Introduction

The purpose of this Manual is to establish a framework for policies and procedures for audit firms to ensure quality control of audit work, as required by International Standard on Auditing (ISA) 220. According to ISA 220, quality control policies and procedures should be implemented at both the level of the audit firm and on individual audits.

Implementation of this Manual requires each audit firm to identify individuals responsible for the various functions contained herein. Audit firms with branch offices may designate responsible individuals in more than one location, but the policies and procedures should be consistently followed in all offices of the firm.

Implementation also requires each audit firm to modify and/or complete the framework provided in this document. Modification should be limited to the procedures only; the stated policies should not be modified. The written policies and procedures should also be updated periodically upon turnover of key personnel, opening or closing of branch offices, modification of professional requirements, or other changes in circumstances.
# Table of Contents

## Volume I

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>Introduction</td>
</tr>
<tr>
<td>II</td>
<td>The Purpose and Objective of an Audit</td>
</tr>
<tr>
<td>III</td>
<td>Pre-engagement activities</td>
</tr>
<tr>
<td>IV</td>
<td>Audit Planning Activities</td>
</tr>
<tr>
<td>V</td>
<td>Design of Auditing Tests</td>
</tr>
<tr>
<td>VI</td>
<td>Executing the Audit Plan</td>
</tr>
<tr>
<td>VII</td>
<td>Evaluating the Findings</td>
</tr>
<tr>
<td>VIII</td>
<td>Completing the Audit</td>
</tr>
<tr>
<td>IX</td>
<td>Preparing and Issuing the Audit Reports</td>
</tr>
<tr>
<td>Appendix 1</td>
<td>Glossary of Terms</td>
</tr>
<tr>
<td>Appendix 2</td>
<td>Illustrative Workpaper Documentation</td>
</tr>
<tr>
<td>Appendix 3</td>
<td>Test of Controls</td>
</tr>
<tr>
<td>Appendix 4</td>
<td>Example Non-Statistical Sampling Application</td>
</tr>
</tbody>
</table>

## Volume II

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>Introduction</td>
</tr>
<tr>
<td>II</td>
<td>Summary of the Audit Process (includes cross-reference between Volume I and Volume II)</td>
</tr>
<tr>
<td>III</td>
<td>Audit Work Programs, Forms and Checklists</td>
</tr>
<tr>
<td>AP 1</td>
<td>Audit Engagement Acceptance Form (for new clients)</td>
</tr>
<tr>
<td>AP 2</td>
<td>Audit Engagement Continuation Form (for recurring audits)</td>
</tr>
<tr>
<td>AP 3a</td>
<td>Audit Planning Questionnaire I (Knowledge of the Client’s Business)</td>
</tr>
<tr>
<td>AP 3b</td>
<td>Audit Planning Questionnaire II (Knowledge of the Client’s Internal Control Systems)</td>
</tr>
<tr>
<td>AP 3c</td>
<td>Audit Planning Questionnaire III (Knowledge of the Client’s Accounting and Financial Reporting Systems)</td>
</tr>
<tr>
<td>AP 3d</td>
<td>Walk-Through Check List</td>
</tr>
<tr>
<td>AP 3e</td>
<td>Financial Reporting Documentation Form</td>
</tr>
<tr>
<td>AP 3f</td>
<td>Materiality Worksheet for Audit Planning Purposes</td>
</tr>
<tr>
<td>AP 3g</td>
<td>Planning Worksheet to Determine Extent of Substantive Tests</td>
</tr>
<tr>
<td>AP 3h</td>
<td>Questionnaire for Risk of Fraud</td>
</tr>
<tr>
<td>AP 3i</td>
<td>Personnel Assignment and Time Budget for the Audit</td>
</tr>
<tr>
<td>AP 3j</td>
<td>Inherent and Combined Risk Assessment Form</td>
</tr>
<tr>
<td>AP 4a</td>
<td>Summary of Audit Differences</td>
</tr>
<tr>
<td>AP 4b</td>
<td>Evaluation of Audit Differences</td>
</tr>
<tr>
<td>AP 10</td>
<td>Audit Program for Cash</td>
</tr>
<tr>
<td>AP 15</td>
<td>Audit Program for Accounts Receivable and Sales</td>
</tr>
<tr>
<td>AP 20</td>
<td>Audit Program for Prepaid Expenses and Other Assets</td>
</tr>
<tr>
<td>AP 25</td>
<td>Audit Program for Investments</td>
</tr>
<tr>
<td>AP 30</td>
<td>Audit Program for Inventories</td>
</tr>
<tr>
<td>AP 32</td>
<td>Audit Program for Observation of Physical Inventory Counts</td>
</tr>
<tr>
<td>AP 35</td>
<td>Audit Program for Fixed Assets</td>
</tr>
<tr>
<td>--------</td>
<td>-----------------------------------------------</td>
</tr>
<tr>
<td>AP 50</td>
<td>Audit Program for Accounts Payable and Purchases</td>
</tr>
<tr>
<td>AP 55</td>
<td>Audit Program for Accrued Liabilities</td>
</tr>
<tr>
<td>AP 60</td>
<td>Audit Program for Debt</td>
</tr>
<tr>
<td>AP 70</td>
<td>Audit Program for Revenues and Expenses</td>
</tr>
<tr>
<td>AP 80</td>
<td>Audit Program for Equity</td>
</tr>
<tr>
<td>AP 100</td>
<td>Audit Program for Subsequent Events</td>
</tr>
<tr>
<td>AP 105</td>
<td>Audit Program for Contingencies and Litigation</td>
</tr>
<tr>
<td>AP 110</td>
<td>Audit Review and Approval Form</td>
</tr>
<tr>
<td>AP 115</td>
<td>Audit Completion Questionnaire</td>
</tr>
<tr>
<td>AP 120</td>
<td>Going Concern Questionnaire</td>
</tr>
<tr>
<td>AP 125</td>
<td>Audit Report Checklist</td>
</tr>
</tbody>
</table>

**Sample Correspondence**

- Letter 1: Audit Engagement Letter
- Letter 2: Management Representation Letter
- Letter 3: Legal Representation Letter

**Sample Requests for Confirmation**

- C-1: Bank Confirmation
- C-2: Accounts Receivable Confirmation – Positive
- C-3: Accounts Receivable Confirmation – Negative
- C-4: Accounts Payable Confirmation

**Example Audit Reports**

- Report 1: Unqualified Opinion, single year financial statements
- Report 2: Unqualified Opinion, comparative (2-year) statements
- Report 3: Qualified Opinion – departure from IAS
- Report 4: Qualified Opinion – inadequate disclosures
- Report 5: Unqualified Opinion – with emphasis paragraph
- Report 6: Qualified Opinion – scope limitation
- Report 7: Disclaimer of Opinion – scope limitation
- Report 8: Qualified Opinion – departure from IAS
- Report 9: Unqualified Opinion – balance sheet only is presented
- Report 10: Adverse Opinion – pervasive and material departure from IAS
- Report 11: Disclaimer of Opinion – combination of scope limitation and significant uncertainty regarding going concern

**Example Other Reports**

- Report 12: Report on components of financial statements
I. Introduction

1.1 Purpose and Organization of the Manual

The government of Mongolia requires audit firms licensed to perform audits in Mongolia to perform their audit work in conformity with International Standards on Auditing (ISA). The purpose of this manual is to provide auditors with guidelines for conducting financial statement audits in compliance with ISA. While there are many different types of audits which an auditor may be engaged to perform, the direction in this manual is limited to the performance of an audit of financial statements.

This Auditing Manual is comprised of two volumes. Volume I provides users with an introduction to the process of performing an audit of financial statements in accordance with ISA, together with practical information and guidelines to assist in the conduct of an audit. This volume is organized to take the user through the steps of an audit, from the initial acceptance of the client to the issuance of an opinion on the financial statements.

Volume II of this manual provides auditors with practical tools for conducting audits of financial statements. Such tools include examples of audit work programs, checklists, correspondence, audit confirmations, etc. These tools should be used in conjunction with the guidelines and explanations provided in Volume I.

Section II of Volume II of this manual includes a cross-reference between the audit programs, correspondence, etc and the corresponding guidance in Volume I.

Use of this manual does not guarantee that an audit will be performed in accordance with ISA. It should be understood that without the education, training, experience and supervision by an experienced auditor, using the guidelines outlined in this manual may result in an audit that does not comply with ISA.

1.2 Items NOT Included in this Manual

Audits of companies in specialized industries require extensive knowledge of the business environment, regulations and operations unique to such industries. This Manual does not address these specialized areas. The primary focus of the guidelines in this manual is the audit of small and medium-sized
business entities in Mongolia. Because International Accounting Standards are relatively new in Mongolia, no reliance on controls (to reduce substantive testing required by the auditor) has been assumed in the suggested audit procedures described in this manual.

This Auditing Manual is not intended to be all-inclusive of the tools, laws and references that are required by the auditor. In addition to all applicable laws, examples of two documents to which the auditor should refer are:

- The audit firm’s own internal policies and procedures
- The Mongolian Code of Professional Ethics

Each of these concepts are discussed briefly below.

1.3 Quality Control Policies in Audits

The ISA “Quality Control for Audit Work” outlines the objectives of general quality control policies and procedures to be followed by auditors. In order to have reliance on the work of auditors, it is necessary to ensure that certain quality control practices are in place. This standard requires that firms adopt quality control policies and procedures at both the level of the audit firm and on individual audits. The audit firm should implement quality control policies and procedures designed to ensure that all audits are conducted in accordance with ISAs or relevant national standards or practices. Some of the quality control objectives for policies and procedures follow.

(a) Personnel in the firm are to adhere to the principles of independence, integrity, objectivity, confidentiality and professional behavior.

Auditors should be straightforward, honest and sincere in their approach to his professional work. They must be fair and must not allow prejudice or bias to override their objectivity. They should maintain an impartial attitude and be free (in both fact and in appearance) of any interest which might be regarded as being incompatible with integrity and objectivity.

(b) The firm is to be staffed by personnel who have attained and maintain the technical standards and professional competence required to enable them to fulfill their responsibilities with due care.

The knowledge and skill level required is quite extensive, including the following areas:

- International Standards on Auditing
- International Accounting Standards
- Financial statement analysis
- Cost and management accounting
- Internal control systems
- Business and economics
- Information Technology and systems
• Applicable laws (insolvency, taxes, employment, etc.)
• Mathematics and statistics
• Professional Code of Ethics

(c) Audit work is to be assigned to personnel who have the degree of technical training and proficiency required in the circumstances.

(d) There is to be sufficient direction, supervision and review of work at all levels to provide reasonable assurance that the work performed meets appropriate standards of quality.

