Good day fellow AUE 303R Student

As you have shown an interest to assist with the working out of the AUE exam papers, please see this document which one of our fellow students was so kind to forward to me.

You will note that there is ± 5 pages missing - I do apologize - It was not sent to me.

I hope that this will assist you with appropriate preparation and gives you that much needed confidence!

Keep well and all of the best!

Mariechen Jannette Basson

Dear student

I would like to welcome you to the studying of the AUE-303 module. As you are aware you are well into your semester and are, hopefully, beginning to prepare for your exams.
To assist you with this preparation and to ensure that it is done correctly and efficiently we have prepared this tutorial pack for you. This pack should be used in **ADDITTION** to your study guide and textbook. It is **NOT** a replacement of the material that UNISA has sent you. What we, together with your lecturer, have done, is to compile all the most important areas of the module and compile it in a manner that will be easier to understand. We have also taken typical examples of UNISA questions and added them throughout the pack together with their solutions.

We would like to recommend that you study this pack and attempt to answer the question **WITHOUT** looking at the answers. If you have failed at that specific question please make a note of it and ask your lecturer for additional assistance if, after the second attempt you still do not pass it.

We at Boston City Campus and Business College wish you good luck for the rest of your studies and in your exams. We would also like to remind you that all the efforts that you put into your studies now, will pay off in your future.

Regards
Your Lecturing team and
The Boston City Campus and Business College team

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THE AUDITING PROCESS

1) PRE-ENGAGEMENT ACTIVITIES

Perform new client investigation or consider changes in existing clients	*ISQC1 –Quality control*
Determine skills, resources and competence requirements	*and ISA 220 -Quality control*
Consider ethical requirements	
Establish terms of engagement-engagement letter	*ISA 210 –Agreeing terms of engagement*

2) PLANNING ACTIVITIES

Understand the entity and it environment-obtain/update knowledge	*ISA 300-Planning and audit*
Obtain understanding internal control & information system-obtain/update knowledge	
Identify & assess risk of material misstatement at overall financial statement level	
Set planning materiality- Identify & assess risk of material misstatement at assertion level	*ISA 320 – Materiality*
Establish an overall audit strategy	
Develop detailed audit plan	*ISA 315 – Identifying and assessing the risks of material misstatements through understanding the entity and its environment*

3) EXECUTION: TESTS OF CONTROL AND SUBSTANTIVE PROCEDURES

Conduct test of control where required	*ISA 330- The auditors response to assessed risks ISA 500- Audit evidence and ISA 530- Audit sampling*
Evaluate results of control tests & modify planned substantive procedures	
Conduct substantive procedures	
Evaluate results of substantive procedures & conduct further substantive procedures if needed	

4) EVALUATING, CONCLUDING AND REPORTING

Conduct overall review of the financial information & evaluate audit evidence	*ISA 700- forming an opinion and reporting on AFS's*
Conclude and formulate an audit opinion	*ISA 705- Modifications to the*

	opinion in the audit report
Report accordingly	↓

THEORETICAL ASPECTS

THE AUDIT OF FINANCIAL STATEMENTS

Objective of an audit

The objective of an audit of financial statements is to enable the auditor to **express an opinion** as to whether or not the financial statements fairly present, in all material respects, the financial position of the entity at a specific date and the results of its operations and cashflow information for the period ended on that date, in accordance with an identified financial reporting framework and/or statutory requirements.

Postulates of auditing

Postulates are the very foundation on which any discipline is built. Academics have attempted to codify certain underlying principles or postulates, which serve as the basis of auditing theory. A postulate is a concept that can be observed to be relevant to some course of study.

Authors Mautz and Sharaf in their seminal work The Philosophy of Auditing define various concepts this can be seen to be relevant to the present day. Eight postulates were laid down by Mautz and Sharaf and are as follows:

(a) Financial statements and financial data are verifiable.
-This postulate proposes that it is possible to verify the clients financial data and if this was not the case, it would be impossible to perform the audit.
With the advent of transactions, trading on the internet and e-commerce, this postulate is under increasing threat as transactions may not be supported by documentation.

(b) There is no necessary conflict of interest between the auditors and management of the enterprise under audit (both the client and the auditor have the same objective with regards to fair presentation)
-Management is presumed to not want to manipulate the AFS's
Professional skepticism is so important to try and preclude fraudulent behavior as well as a full evaluation of managements integrity.

(c) The financial statements and other information submitted for verification are free

from collusive and other unusual irregularities.
- The auditor can start from the basic premise that the financial statements do not contain misstatement s which have arisen out of collusion or similar deceptions. It is questionable today whether this postulate holds true. Professional skepticism and evaluation of managements integrity are thus crucial for an audit.

(d) The existence of a satisfactory system of internal control eliminates the probability of irregularities.
- The postulates suggest that errors and irregularities become possible rather than probable when controls are strong. Internal controls provide the auditor a starting point when conducting an audit. This postulate is crucial to the economic and operational feasibility of audits.

(e) Consistent application of generally accepted accounting principles (GAAP) results in the fair presentation of financial position and the results of operations.
- This postulate proposes that the application of GAAP does result in fair presentation.
This postulate emphasizes the importance of objectivity and of having to measure 'fair presentation' against a predetermined accepted standard.

