoice processing</td>
</tr>
<tr>
<td>Physical controls</td>
<td>Limiting access to computer applications and processes</td>
</tr>
<tr>
<td></td>
<td>Menus on computers limiting areas to which operators have access</td>
</tr>
<tr>
<td></td>
<td>Password controls</td>
</tr>
<tr>
<td></td>
<td>Regular physical verification of non-current assets by managers</td>
</tr>
<tr>
<td></td>
<td>Restricted access to ownership documents eg title deeds, vehicle log books</td>
</tr>
<tr>
<td>Authorisation &amp; approval of documents</td>
<td>Authorisation of orders</td>
</tr>
<tr>
<td></td>
<td>Approval of invoices for payment</td>
</tr>
<tr>
<td></td>
<td>Matching invoices to delivery notes and original orders</td>
</tr>
<tr>
<td></td>
<td>Two signatures on cheques</td>
</tr>
<tr>
<td>Competency and reliability of staff</td>
<td>Regular staff training</td>
</tr>
<tr>
<td></td>
<td>Encouraging staff to achieve professional qualifications</td>
</tr>
<tr>
<td></td>
<td>Clear guidelines for recruitment of staff</td>
</tr>
<tr>
<td></td>
<td>Staff appraisal and review systems</td>
</tr>
<tr>
<td>Arithmetical and accounting checks</td>
<td>Checking calculations on invoices</td>
</tr>
<tr>
<td></td>
<td>Bank reconciliations</td>
</tr>
<tr>
<td></td>
<td>Reconciliation of suppliers’ statements with purchase ledger</td>
</tr>
<tr>
<td></td>
<td>Maintaining control accounts</td>
</tr>
<tr>
<td></td>
<td>Monthly trial balance</td>
</tr>
<tr>
<td></td>
<td>Comparison of financial records with actual counts of inventory and cash</td>
</tr>
</tbody>
</table>
monitoring of controls

ISA 315 ‘Identifying and assessing the risks of material misstatement through understanding the entity and its environment’ states:

‘The auditor shall obtain an understanding of the major activities that the entity uses to monitor internal control over financial reporting, including those related to those control activities relevant to the audit, and how the entity initiates remedial actions to deficiencies in its controls.’

Organisations are required, as part of good internal control systems, to monitor the effectiveness of their systems on an ongoing basis. Auditors are required to review the effectiveness of these monitoring procedures. Examples of monitoring procedures which organisations can use are:

- Internal audit procedures – testing of the systems by auditors employed by the organisation
- Computer programs built into IT systems that continuously monitor the systems – we look at these further in Chapter 5
- Period end reconciliations and supervision of control activities
- Analytical procedures to identify areas of unusual activity or inconsistencies – see Chapter 4
- Self-assessment by management of the effectiveness of the organisation’s oversight and of the control environment

INTERNAL CONTROL QUESTIONNAIRES

As we have seen, auditors have to identify the internal checks operating within the financial system and test them to ensure that they are operating effectively. One technique is to use an Internal Control Questionnaire (ICQ). This consists of a series of questions drawn up by the auditors and designed to identify all internal checks present in each department’s systems. The example below assesses the purchasing system of a client company.
INTERNAL CONTROL QUESTIONNAIRE

Client name: Bobupandown Ltd
Prepared by: JT
Date: 28/09/0X

Period to: 31 March 200X
Reviewed by: DB
Date: 12/10/0X

Purchases System: Purchase Ordering

<table>
<thead>
<tr>
<th>Process</th>
<th>Yes</th>
<th>No</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Are all purchases made as a result of written orders?</td>
<td>✔</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2 Are all orders sequentially numbered?</td>
<td>✔</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3 Are all numbers accounted for?</td>
<td>✔</td>
<td>✔</td>
<td>Spoiled orders destroyed</td>
</tr>
<tr>
<td>4 Do all orders have to be authorised by a senior manager?</td>
<td>✔</td>
<td>✔</td>
<td>MD, Purchasing Manager</td>
</tr>
<tr>
<td>5 Are orders only sent to approved suppliers?</td>
<td>✔</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6 If there is no approved supplier, is the procedure for approving a new supplier carried out before the order is placed?</td>
<td>✔</td>
<td></td>
<td>Only recognised suppliers used</td>
</tr>
<tr>
<td>7 Do all purchase orders show:</td>
<td>✔</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- quantities</td>
<td>✔</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- prices</td>
<td>✔</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- terms</td>
<td>✔</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- initials of authoriser</td>
<td>✔</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- date</td>
<td>✔</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8 Is there a limit to individual order values?</td>
<td>✔</td>
<td></td>
<td>MD- no limit, Purchasing Manager £50,000</td>
</tr>
<tr>
<td>9 Are copies of the purchase order sent to Purchase ledger Stores</td>
<td>✔</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10 Are purchase orders matched to invoices?</td>
<td>✔</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11 Are all orders retained in the Purchasing Department?</td>
<td>✔</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

standardised questionnaires and checklists

As we have seen, the use of Internal Control Questionnaires can assist the auditor to document the client’s system and help produce the program of audit work to test identified controls.