(e) An evaluation of prospective clients and a review, on an ongoing basis of existing clients is to be conducted. In making a decision to accept or retain a client, the firm’s independence and ability to serve the client properly and the integrity of the client’s management are to be considered.

(f) The continued adequacy and operational effectiveness of quality control policies and procedures is to be monitored.

1.4 Code of Professional Ethics

Auditors must comply the Mongolian Code of Professional Ethics, which is based on the ethic requirements suggested by the IFAC. As the Code of Ethics undergoes amendments from time to time, auditors should ensure that they maintain the current requirements and make this information available to all audit staff in their firms.

II. The Purpose and Objectives of a Financial Statement Audit

2.1 What is an Audit?

The publication of the American Accounting Association on Basic Auditing Concepts defines auditing as:

“...a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users.”

Pursuant to the definition above, virtually any information that is quantifiable and verifiable can be audited, as long as the auditor and the auditee (the entity being audited) agree on the criteria to be used as the basis for determining the degree of correspondence with the criteria.

However, as stated in the Introduction, this manual pertains only to the audit of financial statements. In a financial statement audit, the auditor seeks evidence about assertions related mainly to financial information, which is prepared in accordance with International Accounting Standards.
2.2 Objectives of an Audit

According to IFAC, “the objective of an audit of financial statements is to enable the auditor to express an opinion as to whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework.” In Mongolia, the identified financial reporting framework is International Accounting Standards (IAS).

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

2.3 Users of Audited Financial Statements

The third parties interested in the results of an audit can be varied. In most cases, the primary users of the audit report are the owners (or shareholders) of the company. The shareholders are interested in the operating results and financial position of the company in which they have invested. They also want to have an independent assessment of the financial results to determine if the assessment confirms the representations of management who are entrusted with the stewardship of the assets on behalf of the owners.

Other third parties who may be interested in the results of an audit include prospective investors, bankers (for performance on existing loans, adherence to loan covenants, and granting of new loans), and regulatory agencies (such as the Securities Commission or Banking Regulators).

2.4 Scope of an Audit

The term “scope of an audit” refers to the audit procedures deemed necessary in the circumstances to achieve the objective of the audit and render an opinion. The procedures required to conduct an audit in accordance with ISA should be determined by the auditor as a matter of judgment. The auditor should consider the requirements of the ISAs, relevant professional bodies, legislation, regulations, and where appropriate, the terms of the audit engagement and reporting requirements.

2.5 Reasonable Assurance on Financial Statements

An audit in accordance with ISA is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement. Reasonable assurance is a concept relating to the accumulation of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the financial statements taken as a whole. Reasonable assurance relates to the entire audit process.
However, there are inherent limitations in an audit that affect the auditor’s ability to detect material misstatements. These limitations result from factors such as:

(a) The use of testing.
(b) The inherent limitations of any accounting and internal control system (for example, the possibility of collusion).
(c) The fact that most audit evidence is persuasive rather than conclusive.

The work undertaken by the auditor to form an opinion on the financial statements is permeated by judgment, in particular regarding:

(a) The gathering of audit evidence, for example, in deciding the nature, timing and extent of audit procedures.
(b) The drawing of conclusions based on the audit evidence gathered, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

Other limitations may affect the persuasiveness of evidence available to draw conclusions on particular financial statement assertions (for example, transactions between related parties). In these cases certain ISAs identify specified procedures which will, because of the nature of the particular assertions, provide sufficient appropriate audit evidence in the absence of:

(a) Unusual circumstances which increase the risk of material misstatement beyond that which would ordinarily be expected; or
(b) Any indication that a material misstatement occurred.

2.6 Responsibility for Financial Statements

ISA “Objective and General Principles Governing an Audit of Financial Statements” states:

“While the auditor is responsible for forming and expressing an opinion on the financial statements, the responsibility for preparing and presenting the financial statements is that of the management of the entity. The audit of the financial statements does not relieve management of its responsibilities.”

Furthermore, the first paragraph of the standard auditor’s opinion states:

“These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these financial statements based on our audit.”

Often times, this division of responsibility is not clearly understood by all interested parties. Throughout the audit process (from pre-engagement
activities through issuance of the audit report), the auditor should continue to make client management aware that management is responsible for the financial statements. This is accomplished formally before the audit commences, in the Audit Engagement Letter. At the conclusion of audit field work, the Client Representation Letter also makes it clear that management is responsible for the financial statements.

At a more detailed level, the auditor should ensure that the client accepts responsibility for the financial statements by obtaining management’s agreement (preferably in writing) to any “audit adjustments” that are necessary in order for the financial statements to comply with International Accounting Standards. The client may or may not agree to actually record such audit adjustments in its general ledger. If the client agrees to the audit adjustments for purposes of preparing financial statements, this is sufficient for the auditor’s purposes. In fact, the auditor does not have authority to require that the client book the adjustments in its general ledger.

### III. Pre-Engagement Activities

#### 3.1 Acceptance or Retention of Client

The ISA “Quality Control for Audit Work” states:

“An evaluation of prospective clients and a review, on an ongoing basis, of existing clients is to be conducted. In making a decision to accept or retain a client, the firm’s independence and ability to serve the client properly and the integrity of the client’s management are to be considered.”

To comply with this Quality Control Standard, the Executive Director of the firm should make an investigation of prospective clients prior to accepting the first audit engagement. Likewise, the Executive Director should re-evaluate recurring clients on an annual basis. The objective of this investigation is to determine whether:

- The audit firm is independent and can ethically accept the engagement.
- The audit firm has the expertise and competence to perform the audit.
- Management of the company has integrity and is not involved in fraud or illegal acts.
- The company’s reporting system is adequate to provide an “audit trail” and preparation of financial statements.
- Acceptance or retention of the client makes economic sense for the audit firm, based on a cost/benefit analysis.
In order to facilitate the review of prospective and recurring clients, the following forms are available in Section III of Volume II of this Auditing Manual:

- AP 1 Audit Engagement Acceptance Form (for new clients)
- AP 2 Audit Engagement Continuation Form (for recurring clients)

3.2 Communication with Predecessor Auditors

While making the investigations required for determining whether to accept a new client or continue with an existing client, the auditor should consider several sources of information. These include discussions with management, review of interim financial statements, press notices, industry newsletters, etc.

Another very important source of information for investigation of new prospective clients is the predecessor auditor. The IFAC Professional Code of Ethics provides useful guidelines for communication with predecessor auditors. As the IFAC Code is more extensive than the Mongolian Code of Ethics, parts of it are reprinted below for reference purposes.

The following is an excerpt from the IFAC Professional Code of Ethics, paragraphs 13.21 – 13.23:

13.21 Before accepting an appointment involving recurring professional services hitherto carried out by another professional accountant in public practice, the proposed professional accountant in public practice should:

(a) Ascertain if the prospective client has advised the existing accountant of the proposed change and has given permission, preferably in writing, to discuss the client’s affairs fully and freely with the proposed professional accountant in public practice.

(b) When satisfied with the reply received from prospective client, request permission to communicate with the existing accountant. If such permission is refused or the permission referred to in a) above is not given, the proposed professional accountant in public practice should, in the absence of exceptional circumstances of which there is full knowledge, and unless there is satisfaction as to necessary facts by other means, decline the appointment.

(c) On receipt of permission, ask the existing accountant, preferably in writing:

(i) to provide information on any professional reasons which should be known before deciding whether or not to accept the appointment and, if there are such matters; and

(ii) to provide all the necessary details to be able to come to a decision.
13.22 The existing accountant, on receipt of the communication referred to in paragraph 13.21 (c) should forthwith:

(a) Reply, preferably in writing, advising whether there are any professional reasons why the proposed professional accountant in public practice should not accept the appointment.
(b) If there are any such reasons or other matters which should be disclosed, ensure that the client has given permission to give details of this information to the proposed professional accountant in public practice. If permission is not granted, the existing accountant should report that fact to the proposed professional accountant in public practice.
(c) On receipt of permission from the client, disclose all information needed by the proposed professional accountant in public practice to be able to decide whether or not to accept the appointment, and discuss freely with the proposed professional accountant in public practice all matters relevant to the appointment of which the latter should be aware.

13.23 If the proposed professional accountant in public practice does not receive, within a reasonable time, a reply from the existing accountant and there is no reason to believe that there are any exceptional circumstances surrounding the proposed change, the proposed professional accountant in public practice should endeavor to communicate with the existing accountant by some other means. If unable to obtain a satisfactory outcome in this way, the proposed professional accountant in public practice should send a further letter, stating that there is an assumption that there is no professional reason why the appointment should not be accepted and that there is no intention to do so.

3.3 Audit Engagement Letter

In order to meet client expectations and minimize the risk of disputes and possible litigation, it is important that both the auditor and the client have a clear understanding of the nature, scope, reports and other significant matters relating to the services. Accordingly, the auditor should ensure that the arrangements for the audit are agreed in writing by both the client and the auditor.

The written arrangements ordinarily should take the form of an engagement letter and/or contract submitted to the client, preferably prior to commencement of fieldwork.

An example of an Audit Engagement Letter is included in Section III of Volume II of this Auditing Manual:

- Letter 1 Sample Audit Engagement Letter

Delivering the Audit Engagement Letter (and/or contract) and obtaining the client’s signature is only part of the auditor’s task. The auditor should also
discuss the letter with the client to ensure that the understanding is mutual. Unfortunately, many clients do not fully understand the nature of a financial statement audit, the inherent limitations, and the fact that the financial statements themselves are the responsibility of management. Failure to discuss these matters prior to commencing the audit can result in more serious misunderstandings during the audit and possibly litigation.

IV. Audit Planning Activities

4.1 Overview

The ISA on “Planning” states that the auditor should plan the audit work so that the audit will be performed in an effective manner. This means developing a general strategy and a detailed approach for the expected nature, timing and extent of the audit work to be performed. The initial audit plan may change throughout the course of the audit as new information becomes available.

An integral part of the planning process is the assessment of the risk of material misstatements in the financial statements and assessing controls that mitigate this risk. An audit plan can then be developed to provide reasonable assurance that material misstatements are detected.

Audit planning activities generally include the following:

- Obtain an in-depth understanding of client’s business
- Obtain an understanding of the client’s internal control and financial reporting structure.
- Evaluate risks.
- Test controls (This procedure is normally performed if necessary to evaluate control risk at less than maximum. If the auditor does not rely on controls to reduce the amount of substantive audit procedures, testing the controls is not required.)
- Determine materiality limits.
- Determine the audit approach (nature, timing and extent of procedures).
- Design substantive tests.
- Determine staffing requirements and prepare a time budget for audit work.