(f) In the absence of clear evidence to the contrary, what has held true in the past for the enterprise under examination will hold true in the future.
- The auditor may assume that 'things generally stay the same', and thus historical evidence is crucial. The auditor has to draw on past experience when assessing judgements for the future. Factual historical evidence is far more powerful than speculation.

(g) When examining financial data for the purpose of expressing an independent opinion thereon, the auditors act exclusively in the capacity of auditor.
-The auditors opinion can only be relied upon if he is free of any bias whatsoever. The auditor has to be and seen to be independent if he/she is to retain credibility as an auditor.

(h) The professional status of the independent auditor imposes commensurate professional obligations.
-Professional status implies that the auditor has qualities, knowledge and capabilities which set him/her apart from the general public, but that status brings with it responsibility. Thus, the professional needs to accept certain responsibilities including due care, service before personal interest, efficiency and competence.

Audit evidence & sampling

Audit evidence comprises:
- source documents

- accounting records underlying the financial statements
- corroborative information from other (outside) sources

ISA500: "the auditor should obtain sufficient, appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion":
Sufficient – quantity
Appropriate – quality (reliable and relevant)

Materiality

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

Assertions

Financial statement assertions are assertions by management, explicit or otherwise (by implication), which are embodied by the financial statements.

Assertion	Transactions & events	Year end balances
Completeness	X	X
Occurrence	X	
Accuracy	X	
Cut-off	X	
Classification	X	
Existence		X
Valuation & allocation		X
Rights & obligations		X
Presentation & disclosure	X	X

Audit procedures

Tests of control:
Testing of management's internal control system:
- suitability of design
- effective operation
- throughout the period

Substantive procedures:
Testing of assertions to detect material misstatement in the financial statements

- Tests of details of transactions
- Tests of details of balances
- Analytical procedures

SAMPLING

One of the auditors main objectives is to obtain sufficient and appropriate audit evidence to be able to draw conclusions to support the content of the auditors report. Sufficient audit evidence relates to the amount of audit evidence gathered. As it is not practical to perform audit procedures on all of the transactions, events and year end balances of an auditee, there is a need for scientific methods to reduce the amount of audit testing from 100% and still draw relevant conclusions.
Sampling is an audit tool which is used by an auditor to determine what would constitute "sufficient" audit evidence in a given situation.
Sampling can be divided into two groups, namely statistical and haphazard sampling.

Definitions

-*Audit sampling* (sampling) involves the application of audit procedures to less than 100% of items within a class of transactions or account balance such that all sampling units have a chance of selection. This will enable the auditor to obtain and evaluate audit evidence about some characteristic of the items selected in order to form or assist in forming a conclusion concerning the population from which the sample is drawn. Audit sampling can use either a statistical or a non-statistical approach
It is important that the selection of the sampling units shall be done at random i.e.: each sampling unit must stand an equal chance of being selected because statistical sampling is based on randomness.

-*Anomaly* (Anomalous error) means an error that arises from an isolated event that has not recurred other than on specifically identifiable occasions and is therefore not representative of errors in the population.

-*Error* : Tests of controls ⟶ Deviation from a control procedure
: Substantive procedure ⟶ Misstatement of transaction or balances

-*Population* means the entire set of data from which a sample is selected and about which the auditor wishes to draw conclusions. For example, all of the items in a class of transactions or account balance constitute a population. A population may be divided into strata, or subpopulations, with each stratum being examined separately. The term population is used to include the term stratum.

-*Precision (limits)* is the maximum degree with which the conclusion, based on the sample, is likely to deviate from the true characteristics of the population.
The auditor can only estimate the attribute or value of a population with the aid of a sampling method. The answer cannot be expressed in absolute terms especially in view of the fact that only a part of the population is investigated. The estimation is expressed within certain limits/parameters of precision (reliability) from the acceptable error rate in respect of the population. The precision limits represent the parameters within which you expect the actual answer to fall.

-*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 procedure. There are two types of sampling risk:

(a) Over-reliance: The risk the auditor will conclude, in the case of a test of controls, that controls are more effective than they actually are, or in the case of a substantive test of detail, that a material error does not exist when in fact it does. This type of risk affects audit effectiveness and is more likely to lead to an inappropriate audit opinion; and

(b) Under-reliance: The risk the auditor will conclude, in the case of a test of controls, that controls are less effective than they actually are, or in the case of a substantive test of detail, that a material error exists when in fact it does not. This type of risk affects audit efficiency as it would usually lead to additional work to establish that initial conclusions were incorrect.

The mathematical complements of these risks are termed confidence levels.

-*Non-sampling risk* arises from factors that cause the auditor to reach an erroneous conclusion for any reason not related to the size of the sample. For example, ordinarily the auditor finds it necessary to rely on audit evidence that is persuasive rather than conclusive, the auditor might use inappropriate audit procedures, or the auditor might misinterpret audit evidence and fail to recognize an error.

-*Sampling unit* means the individual items constituting a population, for example cheques listed on deposit slips, credit entries on bank statements, sales invoices or debtors' balances, or a monetary unit.