Most audit firms have developed their own standardised ICQ. Additionally, audit firms will have other standard checklists which auditors will use to:

- document their audit work
- ensure all audit tests are documented and reviewed
- carry out final checks to ensure they comply with the necessary disclosures

The use of standardised questionnaires and checklists has advantages and disadvantages as shown by the table below:

<table>
<thead>
<tr>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Well designed checklists can ensure all relevant points are considered by the audit team.</td>
<td>There is no 'one size fits all' so checklists may have to be amended to suit different audit clients. If this is not done properly key points can be missed.</td>
</tr>
<tr>
<td>Checklists can document the work carried out and be used as an aid to the audit supervision.</td>
<td>Checklists inhibit creative thinking by staff on an audit. This can lead to a ‘tick the box’ mentality where it becomes important to tick off the checklist rather than follow up any unusual answers that are given.</td>
</tr>
<tr>
<td>Checklists help improve the quality of audit work by eliminating doubt about whether audit work has been completed.</td>
<td>Checklists must be part of good quality control procedures. On their own they simply record audit work done but do not guarantee the quality of that audit work.</td>
</tr>
<tr>
<td>Checklists save time and money by eliminating unnecessary work.</td>
<td></td>
</tr>
</tbody>
</table>

Most audit firms use checklists to document some of their audit work. Checklists are a useful and worthwhile part of an audit firm’s quality control process and do provide valuable evidence that audit work has been carried out. However, the auditors must not rely too heavily on these checklists so that they miss odd or unusual transactions which might indicate a material error or misstatement.

- Auditors must obtain sufficient knowledge of the client to be able to understand the nature of the business and its transactions and should make themselves aware of the general environment in which the client operates.
- The auditors are required to assess and document significant areas of audit risk, both at the level of the financial statements and also at the individual item disclosure level.
Auditors have to evaluate the risks involved in undertaking the audit. These consist of the risk of a material misstatement which is divided into:

- inherent risk, which is based on the client’s activities, operations, and management
- control risk, based on the ability of the internal controls of the financial system to detect and correct errors or misstatements, and
- the detection risk, which is the risk that an error or misstatement will not be detected by the audit procedures carried out.

Audit risk is the risk of a material misstatement x detection risk. Detection risk is the risk that the auditors’ own procedures will not detect a material error or misstatement.

The overall audit risk is the probability of auditors giving an incorrect opinion; if the level of audit risk is high, the amount of detailed testing the auditors will carry out will be greater than it would be if the risk were low.

Auditors set a level of materiality at the start of the audit. Something is considered material if its misstatement or omission from the financial statements would give the users a misleading view of the company’s financial position.

The auditors document the client’s system using a combination of methods including narrative notes, flowcharts and internal control questionnaires. Auditors can confirm their system documentation using walk through tests.

The auditors must decide on the level of materiality or significance for the financial statements as a whole and at the transaction level. They will then set a level of performance materiality lower than this to take account of both detected and undetected errors.

General client documentation will be retained on the permanent file and reviewed annually.

Auditors must evaluate their clients’ internal control by examining the control environment and control procedures including the client’s procedures for monitoring their effectiveness.

The control environment is the overall attitude of the organisation towards control procedures and activities including the audit.

Control procedures are designed to minimise the possibility of errors or misstatements and to safeguard the assets of the business.