4.2 Understanding the client’s business (form AP 3a)

No auditor can satisfactorily complete an audit without a comprehensive understanding of the client’s business activities and the industry within which the company operates. This understanding is required to:

- Effectively assess the inherent risk of potential financial statement misstatements. Evaluating financial performance in relation to industry, business and economic conditions may provide an indication of the level of this risk. For example, declining profitability may increase the potential for
error and create pressures on the company or management to commit fraudulent acts.

- Identify indicators of possible going concern problems. Business and economic conditions are generally the primary factors leading to going concern problems.

- Address client value and integrity considerations. Knowledge of the business will often give the audit team the opportunity to contribute information or suggestions which will be useful to the client in managing its business.

The following factors should be considered to the extent relevant in a particular client situation:

- The Client’s Business. The auditor should understand the structure and manner in which the client conducts its business in order to interpret its reported performance and assess possible effects on the success of the business and on accounting and reporting matters. The following may be considered:
  
  1. Structure of the company
  2. Key product lines
  3. Markets
  4. Key customers
  5. Sources and methods of financing

- The Industry. Industry conditions create the environment for success or failure of a business and have a particular bearing on judgmental areas such as valuation of assets. The audit team should understand the critical industry conditions affecting the client’s business. Such conditions may include the following matters:
  
  1. Business and economic trends
  2. Competitive environment
  3. Regulatory environment
  4. Technological change
  5. Key industry risk factors

- Financial Performance Indicators. The auditor should understand the key factors regarding the client’s financial condition and profitability. A financial performance review consists of analytical procedures applied during the audit planning and risk assessment phase of the audit. Analytical procedures can be instrumental in identifying risks indicated by unusual or unexpected relationships in the financial statements or in relationships between individual accounts. To the extent practicable, recorded balances may be compared to prior periods, to projected results and to competitors. Examples of balances and ratios that may be analyzed include:
  
  1. Profitability of operations
     - Gross margin percentage
     - Operating income percentage
     - Effective tax rates
- Net income percentage
- Earnings per share

(2) Financial leverage
- Debt to equity ratio
- Ratio of total assets to equity

(3) Asset turnover
- Ratio of revenue to total assets
- Receivables turnover ratio
- Inventory turnover ratio

(4) Liquidity
- Working capital trends
- Operating cash flow trends
- Current ratio
- Quick ratio
- Interest and dividend coverage

- Management and Related Matters. The auditor should understand the important characteristics of management (e.g., technical competence, aggressiveness in applying accounting principles, budgetary pressures, turnover) that could influence the auditor’s assessment of the effectiveness of the overall control environment or the risk of material financial statement misstatements.

- Reporting Environment. Knowledge of the client’s reporting environment is necessary for the audit team to understand the external influences which impact management in its preparation of the financial statements. The following may be addressed:
  1. Reporting requirements
  2. Financial statement users

- EDP Background. The auditor should obtain appropriate background information about the EDP environment. This may include information about EDP organization, hardware, software and data management that may be used in making audit planning decisions.

4.3 Understanding the client’s internal control and accounting and financial reporting structure (forms AP 3b, AP 3c, AP 3d, AP 3e)

The existence of strong internal controls is important for a company in its operation of the business. A company establishes internal control policies and procedures for a variety of reasons, only some of which may be relevant to an audit of its financial statements. In general, the policies and procedures that are relevant to an audit concern the company’s ability to record, process, summarize and report financial information consistent with the assertions embodied in the financial statements.

The auditor is required to obtain an understanding of the internal control and accounting and financial reporting structures in planning the audit. Testing of controls is not specifically required unless the auditor wants to support a control
risk assessment that is less than high (e.g., moderate or low). However, the auditor may want to consider performing some tests of controls in order to provide management with recommendations for improvement in the auditor’s “Management Letter”.

The ISA “Risk Assessments and Internal Control” provides the following guidelines for understanding the client’s internal control environment and internal control systems:

**Accounting and Internal Control Systems**

Internal controls relating to the accounting system are concerned with achieving objectives such as:

- Transactions are executed in accordance with management’s general or specific authorization.
- All transactions and other events are promptly recorded in the correct amount, in the appropriate accounts and in the proper accounting period so as to permit preparation of financial statements in accordance with an identified financial reporting framework (IAS).
- Access to assets and records is permitted only in accordance with management’s authorization.
- Recorded assets are compared with the existing assets at reasonable intervals and appropriate action is taken regarding any differences.

**Inherent limitations of Internal Controls**

Accounting and internal control systems cannot provide management with conclusive evidence that objectives are reached because of inherent limitations. Such limitations include:

- Management’s usual requirement that the cost of an internal control does not exceed the expected benefits to be derived.
- Most internal controls tend to be directed at routine transactions rather than non-routine transactions.
- The potential for human error due to carelessness, distraction, mistakes of judgment and the misunderstanding of instructions.
- The possibility of circumvention of internal controls through the collusion of a member of management or an employee with parties outside or inside the entity.
- The possibility that a person responsible for exercising an internal control could abuse that responsibility, for example, a member of management overriding an internal control.
- The possibility that procedures may become inadequate due to changes in conditions, and compliance with procedures may deteriorate.

**Understanding the Accounting and Internal Control Systems**
When obtaining an understanding of the accounting and internal control systems to plan the audit, the auditor obtains a knowledge of the design of the accounting and internal control systems, and their operation. For example, an auditor may perform a “walk-through” test, that is, tracing a few transactions through the accounting system. When the transactions selected are typical of those transactions that pass through the system, this procedure may be treated as part of the tests of control. The nature and extent of walk-through tests performed by the auditor are such that they alone would not provide sufficient appropriate audit evidence to support a control risk assessment which is less than high.

The nature, timing and extent of the procedures performed by the auditor to obtain an understanding of the accounting and internal control systems will vary with, among other things:

- The size and complexity of the entity and of its computer system.
- Materiality considerations.
- The type of internal controls involved.
- The nature of the entity’s documentation of specific internal controls.
- The auditor’s assessment of inherent risk.

Ordinarily, the auditor’s understanding of the accounting and internal control systems significant to the audit is obtained through previous experience with the entity and is supplemented by:

(a) inquiries of appropriate management, supervisory and other personnel at various organizational levels within the entity, together with reference to documentation, such as procedures manuals, job descriptions and flow charts;

(b) inspection of documents and records produced by the accounting and internal control systems; and

(c) observation of the entity’s activities and operations, including observation of the organization of computer operations, management personnel and the nature of transaction processing.

**Accounting System**

The auditor should obtain an understanding of the accounting system sufficient to identify and understand:

(a) major classes of transactions in the entity’s operations;
(b) how such transactions are initiated;
(c) significant accounting records, supporting documents and accounts in the financial statements; and
(d) the accounting and financial reporting process, from the initiation of significant transactions and other events to their inclusion in the financial statements.

**Control Environment**

The auditor should obtain an understanding of the control environment sufficient to assess directors’ and management’s attitudes, awareness and actions regarding internal controls and their importance in the entity.
Control Procedures

The auditor should obtain an understanding of the control procedures sufficient to develop the audit plan. In obtaining this understanding, the auditor would consider knowledge about the presence or absence of control procedures obtained from the understanding of the control environment and accounting system in determining whether any additional understanding of control procedures is necessary. Because control procedures are integrated with the control environment and the accounting system, as the auditor obtains an understanding of the control environment and the accounting system, some knowledge about control procedures is also likely to be obtained, for example, in obtaining an understanding of the accounting system pertaining to cash, the auditor ordinarily becomes aware of whether bank accounts are reconciled. Ordinarily, development of the overall audit plan does not require an understanding of control procedures for every financial statement assertion in each account balance and transaction class.

4.4 Evaluation of risks (forms AP 3h and AP 3j)

Definitions

“Audit Risk” is the risk that the auditor may unknowingly issue an inappropriate opinion on the financial statements (for example, issue an unqualified opinion when the opinion should have been qualified).

“Control Risk” is the risk that material misstatements will not be prevented or detected and corrected on a timely basis by the client’s internal control structure. Some amount of control risk always exists because of the limitations that exist in any internal control structure. This risk is addressed through the consideration of the overall control environment, accounting system and control procedures.

“Inherent Risk” is the susceptibility of an account balance or class of transactions to material misstatements whether or not the related internal controls are operating. This risk is greater for some accounts than for others. For example, complex calculations are more likely to be misstated than simple calculations. Cash is generally more susceptible to theft than fixed assets, and accounts based on accounting estimates pose greater risk than do accounts based on objective data.

“Detection Risk” is the risk that the audit procedures applied will not detect a material misstatement. It is a function of the effectiveness of the design and application of the audit tests. Some detection risk always exists because of human error and because most accounts are not tested 100 percent. This risk is addressed through the design of an effective and efficient audit plan.

Note that the auditor has some control over the amount of Detection Risk through the audit planning for the nature and extent of audit procedures to be performed. The auditor does not have control over the amount of Control Risk or Inherent Risk. Rather, these risks must be evaluated by the auditor in order to determine
the amount of substantive testing needed to reduce Detection Risk (and therefore Audit Risk) to an acceptably low level.

**Fraud**

The auditor is not held responsible for the prevention of fraud and errors. It is the responsibility of management to implement adequate accounting and internal control systems for the prevention and detection of fraud and errors. However, in planning the audit, the auditor must assess the risk that fraud and illegal acts may cause the financial statements to be materially misstated.

Fraud is defined as an intentional act by one or more individual among management, employees or third parties, which results in a misrepresentation of the financial statements. Fraud may involve:

- Manipulation, falsification or alteration of records or documents
- Misappropriation of assets
- Suppression or omission of the effects of transactions from records or documents
- Recording of transactions without substance, or
- Misapplication of accounting policies.

Form AP 3h (Volume II of this Auditing Manual) may be used to assist the auditor in assessing the risk that fraud and illegal acts may cause the financial statements to be materially misstated.

**Evaluation**

The auditor obtains information needed to evaluate risk during the planning phase of the audit. Assessment of the risk of fraud and knowledge of the client’s business, internal control structure, and accounting and financial reporting structure allow the auditor to make a preliminary assessment about inherent and control risks.

Form AP 3i (Volume II) may be used to assist the auditor in formulating and documenting the combined risk assessment.

**4.5 Materiality (form AP 3f)**

“Materiality” is defined by IFAC as follows:

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. 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 a primary qualitative characteristic which information must have if it is to be useful.

In planning the audit, the auditor should consider, among other matters, a preliminary judgment about materiality. In this sense, materiality refers to the level at which misstatements (either individually or in the aggregate) would be
considered material to the financial statements taken as a whole. In making this judgment, the auditor considers the expectations of financial statement users concerning certain overall elements of the financial statements. For example, in the case of a profitable company, users may evaluate materiality in relation to net income or income from continuing operations. For companies with losses or break-even operations, users may evaluate materiality in relation to “normal” earnings or other financial statement elements, such as total revenues, total assets or shareholders’ equity. These user expectations may also be influenced by qualitative considerations such as trends, restrictive debt covenants and whether the company is public or private.