-*Statistical sampling* means any approach to sampling that has the following characteristics:
(a) Random selection of a sample; and
(b) Use of probability theory to evaluate sample results, including measurement of sampling risk.
A sampling approach that does not have characteristics (a) and (b) is considered non statistical sampling.

-*Stratification* is the process of dividing a population into subpopulations, each of which is a group of sampling units which have similar characteristics (often monetary value).

-*Standard deviation*. The standard deviation of a population is a measure of the central tendency of the value of items in the population around the mean value (normally the arithmetic mean) of the population. The standard deviation is a characteristic of the population and is not subject to the control of the auditor but must be determined by him / her. (By how much an item moves away from its goal)

-*Tolerable error / rate of deviation* mean the maximum error in a population that the auditor is willing to accept whilst still reaching the conclusions that the result from the sample has achieved the audit objective.
Tolerable rate of deviation is expressed as a percentage and usually relates to tests of controls in that the focus is on the rate of deviation from a control procedure.

-*Tolerable misstatement* is a quantitative form of tolerable rate of deviation and involves the application of performance materiality (per ISA 320) to a particular sampling procedure. Tolerable misstatement may be the same amount or an amount lower than performance materiality.

Steps in the sampling process

(Per Auditing Notes)

An important consideration in undertaking a sampling exercise is whether it will be statistically or non-statistically based. The decision will be one of professional judgement, but will be based on the level of assurance required by the auditor, the skills and time available. Regardless of this decision, the steps to be taken remain broadly the same.

1) Determine the objectives of the procedure:
For example the auditor may wish to establish that for every entry in the purchases journal there is a corresponding signed goods received note

2) Determine the procedure to be performed:
This includes specifying clearly the error (deviation or misstatement) condition. So for example in 1 above, the procedure will be to select a sample of entries in the purchases journal (note direction of test) and trace to the purchase invoice and see whether it has a signed GRN attached. The deviation is the absence of the GRN.

3) Confirm that the population is appropriate and complete:
This is the population from which the sample is to be selected and the population upon which an audit conclusion is to be made.
In the example in 1 above, the population will be all purchase journal entries. All units in the population must be available for selection.

4) Define the units of the population:
In the example 1 above, the units will be entries in the purchases journal. The units of the population which are selected for the sample become the units of the sample.

5) Determine the sample size:
The overriding requirement for determining the sample size is whether the sample risk will be reduced to an acceptably low level. For example, if you have a population of 15 000 items and you select a sample of only 20 items; sampling risk will be very high. So the question is how to determine the amount of items to be selected to reduce the sampling risk to an acceptably low level. Professional judgement is crucial in this regard, whether non-statistical (virtually entirely based upon judgement) or statistical (auditor forced to make judgements about specific matters applied to formulas or tables to give sample sizes) approaches are used.

The specific judgments include:

Confidence levels- indicates as a percentage how often a sample will correctly represent the population

Tolerable misstatement- maximum extent of error that the auditor is willing to accept and still feel that the objective of the sampling procedure has been achieved.

Expected misstatement / rate of deviation –Most sampling plans require an estimate of the expected 'error rate' to be made because the greater the anticipated misstatement, the larger the sample size will be to achieve sufficient assurance.

The population size (number of sampling units) - Some sampling plans require that the population size be known to be able to arrive at the sample size. In the above example in point 1, the population will be every entry in the purchases journal.

a) Define the required assurance level (confidence level)

This is the assurance required that the results of the sample will be the same as that for the population. The greater the degree of assurance required, the larger the sample size will be.

For example, if the degree of assurance required is 94% and 100 purchase orders are selected, 94 would be a reliable indication that orders are authorized and valid. However, we would statistically be 94% confident that orders are authorized.

b) Define the precision level

Precision is defined as the maximum degree with which the conclusion, based on the sample, is likely to deviate from the true characteristics of the population.
This involves a statistical computation whereby the precision would vary according to the level of assurance required and the sample size. Low precision and high assurance would

typically be associated with a large sample. Low precision would indicate that the sample is reasonably accurate as a predictor of the extent of deviation or error in the population.

For example, if we assume an assurance level of 95% and precision is 2% for creditors. If the balance for creditors is R100 000, we would be 95% confident that the true value of creditors is between R102 000 and R98 000.

c) Expected error

This is the rate of errors in the population. The larger the expected error, the larger the sample size will be. For example, the auditor may assess the likely portion of unauthorized orders to be 2%.

d) Tolerable error

This is the maximum error in the population that the auditor would be willing to accept and is calculated at the expected error +/- the precision level.
E.g.: expected error is 4% and the precision level is 2%.
Thus, tolerable error will be 4% + 2% = 6

6) Select the sample:
After calculating the sample size (point 5 above), the decision has to be taken as to how to select these items. The following **sample selection methods** could be used:

Random- Every unit must have an equal chance of selection and the selection can be made manually by using random number tables or by computer using random number generation software

Systematic-Selecting a random starting point and then selecting every, say, 20th item. As there may be patterns within the population this is a risky yet cost effective method.

Haphazard- The auditor attempts to simulate randomness by avoiding conscious bias or predictability and not following a structured technique. In a non-statistical sample it is an acceptable technique. It is not a valid method of selection if using statistical sampling as guaranteed randomness is a pre-requisite of the statistical sampling approach.