Control procedures and activities should include the segregation of duties, limiting access to information, authorisation of transactions, checking and reconciliations.
<table>
<thead>
<tr>
<th><strong>Key Terms</strong></th>
<th><strong>Definition</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>permanent file</strong></td>
<td>ongoing information about the client which will be used for successive audits; it includes a copy of the engagement letter and provides a clear picture of the client company, its ownership, management, activities, and its financial systems</td>
</tr>
<tr>
<td><strong>audit risk</strong></td>
<td>the risk that an auditor might give an inappropriate opinion on the financial statements – the higher the risk the greater the investigative work that will have to be carried out</td>
</tr>
<tr>
<td><strong>materiality</strong></td>
<td>the level of significance or importance of a matter detected by the auditors in relation to the accounts as a whole</td>
</tr>
<tr>
<td><strong>performance materiality</strong></td>
<td>a lower level of materiality set by the auditors for the duration of their audit work which will include errors which have been detected and an allowance for possible undetected errors</td>
</tr>
<tr>
<td><strong>risk assessment</strong></td>
<td>a documented process by which auditors assess the likelihood of a material misstatement in the accounts going undetected</td>
</tr>
<tr>
<td><strong>inherent risk</strong></td>
<td>the risk that the accounts will contain a material error or misstatement because of the nature of the client’s business, activities, operations and management</td>
</tr>
<tr>
<td><strong>control risk</strong></td>
<td>the risk that the client’s internal controls will fail to detect errors or misstatements</td>
</tr>
<tr>
<td><strong>detection risk</strong></td>
<td>the risk that audit procedures will fail to detect errors or misstatements</td>
</tr>
<tr>
<td><strong>flowcharts</strong></td>
<td>a system of documenting financial procedures using standardised symbols to create a diagram of the system</td>
</tr>
<tr>
<td><strong>walk through test</strong></td>
<td>a test involving a small number of transactions which an auditor follows through the system to confirm that the systems notes and flowcharts are a true representation of what actually happens</td>
</tr>
</tbody>
</table>
3.1 A trainee auditor has been asked to prepare a briefing for clients as to how an audit assignment is planned. Among other things the briefing contained the following statements:

(a) Performance materiality is set for the actual audit work and is lower than the overall materiality level.

(b) Materiality is measured by size. If errors are not very large the financial statements do not need to be adjusted.

(c) Control procedures are what the auditor relies on. If these exist the auditor can sign the report without worrying about the financial statements being wrong.

(d) Walk through tests are there to support flowcharts. If these tests are satisfactory, the auditor can feel confident that the control procedures are working satisfactorily.

(e) Audit risk is the risk of being sued.

(f) Auditors need to find out all about their clients so they can make a decision about the level of inherent risk.

(g) Segregation of duties is an important part of the control environment.

Which of these statements are incorrect, and why?
3.2 When planning their audit the auditors must consider audit risk and the probability of a material error or misstatement not being detected by the company’s procedures.

Select whether the following factors are likely to increase/reduce or have no effect on audit risk.

<table>
<thead>
<tr>
<th>Factor</th>
<th>Increase</th>
<th>Reduce</th>
<th>No effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) A new computer system was installed during the accounting period</td>
<td>✔</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(b) The company has been closing its shops and concentrating on Internet trading</td>
<td></td>
<td>✔</td>
<td></td>
</tr>
<tr>
<td>(c) A new qualified financial director has been appointed to replace the previously unqualified one</td>
<td>✔</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(d) The company has yet to respond to the points contained in the letter of weakness (management letter) from the previous year’s audit</td>
<td>✔</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(e) The company has appointed two non-executive directors</td>
<td></td>
<td></td>
<td>✔</td>
</tr>
</tbody>
</table>

3.3 External auditors use a variety of methods for documenting systems of control, including flowcharts and internal control questionnaires (ICQs).

For each of the following situations decide whether it would be best to use a flowchart or an Internal Control Questionnaire.

<table>
<thead>
<tr>
<th>Situation</th>
<th>Flowchart</th>
<th>Internal Control Questionnaire</th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Recording a client’s system for the permanent audit file</td>
<td>✔</td>
<td></td>
</tr>
<tr>
<td>(b) Discovering the controls within the purchases system</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(c) Designing audit procedures to test internal controls</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
3.4 The management is responsible for maintaining the internal control environment in order to minimise the probability of a material error or misstatement going undetected.

In each of the following circumstances state whether the external auditor is likely to place reliance or no reliance on the internal controls:

<table>
<thead>
<tr>
<th></th>
<th>Reliance</th>
<th>No reliance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>(a)</strong> The organisation is a small company with a domineering owner who is also the managing director.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>(b)</strong> The company trades through a network of branches all of which have separate autonomous management. There is no centralised accounting system and accounting is based on returns from branches.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>(c)</strong> The company has recently dismissed its financial director following an alleged fraud. An internal review decided that she alone was to blame so promoted the company accountant to finance director and the assistant accountant was also promoted upwards. A new unqualified accounts assistant has been appointed.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

3.5 Accounting systems have both control objectives and control procedures. Procedures are designed to reduce the risk that control objectives are not met.

For each of the items below select whether they are a control objective, a risk or a control procedure.

<table>
<thead>
<tr>
<th></th>
<th>Control objective</th>
<th>Risk</th>
<th>Control procedure</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>(a)</strong> Employees are paid for work not done</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>(b)</strong> All purchase orders in excess of £1000 have to be authorised</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>(c)</strong> Bank reconciliations are prepared monthly</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>(d)</strong> Purchase ledger balances are reconciled to supplier statements</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>(e)</strong> Only goods and services that have been ordered are accepted</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>