When planning an audit, it ordinarily is not feasible to anticipate all of the circumstances that may ultimately influence the judgments that will have to be made in evaluating audit findings at the completion of the audit. For example, actual audited earnings are likely to differ from the unaudited earnings amount used when the preliminary judgment about materiality was made. If the auditor’s judgment about materiality at the completion stage of the audit is significantly lower than his/her preliminary judgment, the auditor should consider whether or not the scope of the audit work performed remains adequate.

The ISA “Audit Materiality” states:

Materiality should be considered by the auditor when:
(a) determining the nature, timing and extent of audit procedures; and
(b) evaluating the effect of misstatements.

Form AP 3f (Volume II of this Auditing Manual) may be used by the auditor to establish the audit materiality amount and the tolerable misstatement. However, the auditor should use judgment to determine whether the approach in form AP 3f is appropriate in the particular circumstances.

4.6 Determining the Audit Approach (form AP 3g)

The nature, timing and extent of testing is a matter of auditor judgment. The approach suggested in form AP 3g is:

(a) Identify individually significant items within the account balance or class of transaction that the auditor is planning to test.
(b) Calculate the remaining balance.
(c) Document how individually significant items and how the remaining balance will be tested, through analytical procedures or substantive tests.

The guidelines in form AP 3g give detailed instructions as to how to perform this analysis. Further discussion of analytical procedures, substantive tests, types of audit evidence and design of substantive tests is included in Section V of this volume.

4.7 Time Budget (form AP 3i)
A critical part of the audit planning process is the assignment of personnel to perform the audit work and development of estimates of time to complete the audit. The qualification of the individuals assigned to each area of the audit should be evaluated as to experience, position, background and special expertise. Supervision and involvement by supervisory personnel should also be planned.

The estimate of time to complete the audit should be documented in detail. A suggested format is included in form AP 3i (Volume II of this Auditing Manual). Estimates of time, delineated by each significant audit area, may be based on prior year actual time, adjusted for changes in circumstances. For first-year audits, the auditor can base the estimate on experience with similar clients and information from the predecessor auditor, if available.

At the completion of the audit, actual time vs. budgeted time should be analyzed, noting any unusual circumstances that caused actual time to vary from the budget and whether such circumstances are expected to be recurring. This analysis will be valuable in planning the audit for the next year.

V. Design of Audit Tests

5.1 Audit Evidence

Audit tests should be designed to allow the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion. Audit evidence is comprised of source documents and accounting records underlying the financial statements and corroborating information from other sources.

The sufficiency of audit evidence is the measure of its quantity. Appropriateness is the measure of the quality of audit evidence, its relevance to a particular assertion, and its reliability. The auditor generally finds it necessary to rely on audit evidence that is persuasive rather than conclusion. For this reason, the auditor will often seek audit evidence from different sources or of a different nature to support the same assertion.

The auditor must apply judgment in determining what is sufficient appropriate audit evidence. During the course of the audit, the audit’s judgment may change, depending on the results of audit procedures performed (including fraud or errors which may have been found). The combined risk assessment (form AP 3j) and materiality determination (form AP 3f) are two factors that influence the auditor’s initial judgment as to what is sufficient appropriate audit evidence. Other factors
include experience gained during previous audits and the source and reliability of information available.

The ISA “Audit Evidence” states:

The reliability of audit evidence is influenced by its source: internal or external, and by its nature: visual, documentary or oral. While the reliability of audit evidence is dependent on individual circumstances, the following generalizations will help in assessing the reliability of audit evidence:

- Audit evidence from external sources (for example, confirmation received from a third party) is more reliable than that generated internally.
- Audit evidence generated internally is more reliable when the related accounting and internal control systems are effective.
- Audit evidence obtained directly by the auditor is more reliable than that obtained from the entity.
- Audit evidence in the form of documents and written representations is more reliable than oral representations.

Audit evidence is more persuasive when items of evidence from different sources or of a different nature are consistent. In these circumstances, the auditor may obtain a cumulative degree of confidence higher than would be obtained from items of audit evidence when considered individually. Conversely, when audit evidence obtained from one source is inconsistent with that obtained from another, the auditor determines what additional procedures are necessary to resolve the inconsistency.

5.2 Methods for Obtaining Audit Evidence

The auditor may obtain audit evidence in a number of ways, including:

Counts of assets and computation. For example, the auditor may count cash on hand to ascertain that the assets in the accounts actually exist and are accurately recorded. Computation consists of checking the arithmetical accuracy of source documents and accounting records or of performing independent calculations.

Observation. Observation involves direct visual viewing of client employees in their work environment, and of other facts and events. Observation of the client’s employees taking a physical inventory can provide firsthand knowledge to help the auditor assess the adequacy of the inventory taking. Watching employees whose functions have accounting significance perform their assigned tasks can help the auditor assess whether specific procedures are operating effectively.

Inquiry. The auditor may ask oral or written question of the client or of third parties. In planning the audit, the auditor must ask questions of the client about procedures in order to obtain an understanding of the client’s business and its internal control structure. The auditor will ask third parties, often legal counsel for the client, about the existence of potential lawsuits and the outcome of current
litigation. In all instances, the results of the inquiries must be documented and the
auditor must evaluate the responses.

**Confirmation.** Confirmation involves obtaining a representation of fact or
condition from a third party, preferably in writing. Examples are confirmation
from a bank of the amount on deposit or of a loan outstanding, a confirmation
from a customer of the existence of a receivable balance, and a confirmation from
a supplier of the existence of a payable balance at a certain date.

**Inspection.** Inspection consists of examining records, documents, or tangible
assets. Inspection of records and documents provides audit evidence of varying
degrees of reliability depending on their nature and source and the effectiveness of
internal controls over their processing. Inspection may include tracing postings
from sales invoices to accounts receivable sub-ledgers; examining invoices,
purchase orders and receiving reports to ensure that the charges to a particular
asset or expense account are adequately supported. The principal objective of
inspecting documents and records is to ensure that the transactions recorded in the
accounts are bona fide, properly supported, authorized and approved.

**Reperformance.** Reperformance involves repeating procedures performed by the
client’s employees, such as counting inventory or other assets, or comparing
purchase orders with receiving reports and suppliers’ invoices.

**Analytical procedures.** Analytical procedures consist of the analysis of significant
ratios and trends, and investigating fluctuations and inconsistent relationships.
These procedures are reasonableness tests of financial information presented by
the client.

### 5.3 Financial Statement Assertions

When a user reads audited financial statements, certain assumptions are rightfully
made. For example, when reading a balance sheet, the user assumes that the
assets exist and are owned by the reporting company. These assumptions are
referred to as “financial statement assertions” because management is asserting
that these assumptions regarding the financial statements are factual. When
planning the nature and extent of auditing tests, the auditor should design
procedures that will test the validity of management’s assertions regarding the
financial statements.

The ISA “Audit Evidence” describes seven financial statement assertions:

Financial statement assertions are assertions by management, explicit or
otherwise, that are embodied in the financial statements. They can be
categorized as follows:

(a) *existence:* an asset or a liability exists at a given date;
(b) *rights and obligations:* an asset or a liability pertains to the entity at a
given date;
(c) **occurrence**: a transaction or event took place which pertains to the entity during the period;
(d) **completeness**: there are no unrecorded assets, liabilities, transactions or events, or undisclosed items;
(e) **valuation**: an asset or liability is recorded at an appropriate carrying value;
(f) **measurement**: a transaction or event is recorded at the proper amount and revenue or expense is allocated to the proper period; and
(g) **presentation and disclosure**: an item is disclosed, classified, and described in accordance with the applicable financial reporting framework.

Ordinarily, audit evidence is obtained regarding each financial statement assertion. Audit evidence regarding one assertion, for example, existence of inventory, will not compensate for failure to obtain audit evidence regarding another, for example, valuation. The nature, timing and extent of substantive procedures will vary depending on the assertions. Tests can provide audit evidence about more than one assertion, for example, collection of receivables may provide audit evidence regarding both existence and valuation.

### 5.4 Auditing Standards vs. Auditing Procedures

The audit report tells the reader that the work has been done in accordance with ISA and that these standards have been adhered to in performing the audit. These standards are intended to provide a common reference that defines for the auditor, the client, and third parties the nature of the audit and its objective and the meaning of the auditor’s report.

*Auditing standards* differ from *auditing procedures* in that procedures relate to acts to be performed by the auditor, whereas standards deal with measures of the quality and objective of the performance of those acts. Auditing standards are concerned with not only the auditor’s professional qualities but also with the judgment exercised by the auditor in the performance of the audit and in the audit report. Auditing standards are general in nature, while auditing procedures are specific.

### 5.5 Nature of Audit Procedures

There are two broad categories of audit procedures by which the auditor may obtain audit evidence:

(a) **Tests of Controls.** Procedures performed to determine whether control techniques which mitigate the risk of material misstatements are operating effectively throughout the audit period. (See examples in Appendix 3)

Control techniques used by a company include the following:

- **Authorization Controls**, which are prevention-oriented. They are designed to prevent misstatements from occurring as a result of unauthorized or
improperly authorized transactions. Transactions may be approved directly by management or designated individuals. Authorization criteria may also be included in computer programs and master files.

- **Transaction Processing Controls** are also prevention-oriented. Examples of such controls (which may be performed manually or by computer programs) are:
  1. Sequential numbering of transactions
  2. Use of control totals to ensure that all data are processed accurately
  3. Matching data from different sources
  4. Review of calculations and classifications
  5. Validation tests to match input data with data on file.

- **Substantiation and Evaluation Controls** are detection-oriented, designed to detect misstatements that have occurred during processing and ensure that they are corrected. Examples are:
  1. Reconciliation of physical inventory counts
  2. Verification of recorded balances with third parties
  3. Reconciliation of subsidiary records with control accounts
  4. Comparison of recorded balances with budgeted or prior amounts
  5. Evaluation of the reasonableness of recorded balances, including valuation allowances.

- **Physical Safeguard Controls** are prevention-oriented and consist of segregation of duties, limited access to assets, etc.

(b) **Substantive tests.** Procedures performed by the auditor to detect material misstatements in financial statement balances and transactions. They include the following broad types:

  1. **Analytical procedures**, which include tests of financial information by evaluating actual versus expected relationships among financial and non-financial data.
  2. **Detail tests**, which include tests of recorded balances by confirmation, observation, inspection of documents, valuation tests and other methods.