Block- This involves selection of a block of contiguous (e.g. numerically consecutive) items from within the population.

7) Perform the audit procedure:
The procedure will be carried out per step 2 above.

8) Analyse the nature and cause of deviations and misstatements

The auditor should analyse the sample results and consider the nature and cause of deviations and misstatements identified.

9) Project the sample results over the population
The auditor will calculate the actual number of misstatements/deviations in the sample. Where statistical sampling is used, the auditor will apply the various determinants to a supplied formula or table.

Where non-statistical approach is used some other method of projecting the sample over the population must be applied (e.g. proportion)

10) Evaluate:
Once the sample result is projected over the population it is compared to the tolerable deviation/misstatement. The auditor then concludes on the sample in terms of his or her confidence level and precision if these have been set.

Should the results of a sampling exercise be unsatisfactory, the auditor may:
-request management to investigate the deviation / misstatement and the potential for further deviations / misstatements and make the necessary adjustments.
-modify planned audit procedures (e.g. extend sample sizes; modify nature of the audit procedure).

Steps in the sampling process
(Per -Dynamic Auditing)

1. Define the population (employees) for the period under review.
2. Define the purpose/objectives/nature of the test.
3. Establish the number of items to be selected/sample size/sample units.
4. Establish what will constitute an error in the selection process.
5. Establish the procedures to be performed on the selected items/sampling method.
6. Select the items of the sample from the population (judgment/random/systematic).
7. Perform audit procedures on the selected items/test items/examine items.
8. Evaluate the results of the items tested.
9. Draw a conclusion on the acceptability of the population (if necessary, perform additional substantive procedures).

Factors influencing sampling size

TOC's
Sample sizes would increase where there is:
-Higher intended reliance on internal controls
-Lower tolerable error
-Higher expected error

-Higher level of assurance required from the sample
-Larger number of items

Substantive procedures
Sample sizes would increase where there is:
-Higher control risk: (sample sizes would decrease as control risk decreases (results of TOC's))
-Sample sizes would decrease where there are other substantive procedures aimed at the same objective
-Higher importance (materiality) of the account balance/class of transaction
-Higher level of assurance required from the sample
-Lower tolerable error
-Higher expected error
-Use of stratification
-Larger number of items

Advantages and disadvantages of statistical sampling

Advantages
-A greater element of surprise exists, as tests are spread throughout the year, which differs from the traditional months, weeks or days.

-Emphasis could be placed on important items (e.g. higher value items, if stratification is used)

-The auditor could place more reliance on his/her procedures as this reliance is statistically determined. In case of alleged negligence the auditor will have a better defence.

-The computer could be used to a greater extent to select items, perform calculations, etc.

-Audit personnel will use more initiative as they have a better understanding and appreciation of the system

-Audit personnel will have a better understanding of the system as the client's system, especially internal controls, was tested earlier on.

-An objective selection of items is done. Judgement factors play no role.

-Statistical methods provide definition and empirical assessment of the risks involved in audit sampling.

-With a large population, the test is smaller than with other techniques. The sample size does not increase in proportion to the size of the population.

-This might be more economical technique owing to smaller samples

-Quicker availability of information than with other techniques

Disadvantages

-Special training of personnel is necessary. Where audit personnel change regularly, this may involve large costs for the auditor.

- This can be an expensive technique due to the time it takes to determine and select the sample

-This is usually not appropriate for the audit of smaller undertakings. Lack of internal controls may force the auditor to test all items or perform extensive substantive procedures.

-Only one aspect of the audit can be tested at any one time.

-The conclusion reached is applicable only to the population from which the items were selected

-Where the items in the sample are not sequential, the search for the items can be time consuming and expensive.

Systematic sampling method

Step 1) Define the population
Step 2) Determine the number of items in the population
Step 3) Determine the sample size
Step 4) Calculate the interval:
Population size ÷ sample size = interval
Step 5) Choose a random starting point (E.g. between the first cheque number and the interval)
Steps 6) systematically select the sample units by adding the interval per step 4 to the previous item, starting with the random starting point (step 5)
Step 7) Ensure there is no repetitive pattern in the population and that the result is not an unrepresentative

Monetary unit sampling

Step 1) Determine the total value of the population
Step 2) Decide on a confidence level after the internal control has been evaluated
Step 3) Decide on the level of monetary precision
Step 4) Convert the confidence level to a reliability factor using an appropriate table
Step 5) Calculate the J-factor
Step 6) Calculate the sample size
Step 7) Draw the sample
Step 8) Examine the sample items
Step 9) Draw conclusions & consider any further steps

THE OVERALL AUDIT PLAN
The accounting system

The auditor needs to obtain an understanding of the accounting system.

The following method can be employed to identify activities or actions in an accounting system for various transactions and / or balances:

- Identify the authorisation for the transaction (e.g. sales manager authorises sales)
- Identify the source documents relevant to the transaction (e.g. delivery note, sales invoice)
- Identify the information contained in the source documents which can be used to validate the transaction (e.g. debtor name, date, amount)
- Identify the accounting records for recording the transaction (e.g. sales journal)
- Identify the accounting entries required to record the transaction (e.g. sales journal, debtors ledger)
- Identify the method of handling ledger balances in the accounting system up to the disclosure in the financial statements (e.g. debtors, allowance for credit losses)
- Identify the possible sources from which external audit evidence can be acquired to substantiate the audit objectives (e.g. debtors confirmation letter)

Using the computer to obtain audit evidence

- Enquire and/or retrieve computer stored data
- Scrutinise files / data using specified criteria
- Determine the accuracy of computations
- Perform audit procedures according to specified criteria, e.g. reasonable tests, exception reports

- Computer assisted audit techniques (CAAT's), e.g. test data, parallel simulation
- Correspondence, reports (word processing)
- Analytical review techniques

Proper formulation of audit procedures

Audit procedures are instructions to audit staff and should be formulated using the following verbs (as opposed to "ensure that" or "check"):

- Inspect
- Observe
- Enquire
- Confirm
- Calculate
- Recalculate
- Reperform

PRELIMINARY ENGAGEMENT ACTIVITIES

Points to consider before accepting an audit engagement

The following should be considered before accepting or renewing an audit engagement:

- availability of sufficient, suitable personnel
- independence of the auditor and his staff
- business reputation and integrity of management and the client (business risk)
- changes in the entity e.g. changes in management or ownership

An auditor acting for a client is exposed to 2 kinds of risk:

- audit risk (see previous chapters)
- auditor's business risk

Business risk is the risk:

- of loss or prejudice to an auditor's professional practice owing to unfavourable publicity or events that arise in relation to the AFS on which the auditor reports
- that the client will not pay their auditing fees
- of negative influence on the auditor's reputation arising from his connection with certain clients

If business risk is assessed as high, the auditor should not accept the engagement. However, should the auditor decide to take on the client, a more conservative view regarding overall audit risk should be adopted (resulting in increased audit work).

ISA 210 -AGREEING THE TERMS OF AUDIT ENGAGEMENTS

The objective of the auditor is to accept or continue an engagement only when the basis upon which it is to be performed has been agreed through establishing whether the preconditions for the audit are present & confirming that there is a common understanding between the auditor and management (those charged with governance) of the terms of the engagement.

Important elements of ISA 210

1. The auditor and client should agree on the terms of the engagement.
2. On recurring audits, the auditor should consider whether or not circumstances require the terms of the engagement to be revised and whether or not there is a need to remind the client of the existing terms of the engagement.
3. An auditor that who before the completion of an engagement, is requested to change the engagement to one that provides a lower level of assurance, should consider the appropriateness of doing so.
4. Where the terms of an engagement are changed, the auditor and client should agree on new terms.
5. The auditor should not agree to a change of engagement where there is no reasonable justification for doing so.
6. If the auditor is unable to agree to a change of the engagement, and is not permitted to continue the original engagement, the auditor should withdraw and consider whether or not there is any obligation, either contractual or otherwise, to report to

other parties, such as the board of directors or the shareholders, the circumstances necessitating the withdrawal.

The auditor and client should agree on the terms of an engagement. The agreed terms should be found in an audit engagement letter or in another suitable from such as a contract.

Audit engagement letters:

Before an engagement commences, the auditor should give a client an engagement letter.

The engagement letter would usually include the following:

1. The objective of the audit of the financial statements,
2. Management responsibility for the financial statement,
3. Management's responsibility to implement and maintain internal control systems to prevent errors and irregularities including fraud and illegal acts.
4. The scope of the audit, including reference to any applicable legislation, regulations, or generally accepted auditing standards.
5. The form of any reports or other communication of results of the engagement,
6. The fact that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of a system of internal control, there is an unavoidable risk that even some material misstatement may remain undiscovered, and
7. Access to whatever records, documentation other information needed in connection with the audit.

The auditor may also want to include the following in the letter

- Arrangements relating to the planning of the audit.
- Expectation of receiving from management written confirmation concerning representations made in connection with the audit.
- Descriptions of any other letters or reports the auditor expects to issue to the client.
- Basis on which fees are computed and any billing arrangements
- Request for the client to confirm the terms to the engagement by acknowledging receipt of the engagement letter.

The auditor may also wish to include:

- Arrangements concerning the involvement of other auditors in some aspects of the audit.
- Arrangements concerning the involvement of internal auditors or other client staff.
- Arrangements, if any, to be made with the predecessor auditor, in the case of an initial audit.
- Any restriction of the auditor's liability when such possibility exists per the APA allows an auditor to disclaim liability.
- A reference to any further agreements between the auditor and client

When the auditor of a parent entity is also the auditor of the subsidiary, branch or division, the factors influence the decision whether or not to send a separate engagement letter to the component include the following:

- Who appoints the auditor of the component?
- Whether or not a separate audit report is to be issued on the component.
- Legal requirements.
- The extent of any work performed by the other auditor.
- Degree of ownership by the parent.
- Degree of independence of the component's management

There are other points that may be included in the engagement letter at the option to the auditor. These may be found in the appendices to the statement.

Recurring audits

On recurring audits, the auditor should consider whether or not circumstances require the terms of engagement to be revised and whether or not there is a need to remind the client of the existing terms of engagement.