Note that some substantive tests may actually be tests of certain substantiation and evaluation controls performed by the client. Thus, these tests often have “dual-purpose” nature. Dual-purpose tests substantiate the accuracy of account balances or results of process, and they also verify that related control techniques are operating effectively. For example, in testing a sample of disbursement transactions, the auditor may observe evidence of clerical accuracy checks, matching of documents, and approval by the client (tests of control).

### 5.6 Designing Audit Procedures

**Criteria Affecting Design of Audit Procedures**

Selection of the nature and extent of audit procedures to be performed is affected by the following:

- The identified types of misstatements that could occur within an account or class of transactions.
• The assessed level of risk. Generally, as the assessed level of risk increases, (a) additional types of procedures should be performed and (b) procedures should be more reliable for the detection of misstatements. The assessed level of risk also directly affects the extent of audit procedures to be performed.

• Effectiveness of the internal control structure. Generally, as the effectiveness of controls decreases, (a) the ability to rely on such controls decreases, (b) the ability to rely on client-generated reports in substantive tests decreases, and (c) additional types of substantive tests may be necessary.

• Relative efficiency of alternative audit procedures.

• Materiality.

Direction of Testing

Audit procedures designed to directly test a particular account balance or class of transactions for overstatement or understatement will simultaneously indirectly test other account balances or classes of transactions for overstatement or understatement. This is due to the double-entry bookkeeping system. For example, if Cash is overstated, then a debit entry to Cash was erroneously made. Therefore, in order for the general ledger to balance, an erroneous credit entry would also have been made to some other asset account, or to a liability, revenue expense, or equity account. This idea is summarized in the chart below:

<table>
<thead>
<tr>
<th>Account/Direct Test</th>
<th>Assets</th>
<th>Liabilities</th>
<th>Equity</th>
<th>Revenues</th>
<th>Expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>O</td>
<td>U</td>
<td>O</td>
<td>O</td>
<td>U</td>
</tr>
<tr>
<td>Liabilities</td>
<td>U</td>
<td>U</td>
<td>U</td>
<td>O</td>
<td>U</td>
</tr>
<tr>
<td>Equity</td>
<td>U</td>
<td>U</td>
<td>O</td>
<td>O</td>
<td>U</td>
</tr>
<tr>
<td>Revenues</td>
<td>U</td>
<td>U</td>
<td>O</td>
<td>O</td>
<td>U</td>
</tr>
<tr>
<td>Expenses</td>
<td>O</td>
<td>U</td>
<td>O</td>
<td>O</td>
<td>U</td>
</tr>
</tbody>
</table>

O = Overstatement
U = Understatement

Audit Programs

Audit programs are a useful tool for auditors to use in executing the audit plan, and they reduce the risk of omitting important procedures. There are two approaches for the auditor to consider in designing audit programs:

(1) Unique Programs. The auditor could design unique audit programs for each individual audit. First, the auditor would develop specific audit objectives for each material account balance or class of transactions, then select audit procedures for the particular audit engagement to meet those objectives. The auditor could use a “source list” of typical auditing procedures to ensure that audit procedures are not omitted. (The example audit programs included in Volume II of this manual could serve as a source list for this purpose.) The advantage of this approach is that it results in audit programs tailored to the needs of the particular audit engagement. The disadvantage is that additional costs and start-up time may be required.
(2) Standardized Programs. This approach takes advantage of the accumulated experience of other auditors and minimizes the risk of omitting important procedures. The disadvantage is that it may encourage a mechanical approach to the audit and discourage auditor judgment.

Example audit programs for the significant account balances and classes of transactions for a typical enterprise are included in Volume II of this auditing manual. Each program calls for analytical procedures and other substantive tests, but the programs do not tell the auditor how much testing to perform or how to select individual items for testing. The extent of testing depends largely on the criteria established during the planning process and will vary from audit to audit, depending on materiality, risks and other factors.

The auditor should refer to the documentation of the nature and extent of testing decided during the planning phase of the audit. (One suggested approach for determining the extent of testing is set forth in Form AP 3g). The audit programs in Volume II can be used as a guide to implement the planned audit approach, but they should not be used mechanically without consideration of the circumstances of each particular audit. The programs should be modified by the auditor to ensure that the audit objectives are met.

VI. Executing the Audit Plan

6.1 Completing the Audit Programs

Selecting Individual Items for Testing

The issue of how to select individual items for testing might best be approached by looking at a particular audit program. Notice, for example, that the Audit Program for Accounts Receivable (AP 15) tells the auditor to select individual accounts for confirmation. The audit program does not specify how to make the selection, as this decision will vary depending on the circumstances of the particular audit engagement. The auditor must refer to the auditing planning documentation (specifically form AP 3g) to determine how to proceed with the selection of individual accounts for confirmation.

If, during the planning process, the auditor used the approach suggested in form AP 3g (Planning Worksheet to Determine Extent of Substantive Tests), detailed testing would be performed for all “individually significant items” (or in some cases a sample of these items). The nature and extent of audit procedures pertaining to the “remaining balance” should also be documented in form AP 3g.

Guidance regarding selection of individual items for testing is provided in the ISA “Audit Sampling and Other Selective Testing Procedures” and should be considered when completing form AP 3g:
When designing audit procedures, the auditor should determine appropriate means of selecting items for testing. This means available to the auditor are:

(a) Selecting all items (100% examination);
(b) Selecting specific items, and
(c) Audit sampling

The decision as to which approach to use will depend on the circumstances, and the application of any one or combination of the above means may be appropriate in particular circumstances. While the decision as to which means, or combination of means, to use is made on the basis on audit risk and audit efficiency, the auditor needs to be satisfied that methods used are effective in providing sufficient appropriate audit evidence to meet the objectives of the test.

Selecting all items
The auditor may decide that it will be most appropriate to examine the entire population of items that make up an account balance or class of transactions (or a stratum within that population). 100% examination is unlikely in the case of tests of control; however, it is more common for substantive procedures. For example, 100% examination may be appropriate when the population constitutes a small number of large value items, when both inherent and control risks are high and other means do not provide sufficient appropriate audit evidence, or when the repetitive nature of a calculation or other process performed by a computer information system makes a 100% examination cost effective.

Selecting Specific Items
The auditor may decide to select specific items from a population based on such factors as knowledge of the client’s business, preliminary assessments of inherent and control risks, and the characteristics of the population being tested. The judgmental selection of specific items is subject to non-sampling risk. Specific items selected may include:

- **High value or key items.** The auditor may decide to select specific items within a population because they are of high value, or exhibit some other characteristic, for example items that are suspicious, unusual, particularly risk-prone or that have a history of error.
- **All items over a certain amount.** The auditor may decide to examine items whose values exceed a certain amount so as to verify a large proportion of the total amount of an account balance or class of transactions.
- **Items to obtain information.** The auditor may examine items to obtain information about matters such as the client’s business, the nature of transactions, accounting and internal control systems.
• **Items to test procedures.** The auditor may use judgment to select and examine specific items to determine whether or not a particular procedure is being performed.

While selective examination of specific items from an account balance or class of transactions will often be an efficient means of gathering audit evidence, it does not constitute audit sampling. The results of procedures applied to items selected in this way cannot be projected to the entire population. The auditor considers the need to obtain appropriate evidence regarding the remainder of the population when that remainder is material.

**Audit Sampling**

The auditor may decide to apply audit sampling to an account balance or class of transactions. Audit sampling can be applied using either non-statistical or statistical sampling methods.

The decision whether to use a statistical or non-statistical approach is a matter for the auditor’s judgment regarding the most efficient manner to obtain sufficient appropriate audit evidence in the particular circumstances.

Further guidance regarding audit sampling is included in section 6.2 below.

**6.2 Audit Sampling**

Audit sampling involves the application of audit procedures to less than 100% of the items within an account balance or class of transactions in such a way that all items have a chance of being selected. This enables the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form a conclusion about the population from which the sample is drawn. Audit sampling can use either a statistical or non-statistical approach. Statistical sampling means any approach to sampling that results in the random selection of a sample and the use of probability theory to evaluate sample results. Audit sampling can be used to test controls or to apply substantive audit procedures.

**Stratification.** Before applying audit sampling, audit efficiency may be gained by stratifying the population. “Stratification” is the process of dividing a population into sub-populations, each of which is a group of sampling units which have similar characteristics. When performing substantive procedures, account balances or classes of transactions are often stratified by monetary value. This allows greater audit effort to be directed to the larger value items which may contain the greatest potential monetary error in terms of overstatement. In the methodology set forth in Form AP 3g, the auditor identifies “individually significant” items and then computes a “remaining balance”. By following this approach, the auditor is stratifying the population.

**Population.** The “population” means the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions. It is important
for the auditor to ensure that the population is (1) appropriate to the objective of the sampling procedures and (2) complete. In determining whether a population is appropriate, the auditor should consider the direction of testing. For example, if the objective is to test accounts payable for understatement, the auditor should not sample from the recorded listing of accounts payable. Rather, the appropriate population would be subsequent disbursements, unpaid invoices, suppliers’ statements, or unmatched receiving reports.

**Sampling Risk.** As discussed in section 6.2 above, the auditor may decide to test all items in a population or only selected items. “Sampling risk” arises from the possibility that the auditor’s conclusion, based on a sample, may be different from the conclusion reached if the entire population were subjected to the same audit procedures.

Sampling risk is a component of detection risk (the risk that material misstatements will not be detected by the auditor’s substantive procedures). For example, the auditor may apply sampling to select items for substantive testing and find only minor misstatements in the test of details when, in fact, the population misstatement is greater than the tolerable amount. Sampling risk can be reduced by increasing sample size.

**Sample Size and Selecting the Sample.** In determining sample size, the auditor should consider the level of sampling risk that is acceptable. The lower the risk the auditor is willing to accept, the greater the sample size will need to be. The sample size can be determined by the application of a statistically-based formula or through the exercise of professional judgment.

The purpose of sampling is to draw conclusions about the entire population. Therefore, the auditor should endeavor to select a representative sample by choosing sample items with characteristics typical of the population. The sample should be selected so that bias is avoided. The principal methods of selecting samples are:

- The use of random number tables or computer programs.
- Systematic selection, in which the number of sampling units in the population is divided by the sample size to give a sampling interval. For example, if the computed sampling interval was 40, the auditor would determining a “starting point” somewhere within the first 40 units in the population (which would be the first selection) and then select every 40th item thereafter.
- Haphazard selection, in which the auditor selects the sample without following a structured technique but yet makes the selection in an unbiased manner. This method is not appropriate when using statistical sampling.