There is no need to send a new engagement letter each period. This is at the discretion of the auditor. However, if there is any change in the structure or management of the client, or the auditor believes that management did not understand the terms of the previous engagement letter, anew engagement letter should be issued.

If an auditor does not send a new engagement letter, the client should be reminded of the old engagement letter.

An auditor, who before the completion of an engagement, is requested to change the engagement to one that provides a lower level of assurance, should consider the appropriateness of doing so.

The following would usually be a reasonable basis for changing an engagement letter:

1. A change in circumstances that effects the entity's requirements, and
2. A misunderstanding concerning the nature of services orlginally requested.

The following would not usually be a reasonable basis for changing an engagement letter:

1. a change relating to information that is incorrect, incomplete, or otherwise unsatisfactory and
2. changes that imply a scope restriction.

PLANNING ACTIVITIES

Advantages of adequate audit planning:

- helps to ensure that due attention is given to important areas of the audit
- helps to ensure that potential problems are expeditiously identified
- helps to ensure that the work is timeously completed
- makes it easier to properly allocate work to assistants
- assists in the co-ordination of work done by other auditors and experts

Knowledge and understanding of the business and internal controls

The auditor should obtain knowledge under the following main categories

a) **General economic factors:**

- recession / period of growth
- taxes
- inflation etc.

b) **The industry – important conditions affecting the client's business**

- Specific reporting requirements

- Environmental restrictions

c) Aspects relating to the entity

- Management and ownership (corporate structure, board of directors)
- Nature of the entity's business (franchises, major suppliers)
- Financial performance and profitability (ratios, trends, operating statistics)
- Reporting environment (deadlines, profit share)
- Statutory and non-statutory requirements (taxation, regulatory agency)

Acquiring knowledge of a client's business

- The acquisition of knowledge is a cumulative process and should not be limited to acceptance of the engagement. The auditor should continually update his knowledge of the business by gathering and evaluating information and comparing it to audit evidence that has previously been collected.
- For continuous engagements, the auditor would have to update and re-evaluate previously collected information. Significant changes would be investigated and documented.

The auditor can obtain knowledge of the business from the following sources (amongst other):

- Previous experience of the entity and type of business
- Discussions with internal auditors
- Inspection of internal auditor reports
- Discussions with client staff
- Publications relating to the industry
- Legislation and regulations affecting the entity
- Documents supplied by the entity
- Discussions with experts
- Examination of official documents e.g. tax returns

Application of the knowledge of a client's business
The auditor uses his knowledge of the business:

- to weigh up the AFS and consider whether the assertions contained therein agree with his knowledge of the business
- as a frame of reference that will enable him to exercise professional judgement

Assessment of inherent risk

- During the planning stage the auditor should assess inherent risk at the overall financial statement level
- The objective of assessing inherent risk is to:
  - -identify high risk areas which may require special attention
  - -assess the possibility that material errors may be present in the AFS

- Should the auditor automatically choose to accept inherent risk as high (i.e. without basing this assessment on audit testing), he would carry out extensive substantive procedures to reduce detection risk to a level that would result in acceptable audit risk
- The above approach is, however, only applicable where the auditor feels that the effort required is to assess inherent risk exceeds the benefits of reduced substantive procedures.

Obtain an understanding of the accounting and internal control systems

- The auditors understanding of the accounting and internal control systems should:
- Be sufficient to enable the auditor to develop an effective and efficient overall audit plan
- Include specific information relating to the control environment and control procedures
- Be documented
- If sufficient evidence is obtained to indicate all systems are functioning reliably throughout the period under review, the auditor would rely provisionally on the assumption that the accounting and internal control systems produced reliable financial information during that period.

Preliminary assessment of control risk

- The preliminary assessment of control risk is done according to the assertions for each accounting balance or class of transaction
- The auditor's assessment is based on the identification of effective internal controls for preventing, detecting or rectifying any material misstatements that could affect the fair presentation of the AFS
- The auditor may then accept the accurate functioning of the controls when auditing any representations

Where control risk is assessed as low, the auditor should carry out tests of control to obtain evidence that the internal controls operated as designed throughout the period under review.
Where control risk is assessed as high, the auditor should:
Determine what possible errors and irregularities could occur as a result of weakness in the accounting and internal control systems.
Decided on appropriate substantive procedures to detect such errors.

Advantages of developing and documenting an overall auditing plan:

- Helps the auditor analyze factors that influence audit decisions
- Provides a framework to help the auditor evaluate the efficiency, effectiveness and

completeness of the planned audit procedures
- A means of introducing the audit approach the audit team

The audit plan may require revision throughout the audit the process.
The overall audit plan should take into account the following:

-determining the stages at which the audit should be conducted
-allocating personnel to the audit to ensure that audit tasks are only assigned to competent persons

AUDIT MATERIALITY AND RISK (ISA 320 and ISA 315-overview)

What is the relationship between audit risk and materiality?

There is an inverse relationship between materiality and the level of audit risk. The higher the materiality level, the lower the acceptable level of audit risk will be, and vice versa.
Thus the higher the assessment of audit risk, the lower (smaller) the amount that would be specified as the material amount in order to avoid failing to detect any possible misstatements in the financial statements.
If the assessment of audit risk is determined to be low, the materiality level will be set at a higher amount because there is only a very small chance that material misstatements could occur and remain undetected.

Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

The size of an error thus could influence the economic decisions of the users of financial statements. The materiality level will in essence be an accepted level or threshold of misstatements detected.

Materiality is thus a fundamental principal and should be calculated and considered by the auditor at the following stages:

- Planning materiality: Determining the nature, timing and extent of audit procedures (planning stage)
-Performance materiality: During the performance of the audit (execution stage)
- Final materiality: Evaluating the effect of misstatements (final/conclusion stage).

1. ***Planning materiality*** (Risk assessment phase*):*

When planning the audit, the auditor makes judgements about the size of misstatements that will be considered material. Having an idea about the size of misstatements he / she is looking for will help the auditor in:
-Determining the nature, timing and extent of risk assessment procedures
-Identifying and assessing the risk of material misstatements
-Determining the nature, timing and extent of further audit procedures

Planning materiality is an overall guideline to the audit and is the auditors judgements as to the amount of misstatements a user can 'live with'.

There will be a planning materiality level set for the financial statements as a whole and planning materiality levels (of a lesser amount)to be applied to classes of transactions, account balances and disclosures.

2. ***Performance materiality*** (further procedures phase)*:*

The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures.
Performance materiality directly influences the extent (and nature and timing) of further audit procedures which are conducted by the auditors on a particular class of transactions or account balances

Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Similarly, performance materiality relating to a materiality level determined for a particular class of transactions, account balance or disclosure is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and

undetected misstatements in that particular class of transactions, account balance or disclosure exceeds the materiality level for that particular class of transactions, account balance or disclosure. The determination of performance materiality is not a simple mechanical calculation and involves the exercise of professional judgment. It is affected by the auditor's understanding of the entity, updated during the performance of the risk assessment procedures; and the nature and extent of misstatements identified in previous audits and thereby the auditor's expectations in relation to misstatements in the current period.

Basically, performance materiality will be set when the auditor performs tests on specific account balances or classes of transactions.
Eg: If planning materiality is set for trade creditors at R100 000, that means that fair presentation of trade creditors will be achieved even if material misstatements of up to R100 000 are not detected.
So the question is whether the auditor, when carrying out procedures on trade creditors, is his / her only objective to be solely to detect errors which are individually over R100 00?
The answer is no. The R100 000 planning materiality is the total or maximum amount of misstatement which the auditor considers to be acceptable for creditors. If the auditor looks only for individual errors of R100 000 he / she will be overlooking the fact that the balance could be overstated by individual errors of less than R100 000, but in aggregate could exceed R100 000.
Performance materiality is again a matter of professional judgement.
Performance materiality levels are lower / stricter than planning materiality levels, larger samples (extent) will be tested as the auditor will not be looking for individual errors exceeding R100 000, but rather smaller errors when added together exceed R100 000.

Revision of planning and performance materiality:
Planning and performance materiality may be modified by the auditor through the audit process.
Planning materiality was an 'estimate' of what users would regard as an acceptable level of misstatement that would not impact their decisions. If something subsequently affects this initial estimate, he / she may change the materiality levels.

Performance materiality directly influences the extent (and nature and timing) of further audit procedures which are conducted by the auditors on a particular class of transactions or account balances.
The auditor sets performance materiality to match his / her assessment of risk of material misstatement in the class of transactions or account balances, so if information comes to the auditor which changes his / her initial assessment of material misstatement, the performance materiality may need to change.

3. ***Final materiality at evaluation stage***

The auditor's determination of materiality in accordance with ISA 320 is often based on estimates of the entity's financial results, because the actual financial results may not yet be known. Therefore, prior to the auditor's evaluation of the effect of uncorrected misstatements, it may be necessary to revise materiality determined in accordance with ISA 320 based on the actual financial results.
ISA 320 explains that, as the audit progresses, materiality for the financial statements as a whole (and, if applicable, the materiality level or levels for particular classes of transactions, account balances or disclosures) is revised in the event of the auditor becoming aware of information during the audit that would have caused the auditor to have determined a different amount (or amounts) initially.
Thus, any significant revision is likely to have been made before the auditor evaluates the effect of uncorrected misstatements. However, if the auditor's reassessment of materiality determined ,gives rise to a lower amount (or amounts), then performance materiality and the appropriateness of the nature, timing and extent of the further audit procedures are reconsidered so as to obtain sufficient appropriate audit evidence on which to base the audit opinion.

Each individual misstatement is considered to evaluate its effect on the relevant classes of transactions, account balances or disclosures, including whether the materiality level for that particular class of transactions, account balance or disclosure, if any, has been exceeded.
If an individual misstatement is judged to be material, it is unlikely that it can be offset by other misstatements. For example, if revenue has been materially overstated, the financial statements as a whole will be materially misstated, even if the effect of the misstatement on earnings is completely offset by an equivalent overstatement of expenses. It may be appropriate to offset misstatements within the same account balance or class of transactions; however, the risk that further undetected misstatements may exist is considered before concluding that offsetting even immaterial misstatements is appropriate.

ISA 500 –AUDIT EVIDENCE

The auditor shall design and perform audit procedures that are appropriate in the circumstances for obtaining sufficient and appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw conclusions on which to base the audit opinion.