**Evaluating the Sample Results.** The auditor uses sampling to select individual items to determine whether a relevant characteristic is present in the selected items. This is based on the auditor’s preliminary assessment that the relevant characteristic is present in the population. After applying tests to the sample items, the auditor must then evaluate the results to determine whether the preliminary assessment of the relevant characteristic of the population is confirmed or needs to be revised.
To evaluate the sample results, the auditor should first determine the nature of the errors detected when the selected items were tested. Some errors may be caused by an isolated event that has not recurred other than on specifically identifiable occasions. These “anomalous errors” are not representative of errors in the population. Errors other than anomalous errors must be projected to the population to estimate the amount of error in total. This can be done mathematically if statistical sampling was applied.

If the total amount of projected error plus anomalous error is greater than (or close to) the tolerable misstatement for the account balance or class of transactions, there is an indication that the preliminary assessment of the relevant characteristic of the population needs to be revised. In this case, the auditor may request management to investigate the identified errors and the potential for further errors. The auditor may also modify the planned audit procedures by increasing the sample size.

6.3 Confirmation Procedures

External confirmation is the process of obtaining and evaluating audit evidence through a direct communication from a third party in response to a request for information about a particular item. Confirmation can be made either orally or in writing, although written confirmation is more reliable and therefore preferable. Examples of written confirmation requests are included in Volume II of this Auditing Manual.

Positive and Negative Confirmation Requests. The auditor may use positive or negative confirmation requests or a combination of both. This decision should be made during the audit planning and documented in form AP 3g. A positive confirmation request asks the respondent to reply to the auditor in all cases either by (1) indicating agreement with the given information or by (2) asking the respondent to fill in information. Although there is a risk that a respondent may reply to the request without verifying the information, positive confirmation requests are ordinarily expected to provide reliable audit evidence.

A negative confirmation request asks the respondent to reply only in the event of disagreement with the information provided in the request. Negative confirmation requests ordinarily provides less reliable evidence than positive confirmation requests. When no response is received to a negative confirmation request, the auditor does not have explicit evidence that the respondent received the confirmation request and verified the information. Therefore, negative confirmation requests are generally limited to situations when:

- The assessed level of inherent and control risk is low;
- A large number of small balances is involved;
- A substantial number of errors is not expected; and
- The auditor has no reason to believe that respondents will disregard these requests.

Controlling the Confirmation Process. Requests for confirmation should be prepared on the client’s letterhead and must be signed by the client, thereby giving the respondent the client’s permission to respond to the auditor. However, the
The auditor should control the confirmation process to prevent the client's employees from having any opportunity to alter or intercept a confirmation request or the respondent’s reply. Suggestions for controlling the confirmation process include:

- If confirmation requests are mailed, the return address on the envelope should be the auditor’s.
- The auditor should mail or deliver the confirmation requests personally.
- The requests should instruct the respondent to respond directly to the auditor and should give the auditor’s name and address.
- The auditor should consider enclosing a self-addressed return envelope to minimize the risk that the respondent will reply to the client rather than directly to the auditor.
- The confirmation requests should be carefully designed to make sure that the person receiving the request has easy access to the information requested.
- If it is necessary to send confirmation requests by fax, the auditor should verify that the fax number is legitimate and should personally send the fax (rather than allowing client personnel to send).
- If it is necessary to receive confirmation replies by fax, the respondent should be requested to send the fax directly to the auditor. The auditor should validate that the fax was sent by the appropriate party (for example, by calling to verify the date and content of the fax).
- For oral responses to confirmation requests, the auditor should verify the identity of the respondent and document the response in the audit workpapers.
- If responses to positive confirmation requests are not received within a reasonable timeframe, the auditor should send a second request.

Other Considerations.

The auditor should be alert to confirmation requests that are returned by the post office as “non-deliverable”, as this may be an indication of fictitious customers.

If the reply rate for positive confirmation requests is low, the auditor should ask the client to contact the respondents and encourage them to respond. Otherwise, the auditor should consider whether alternative procedures will provide sufficient appropriate audit evidence and modify the audit approach accordingly.

6.4 Documentation and Review

The ISA “Documentation” states:

The auditor should record in the working papers information on planning the audit work, the nature, timing and extent of the audit procedures performed, the results thereof, and the conclusions drawn from the audit evidence obtained. Working papers would include the auditor’s reasoning on all significant matters which require the exercise of judgment, together with the auditor’s conclusion thereon. In areas involving difficult questions of principle or judgment, working papers will record the relevant facts that were known by the auditor at the time the conclusions were reached.
Working papers are designed and organized to meet the circumstances and the auditor’s needs for each individual audit. The use of standardized working papers (for example, checklists, specimen letters, standard organization of working papers) may improve the efficiency with which such working papers are prepared and reviewed. They facilitate the delegation of work while providing a means to control its quality.

To improve audit efficiency, the auditor may utilize schedules, analyses and other documentation prepared by the entity. In such circumstances, the auditor would need to be satisfied that those materials have been properly prepared.

Working papers ordinarily include:

- Information concerning the legal and organizational structure of the entity.
- Extracts or copies of important legal documents, agreements and minutes.
- Information concerning the industry, economic environment and legislative environment within which the entity operates.
- Evidence of the planning process including audit programs and any changes thereto.
- Evidence of the auditor’s understanding of the accounting and internal control systems.
- Evidence of inherent and control risk assessments and any revisions thereof.
- Evidence of the auditor’s consideration of the work of internal auditing and conclusions reached.
- Analyses of transactions and balances.
- Analyses of significant ratios and trends.
- A record of the nature, timing and extent of audit procedures performed and the results of such procedures.
- Copies of communications with other auditors, experts and other third parties.
- Copies of letters or notes concerning audit matters communicated to or discussed with the entity, including the terms of the engagement and material weaknesses in internal control.
- Letters of representation received from the entity.
- Conclusions reached by the auditor concerning significant aspects of the audit, including how exceptions and unusual matters, if any, disclosed by the auditor’s procedures were resolved or treated.
- Copies of the financial statements and auditor’s report.

**Organization of the Audit Workpapers**
Audit workpapers can generally be divided into two categories:

- **Current Files**: Documentation relating to audit work performed on the current audit.
- **Permanent Files**: Items such as bylaws, long-term lease agreements, etc., which will be useful on recurring audits. The content of the permanent file should be updated each year.

The current workpaper files should be organized to fit the circumstances. However, the files should be organized and indexed with the following objectives in mind:

- Organize the workpapers in a logical manner that best supports the financial statements on which the auditor is reporting.
- Create a hierarchy of working papers that demonstrates their relationships. For example, all cash accounts should be in one section, accounts receivable in another, etc.
- Provide an efficient means to reference the work performed to the applicable audit program steps, by indicating on the audit program the location (index number) of the evidence of work performed.
- Aid the reviewers in identifying and/or locating the workpapers pertinent to their review.

A sample workpaper index and examples of workpaper format is included in Appendix II of this manual.

**Confidentiality and Custody**

Audit workpapers are the property of the auditor, although the auditor may want to make certain workpapers available to the client.

The auditor should adopt appropriate procedures for maintaining the confidentiality and safe custody of the workpapers. They should be retained for a period sufficient to meet the needs of the auditor and in accordance with legal and professional requirements.

**Review of the Audit Workpapers**

The ISA “Quality Control for Audit Work” calls for work performed by audit assistants to be reviewed to consider whether:

- the work was performed in accordance with the audit program;
- the work performed and the results thereof are adequately documented;
- all significant audit matters were resolved or are documented in the audit conclusions;
- the objectives of the audit procedures were achieved; and
- conclusions are consistent with the results of the procedures performed and support the audit opinion.

To apply these guidelines into practice, the detailed review of the current workpaper file generally observes the following steps:
For each financial statement component, review the audit program and supporting schedules to assure that:

1. Each audit program and supporting schedule is complete and properly headed (name of client, balance sheet date, and title of schedule), initialed by the person who performed the work, indexed, and cross-referenced to the working trial balance.

2. Amounts in supporting schedules agree with amounts in the working trial balance and amounts “balance per books” have been traced to the general ledger.

3. The supporting schedules indicate that all procedures in the audit programs have been completed. (If standardized audit programs are used, some procedures maybe “N/A” if they do not apply to the particular audit).

4. Any misstatements discovered have been properly identified, analyzed and posted to the Summary of Audit Differences schedule.

- Assure that the permanent file has been updated for the current year and any applicable information has been cross-referenced to the current year files.
- Assure that the general section of the current file (all workpapers other than those relating to financial statement components) have been properly headed, completed, indexed and cross-referenced.
- Assure that the financial statements have been drafted and cross-referenced to the working trial balance and other workpapers, as necessary.

VII. Evaluating the Findings

7.1 Summarizing Audit Differences and Discussion with Management

One of the final steps near completion of the audit is evaluation of the misstatements discovered during fieldwork. In order to accomplish this, it is necessary to summarize audit differences in one place in the working papers. Form AP 4a in Volume II provides an example format for documenting this summary. In order to facilitate discussions with management, the summary should consist of the actual entries that are needed correct the audit differences, along with working paper references and a brief explanation of the nature of the errors noted.

After summarizing the audit differences, the auditor should discuss each adjusting entry with appropriate client management and thoroughly explain why the adjustments are necessary for the financial statements to comply with IAS. The auditor cannot require that management accept the adjustments. For those adjustments that the client agrees to, the auditor should ensure that they are posted in the working trial balance in the auditor’s working papers and other supporting working papers. It is very important to document the client’s agreement (or non agreement) to adjustments to the financial statements, preferably in writing. This
might be accomplished by detailing this information in the Management Representation Letter and/or by having the client initial the entries listed in Form AP 4a. Adjustments that are not agreed to by the client should be further evaluated to determine the effect on the financial statements and the auditor’s report. Form AP 4b may be used for this evaluation. (See section 7.3 below).

The auditor may also wish to provide a copy of the adjusting entries to the client to facilitate recording them in the client’s books. Therefore, it is important that the adjusting entries posted in Form AP 4a include adequate detail (account numbers, etc.) for the client to record the adjustments. Even though the client agrees to certain adjustments for preparation of the audited financial statements, the auditor cannot require client to actually record the adjustments in their books. Since the auditor opines on the financial statements (and not on the books and records of the client), failure to actually record adjustments does not affect the auditor’s opinion as long as management agrees to the adjustments for financial statement purposes. The auditor should, however, encourage the client to book the adjustments and should provide assistance in doing so, as requested.

Example: The auditor is performing an auditor for the year ended December 31, 2003. While testing the client’s calculation of depreciation expense, the auditor found that the calculation was in error. A new branch building was purchased on January 2, 2003, but depreciation on the building was not begun until February. This resulted in an understatement of depreciation expense of 100,000 togros. (The auditor performed sufficient additional testing to determine that this error was isolated.) The auditor should post the following adjusting entry (the entry needed to correct the error) to Form AP 4a:

<table>
<thead>
<tr>
<th>Workpaper Reference</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>XXX</td>
<td>A/C #...Depreciation Expense</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td>A/C #.....Accumulated Depreciation</td>
<td>100,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

To correct for depreciation expense on the branch office building which was erroneously omitted from the depreciation calculation for the month of January, 2003.

7.2 Effect of Prior Year Differences

Two situations may exist which will require current year audit adjustments to correct for the effect of prior year audit differences:

(1) As noted above, the auditor cannot require the client to record audit adjustments in the general ledger. If prior year audit adjustments were not recorded by the client, the auditor must consider the effect on the current year audit. To continue the example in section 7.1, assume that the client did not record the adjustment to depreciation expense in its general ledger. When the auditor returns the next year to perform the audit on the 2004 financial statements, the following adjustment should be posted to Form AP 4a:
(2) If prior year audit adjustments were recorded by the client, the auditor must determine how and when the adjustments were recorded and consider the effect on the current year audit. Again using the example in section 7.1, assume that the client recorded the adjustment to depreciation expense, but it was recorded in 2004. When the auditor returns the next year to perform the audit on the 2004 financial statements, the following adjustment should be posted to Form AP 4a:

<table>
<thead>
<tr>
<th>Workpaper Reference</th>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>XXX</td>
<td>A/C #...Retained Earnings</td>
<td>100,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>A/C #.....Accumulated Depreciation</td>
<td></td>
<td>100,000</td>
</tr>
</tbody>
</table>

To correct for prior year adjustment #_____ which was recorded in the client’s general ledger in 2004, resulting in an overstatement of current year depreciation expense.

In scenarios (1) and (2) above, the auditor should treat the adjustment entries (posted on Form AP 4a) the same as other current year audit differences detected during the audit. In other words, these adjustments should be discussed with management to determine if the client agrees they are necessary for financial statement purposes. If the client does not agree, the effect of the entries should be posted to Form AP 4b for further evaluation (see section 7.3 below).

**Reclassifications.** Note that some audit adjustments represent reclassifications for financial statement purposes that should not be recorded by the client. For example, assume a material debit balance in an accounts payable item that IAS requires to be reclassified to an asset. The client most likely will not record this reclassification in its general ledger. When the auditor returns in the subsequent year to perform the audit, reclassifications of this type do not automatically require a current year audit adjustment. The auditor should be alert, however, for similar circumstances (significant debit balances in accounts payable items) that will require a new reclassification entry for the current year financial statements.

**7.3 Evaluation of Audit Differences**

The auditor should discuss the summary of audit differences (Form AP 4a) with the client to ascertain whether the client is in agreement that adjustment is necessary for the financial statements to comply with IAS. Those adjustments that the client does not agree to make (for purposes of preparing the financial statements), must be further evaluated to determine the effect on the financial statements and the auditor’s report.
Form AP 4b may be used to facilitate the evaluation of audit differences. This process includes the following:

(1) For all adjustments (from Form AP 4a) that the client does not agree to make for financial statement purposes, post the effect of the adjustment to Form AP 4b. For example, consider the error in depreciation expense described in section 7.1 above. If the client does not agree to make the adjustment for financial statement purposes, the following should be posted to AP 4b:

<table>
<thead>
<tr>
<th>Description</th>
<th>Total Assets</th>
<th>Total Liabilities</th>
<th>Equity</th>
<th>Revenues</th>
<th>Net Income</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Effect on the Financial Statements</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Overstatement (Understatement)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>In thousands of togrogs</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Understatement of depreciation expense (adjustment #___ at Form AP 4a)</td>
<td>100</td>
<td>100</td>
<td>100</td>
<td></td>
<td>100</td>
</tr>
</tbody>
</table>

(Note: In practice, adjustments which the client does not agree to make generally occur in the area of audit estimates, such as valuation allowances. It would be unusual for the client not to agree to the adjustment to depreciation, used in the example above. This example is used here as a demonstration of how to convert a proposed audit adjustment into the effect on the financial statements.)

(2) The auditor must determine if the effect of the uncorrected differences listed in Form 4b is material to the financial statements. Auditors should consider the materiality of individual misstatements, as well as the combined effect of all misstatements on the financial statement totals or subtotals. Caution should be exercised to ensure that an individually material misstatement is not offset against other misstatements (that have an opposite effect) to diminish the effect on financial statement totals or subtotals. For example, assuming revenues are significant to a client’s financial statements, a material misstatement of revenue should not be netted against an offsetting misstatement of expenses, even though the effect on net income is not material. In addition, the auditor should consider the tax effect of the audit differences, if any.

(3) If the auditor determines that the effect of the uncorrected differences is material to the financial statements (or financial statement totals or subtotals), further discussion with the client should take place. The auditor should explain to the client that if corrections are not made to the financial statements, the auditor will have to qualify his opinion.
VIII. Completing the Audit

Following is a list of procedures to be completed in the final stages of the audit:

- Obtain and review the financial statements prepared by the client (or assist the client in preparing).
- Review subsequent events.
- Evaluate the effect of contingencies and litigation.
- Obtain the Management Representation Letter.
- Consider the validity of the going concern assumption.
- Perform a final audit review and approval.

8.1 Financial Statements (Form AP 125)

Management is responsible for the financial statements, but as a practical matter the auditor often must assist the client in preparation of the financial statements and footnotes. This process should begin early in the audit process to avoid a last-minute rush, although final audited amounts will not be known until completion of fieldwork and review of audit findings.

The financial statements must be prepared in accordance with International Accounting Standards, including all required footnote disclosures. Ensuring adherence with these standards is a considerable task. To assist the auditor, an Audit Report Checklist (AP 125) is included in Volume II of this manual.

In addition to completing the checklist, the auditor should include a “referenced” copy of the financial statements and footnotes in the audit workpapers. Each financial statement amount and footnote disclosure should be referenced to documentation in the audit workpapers to ensure that all amounts (including disclosure amounts) were tested by the auditor.

8.2 Subsequent events (Form AP 100)
The term “subsequent events” generally refers to events occurring after the balance sheet date. IAS #10 addresses the accounting treatment and ISA #560 addresses the audit treatment for subsequent events.

“Accounting” Definition:

IAS #10 “Events After the Balance Sheet Date” prescribes the accounting treatment for events occurring after the balance sheet date. There are two types of subsequent events described in IAS 10, and each type has a different effect on the audited financial statements:

1. Events or facts that provide further evidence of conditions that existed at the balance sheet date. For example, events may occur after year-end but before preparation of the audited financial statements that tell us with certainty whether questionable accounts receivable are collectible.

   Accounting treatment: This type of subsequent event requires that the financial statements be adjusted.

2. Events or facts that represent conditions that arose subsequent to the balance sheet date. For example, a fire or earthquake may occur after year-end that destroys the company’s primary manufacturing facility.

   Accounting treatment: This type of subsequent event does not require that the financial statements be adjusted but must be disclosed in the footnotes to the financial statements.

Audit Procedures regarding Subsequent Events:

Subsequent Events, as described in the International Standards on Auditing, include:

- Events occurring between the end of the reporting period (the balance sheet date) and the date of the auditor’s report, AND
- Facts discovered after the date of the auditor’s report.

1. Procedures before the date of the audit report:

   (a) Review procedures management has established to ensure that subsequent events are identified.
   (b) Read minutes of the meetings of shareholders, the board of directors and audit and executive committees held after the end of the reporting period (the balance sheet date). If minutes are not yet available, inquire about matters discussed at the meetings.
   (c) Read the latest available interim financial statements for the company. As considered necessary and appropriate, also review the budgets, cash flow forecasts and other related management reports. *(The emphasis should be on (1) changes in the business relative to results for the same period in the year under audit and (2) changes after year-end. The auditor should...*}
make inquiries of management about significant changes in the operating results.)

(d) Inquire, or extend previous oral or written inquiries, of the company’s lawyers concerning litigation and claims. (This relates to the search for unrecorded or undisclosed contingent liabilities. In order to ensure that the attorney’s response covers the “subsequent events” period, a common approach is to request the attorney to date and mail his letter as of the expected completion date for field work.)

(e) Review cash receipts for accounts receivable and sales. (Receipt or non-receipt of payment of accounts receivable after year-end may indicate whether the accounts receivable are collectible.)

(f) Inquire of management as to the existence of subsequent events. (Normally, such inquiries should relate to potential contingent liabilities or commitments, significant changes in the assets or capital structure of the company, current status of items that were not completely resolved at the balance sheet date, and unusual adjustments made subsequent to the balance sheet date.)

2. Procedures after the date of the audit report:

(a) Before financial statements are issued:

The auditor does not have a duty to actively search for evidence of events occurring after the date of the audit report but before the financial statements are issued (to shareholders). However, the auditor should not ignore any knowledge which he/she acquires from whatever source. If the auditor feels that the information would have altered the audit report, had he/she been aware of it prior to the date of the report, the matter should be discussed with the directors of the company. The directors should be encouraged to amend financial statements where required, and the auditor should issue a new audit report on the new financial statements.

In this situation, the auditor must extend the “subsequent events” audit procedures through the date of the event causing the amendment of the financial statements. The date of the auditor’s report should also be amended.

(b) After financial statements are issued:

If financial statements have already been issued, the directors may still revise them. In such circumstances, auditors are required to issue a new audit report containing an “emphasis of matter” paragraph, referring to the note in the financial statements that more extensively discusses the reason for the revision.

Whenever a new audit report is issued, the auditor should update his subsequent events review up to the date of the new report.

8.3 Contingencies and Litigation (Form AP 105)
A contingency may be defined as an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss that will be resolved when one or more future events occur or fail to occur. An example of a gain contingency is a claim against others for patent infringement. Consistent with the concept of conservatism, contingent gains are not recorded until they are realized, due to the uncertainty of the resultant gain.