Audit evidence: The information used by the auditor in arriving at the conclusions of which his/her audit opinion is based, and includes information contained in the accounting records underlying the financial statements and other information.

Accounting records: This generally includes the records of accounting entries and supporting records such as cheques and electronic transfer records, invoices, contracts, and the general and subsidiary ledgers, journal entries, etc.

The audit evidence obtained should be:
-Sufficient: that is, of the right *quantity* and the right *quality*, and
-Appropriate: that is, *relevant* and *reliable*.

The auditor obtains audit evidence by means of:
- Risk assessment procedures;
- A combination of tests of controls and substantive procedures; and
- In some circumstances, entirely from substantive procedures

1) Risk assessment procedures
Consist of:
-Enquiries of management and others within the entity (e.g. employees internal audit, internal legal council, etc);
-Observation and inspection (operations, documents, records, control manuals, management reports, premises and plant facilities, etc.); and
-Analytical procedures

2) Tests of controls

These are audit procedures designed to evaluate the operating effectiveness of controls in preventing, detecting and correcting material misstatements at the assertion level.

Specifically they will test:
- The suitability of the design of the internal controls to prevent, detect and correct material misstatements (fraud and error); and
- The existence and effective operation of the systems throughout the period of reliance.

3) Substantive procedures

These are audit procedures designed to detect material misstatements at the assertion level.

They consist of:
- Test of details of transactions, balances and disclosures; and
- Substantive analytical procedures

The nature, timing and extent of substantive procedures will depend on:
- Risk of material misstatement of the financial statement assertions;
- The appropriateness and reliability of audit evidence that can be obtained by means of substantive procedures;
- The results of the tests of controls (effectiveness of internal controls)

The auditor must design and perform substantive procedures for each material class of transaction, accounts, balances and disclosure. This depending on the circumstances consists of:

- Substantive analytical procedures only;
- Tests of details only;
- A combination of substantive analytical procedures and tests of details.

The auditor obtains audit evidence by means of one or more of the following procedures:

-Inspection of records or documents and of tangible assets;
-Observation of a process or procedure (note that this is limited to the moment at which the observation took place);
-Making inquiries of knowledgeable persons, both financial and others, from the entity or outside the entity;
-External confirmation of information as a written response to the auditor from a third party;
-Recalculation of the mathematical accuracy of documents or records;
-Re performance by the auditor, manually or through CAATs, of procedures or controls; that was originally performed as part of the entity's internal control;
-Analytical procedures of financial and non-financial data.
Details of substantive testing of transaction from source to trial balance -
Other: & tracing
-The auditor must obtain audit evidence for each assertion in the financial statements.
-Audit evidence is often more persuasive than conclusive.
-Audit evidence is more persuasive if evidence from different sources is consistent.
-Where audit evidence from different sources or of a different nature is inconsistent, the auditor must perform additional procedures to resolve the inconsistency.
-Consideration should be given to the cost involved in obtaining audit evidence and the usefulness thereof.
-If unable to obtain sufficient appropriate audit evidence, the auditor should express a qualified opinion or a disclaimer of opinion.

ISA 505-EXTERNAL CONFIRMATIONS

External confirmation is audit evidence obtained as a direct response to the auditor from a third party (the confirming party) in paper, electronic or other form.
External confirmations obtained by the auditor can be an effective way of obtaining sufficient appropriate audit evidence, because:
-external confirmations are more reliable than internal evidence;
-written evidence is more reliable than oral evidence; and
-evidence obtained directly by the auditor from 3rd parties provides the highest level of audit assurance.

External confirmations are used mainly to verify account balances, but are also suitable for confirmation of the terms of agreements, contracts or transactions with third parties.

Situations where external confirmations may be used include the following:
-bank balances and other information;
-accounts receivable (debtors) balances;
-inventory held by third parties;
-share certificates held by third parties;
-title deeds and investment certificates held by third parties;
-loan balances; and
-account payable (creditors) balances.

Positive versus negative confirmations

Positive confirmations
A positive confirmation request asks the respondent to respond directly to the auditor in all cases & is ordinarily expected to provide audit evidence with a high level of reliability.
The risk exists that a respondent may reply without verifying that the info is correct.

Negative confirmations
A negative confirmation request asks the respondent to respond only in the event of disagreement with the information provided in the request. Negative confirmations provide less persuasive audit evidence than positive confirmations. The auditor shall generally not use negative confirmation requests as the sole substantive procedure to address risks of material misstatement at assertion level unless:
-the assessed risk of material misstatement is low;
-a population consists of large numbers of small items;
-a low exception rate is expected;
-no reason exists to believe that respondents will disregard these requests.

The reliability of external confirmations will depend on the procedures applied by the auditor in respect of:
-the design of the confirmation required;
-performance of and control over the confirmation procedures;
-the evaluation of the results of the confirmation procedures.

ISA 510-INITIAL ENGAGEMENTS – OPENING BALANCES

Opening balances:
These are account balances that exist at the beginning of the period. Opening balances are based on the closing balances of the prior period and reflect the effects of transactions and events of prior periods and accounting policies applied in the prior period. Opening balances also include matters requiring disclosure that existed at the beginning of the period, such as contingencies and commitments.