Examples of contingent losses include the probable loss resulting from the guarantee of the indebtedness of others, or an obligation relating to a product warranty. Contingent losses may require (1) recording, (2) disclosure, (3) both, or (4) neither, depending on the likelihood of occurrence and the estimation of the amount. The ranges of likelihood of occurrence, and the possible effects on the financial statements follows:

<table>
<thead>
<tr>
<th>Likelihood</th>
<th>Definition</th>
<th>Effect on Financial Statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Probable</td>
<td>The future event or events are likely to occur.</td>
<td>If amount of loss can be reasonably estimated, the amount should be accrued and disclosed. If amount of loss cannot be reasonably estimated, the contingency should be disclosed.</td>
</tr>
<tr>
<td>Reasonably Possible</td>
<td>The chance of the future event or events occurring is more than remote but less than likely.</td>
<td>The contingency should be disclosed, irregardless of whether the amount of the loss can be reasonably estimated.</td>
</tr>
<tr>
<td>Remote</td>
<td>The chance of the future event or events occurring is slight.</td>
<td>Generally no accrual or disclosure is necessary.</td>
</tr>
</tbody>
</table>

Auditing loss contingencies is one of the most difficult aspects of many audits, and the variety of conditions encountered makes it impossible to describe the auditor’s task definitively. Form AP 105 (Audit Program for Contingencies and Litigation) is designed to assist the auditor in identifying sources of information regarding contingencies. One important procedure is obtaining a representation letter from the client’s attorney. (See example Letter 3 in Volume II for a request for attorney’s letter). The responses from the attorneys should be evaluated carefully in view of the information included in the above table. The auditor must also consider the effect, if any, that contingencies have on the auditor’s report (discussed in Section IX of this volume).

8.4 Management Representation Letter

The auditor should obtain written representations from management, dated the same date as the auditor’s report. At a minimum, management should acknowledge its responsibility for the fair presentation of the financial statements in accordance with IAS. An example Management Representation Letter is included in Volume II (Letter 2). Although the letter is prepared on client letterhead, the auditor should provide the client with a copy of the items that
should be included. In some cases, the auditor may wish to draft the letter for the client.

Similar to the audit engagement letter, the auditor must go beyond obtaining a signed copy of the letter. The auditor should discuss the contents of the letter so that the risk of misunderstandings is minimized. This is particularly important when the client is inexperienced in ISA audits and the auditor has drafted the Management Representation Letter for the client.

8.5 Going Concern Assumption (Form AP 120)

Accounting

The financial statements are normally prepared under the assumption that the entity is a going concern. The going concern assumption may best be described by referring to IAS 1 “Presentation of Financial Statements”, paragraphs 23 and 24:

“When preparing financial statements, management should make an assessment of an enterprise’s ability to continue as a going concern. Financial statements should be prepared on a going concern basis unless management intends to liquidate the enterprise or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions which may cast significant doubt upon the enterprise’s ability to continue as a going concern, those uncertainties should be disclosed. When the financial statements are not prepared on a going concern basis, that fact should be disclosed, together with the basis on which the financial statements are prepared [such as “liquidation basis”] and the reasons why the enterprise is not considered to be a going concern.

In assessing whether the going concern assumption is appropriate, management takes into account all available information for the foreseeable future, which should be at least, but is not limited to, twelve months from the balance sheet date. The degree of consideration depends on the facts in each case. When an enterprise has a history of profitable operations and ready access to financial resources, a conclusion that the going concern basis of accounting is appropriate can be reached without detailed analysis. In other cases, management may need to consider a wide range of factors surrounding current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate.”

Auditing Procedures

As noted above, management must make significant judgments about the appropriateness of the going concern assumption. This effectively puts the auditor in the position of auditing management’s judgment. The auditor must evaluate
events or conditions, which individually or collectively, may cast significant doubt about the going concern assumption, including:

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal.
- Excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by debtors and other creditors.
- Negative operating cash flows.
- Adverse key financial ratios.
- Substantial operating losses.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Loss of key management without replacement.
- Loss of a major market, franchise, license, or principal supplier.
- Labor difficulties or shortages of important supplies.
- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may result in claims that are unlikely to be satisfied.
- Changes in legislation or government policy expected to adversely affect the entity.

Form AP 120 in Volume II can be used to assist the auditor in documenting the assessment of the going concern assumption.

Effect on Auditor’s Report

Based on the audit evidence obtained, the auditor should determine if, in the auditor’s judgment, a material uncertain exists related to events or conditions that may cast doubt on the entity’s ability to continue as a going concern. A “material uncertainty” exists when, in the auditor’s judgment, the potential impact is such that clear disclosure in the footnotes is necessary for the presentation of the financial statements not to be misleading.

The diagram on the following page provides a guideline for the auditor to determine the effect of a going concern uncertainty on the auditor’s opinion.
Is going concern assumption appropriate?

Yes

Does a material uncertainty exist?

No

Yes

Are financial statements prepared ongoing concern basis?

No

Yes

Is adequate disclosure made in the footnote?

No

Yes

Are the financial statements prepared on an alternative basis (such as liquidation basis) that the auditor believes is appropriate?

Yes

No

Unqualified opinion

Qualified or adverse opinion

Adverse opinion

Unqualified opinion, with emphasis paragraph added
8.6 Final Review and Approval (Form AP 110)

A final review of the audit working papers, financial statements, audit report, and supporting documentation should be performed. Documentation of the final review should be made by both the staff accountant in charge of fieldwork and a Director of the audit firm, if applicable. A self-explanatory final review checklist is provided in Volume II (Form AP 110).

IX. Preparing and Issuing the Audit Reports

The auditor’s report on the audit of the financial statements and the auditor’s report to management are the deliverable products that result from weeks or months of work conducted by the auditor. The basis of the auditor’s opinion on the financial statements is the audit evidence obtained during the audit and the conclusions drawn from that work.

The terms “auditor’s report” and “auditor's opinion” may seem redundant. In one sense the terms are redundant, but there is a distinction. If the auditor issues a qualified, unqualified, or adverse opinion (defined below), this document may be called either an auditor’s report or an auditor’s opinion. However, if the auditor issues a disclaimer of opinion, this document must be referred to as an auditor’s report because no opinion was given.

The auditor’s report should be discussed thoroughly with management prior to issuance. The auditor should refer to the Mongolian Law on Audit for specific requirements.

9.1 Basic Elements of the Auditor’s Report (or Auditor’s Opinion)

The format of the auditor’s report on financial statements is quite specific, including the following elements:
Title. The report should have an appropriate title, which normally includes the term “Independent Auditor”. Examples: “Report of Independent Auditor” or “Opinion of Independent Auditor”.

Addressee. The auditor’s report should be appropriately addressed as required by local circumstances in Mongolia. According to ISA guidelines, the report is ordinarily addressed either to the shareholders of the representative governing board.

Opening or Introductory Paragraph. The first paragraph of the auditor’s report should:

• Identify the financial statements of the entity that have been audited, including the date of the balance sheet and the period covered by the other financial statements.
• Include a statement that the financial statements are the responsibility of management and a statement that the responsibility of the auditor is to express an opinion on the financial statements based on the audit.

Scope Paragraph. The second (scope) paragraph describes the scope of the audit by stating that the audit was conducted in accordance with ISA and the audit was planned and performed to obtain reasonable assurance about whether the financial statements are free from material error. The report should describe the audit as including:

• Examining, on a test basis, evidence to support the financial statement amounts and disclosures;
• Assessing the accounting principles used in the preparation of the financial statements;
• Assessing the significant estimates made by management in the preparation of the financial statements; and
• Evaluating the overall financial statement presentation.

Opinion Paragraph. The opinion paragraph of the auditor’s report should clearly indicate the financial reporting framework used to prepare the financial statements (IAS) and state the auditor’s opinion as to whether the financial statements give a true and fair view in accordance with IAS.

Depending on the circumstances, the auditor’s report may be “modified” and contain additional paragraphs. Examples of auditor’s reports are included in Volume II of this manual.

9.2 Types of Auditor’s Reports

Unqualified Opinion (Examples 1, 2, and 9 in Volume II)
An unqualified opinion concludes that the financial statements give a true and fair view of the financial position of the company as of (the balance sheet date) and of the results of its operations and its cash flows for the year (or period) then ended in accordance with IAS. This type of opinion should be issued only when none of the conditions noted in the definitions below exist.

Qualified Opinion (Examples 3, 4, 6, 8 in Volume II)
A qualified opinion should be issued when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of a disagreement with management (regarding accounting treatment or adequacy of disclosures) or limitation on scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion. A qualified opinion should be expressed as being “except for” the effects of the matter to which the qualification relates.

**Adverse Opinion (Example 10 in Volume II)**
The auditor should express an adverse opinion when the effect of a disagreement with management (regarding accounting treatment or adequacy of disclosures) is so material and pervasive that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements. In the opinion paragraph, the auditor states that the financial statements do not give a true and fair view.

**Disclaimer of Opinion (Examples 7 and 11 in Volume II)**
In some situations the auditor will not be able to express any kind of opinion on the financial statements. A disclaimer of opinion should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.

**Modified Reports**
An auditor’s report is considered to be modified (deviates from the standard three-paragraph unqualified opinion) in the following situations:
(a) An “emphasis paragraph” is added to an unqualified opinion to highlight a material matter that is disclosed in the footnotes, where the matter is discussed more extensively. Examples include disclosures regarding a going concern problem or significant uncertainties regarding other matters. Note that adding an emphasis paragraph to the auditor’s report in these situations does not change the nature of the opinion (unqualified). (See Example 5 in Volume II).
(b) The auditor issues a qualified or adverse opinion or a disclaimer of opinion. In these situations, the auditor’s report should include a explanation of the reason for the qualified or adverse opinion or disclaimer of opinion. For qualified or adverse opinions, the effect of the departures from IAS or inadequate disclosures should be set forth in the auditor’s report. If the auditor is unable to quantify the effect, this should be stated in the report.

**Going Concern Considerations**
If uncertainties exist about the entity’s ability to continue as a going concern, the auditor must carefully evaluate the effect on the auditor’s report. This matter was discussed in the previous section at 8.5.

**Initial Audits**
If the company’s financial statements for the previous year have not been audited, it may be impractical for the auditor to perform sufficient audit procedures to gain audit satisfaction with regard to opening balances. This may result in a scope limitation imposed on the current year audit. An alternative, if acceptable to the client, would be to perform an audit of only the balance sheet (See Audit Report...
Example 9 in Volume II). In the subsequent year, this situation would no longer exist.

9.3 Issuing the Audit Report and Communicating with the Client

Prior to releasing the auditor’s report, it is important to discuss the results of the audit with the client. Although audit differences have already been discussed and resolved, the auditor should allow the client sufficient time to review the final draft of the financial statements accompanied with the draft auditor’s report.

The auditor should also discuss with the client potential improvements to accounting procedures and internal control matters. Ordinarily, the auditor will want to provide written recommendations, but oral communication is important to avoid misunderstandings. In communicating internal control matters to the client (orally or in writing), it is important that the communication:

- Not include language that is in conflict with the opinion expressed in the auditor’s report.
- State that the accounting and internal control systems were considered only to the extent necessary to determine the auditing procedures to obtain evidence to support the auditor’s opinion on the financial statements.
- State that the auditor’s observations and recommendations are based solely on matters that came to the auditor’s attention as a result of the audit. Therefore, other weaknesses in internal control may exist.
- Include a statement that the communication is provided for use only by management.