

RELEVANT TO FOUNDATION LEVEL PAPER FAU / ACCA QUALIFICATION PAPER F8

## Audit procedures

Audit procedures are an important area of the syllabus, though candidates often use inappropriate audit procedures to answer questions. The following tips will help you to understand the concepts and write appropriate audit procedures.

Every procedure must state:

- the assertion tested
- the audit procedure
- the reason for the procedure.

Each of these points is explained below.

### STEP 1 – IDENTIFY THE ASSERTION TESTED

Audit procedures are performed in order to test financial statement assertions. Therefore, the first step in explaining an audit procedure is to **identify the assertion that needs to be tested**.

The assertions embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur, may take the following forms:

Transactions and events	Account balances at the period-end	Presentation and disclosure
<ul style="list-style-type: none"> <li>• Occurrence</li> <li>• Completeness</li> <li>• Accuracy</li> <li>• Cutoff</li> <li>• Classification</li> </ul>	<ul style="list-style-type: none"> <li>• Existence</li> <li>• Rights and obligations</li> <li>• Completeness</li> <li>• Valuation and allocation</li> </ul>	<ul style="list-style-type: none"> <li>• Occurrence and rights and obligations</li> <li>• Completeness</li> <li>• Classification and understandability</li> <li>• Accuracy and valuation</li> </ul>

A brief explanation of the various assertions is as follows:

### Completeness

This means that *all* transactions have been recorded in the financial statements – ie all assets, liabilities, equity interests (capital and reserves) and other disclosures have been included in the financial statements.

### Occurrence

This assertion means that transactions and events and other matters that have been recorded actually took place – and relate to this organisation.

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### Valuation and allocation

This means that all items have been included in the financial statements at appropriate amounts according to company policy and the relevant financial reporting framework. Furthermore, any allocations or valuation adjustments required (like impairment) have been made and financial and other information is disclosed fairly and at appropriate amounts.

### Classification and understandability

Financial information is appropriately presented and disclosed, and disclosures are clearly expressed so as to make them understandable to the users. For this, the disclosures should use simple language and state matters clearly and concisely.

### Accuracy

Accuracy means that amounts and other data relating to transactions and events have been recorded at the correct amounts – ie at the amounts appearing in the source documents.

### Rights and obligations

This means that the entity has a right to its assets – ie it is free to use or dispose of the assets as it sees fit. Furthermore, the entity is obliged to pay off the liabilities that are shown in the statement of financial position.

### Existence

This means that assets, liabilities and equity interests (capital and reserves) are physically present/belong to the entity on the reporting date.

### Cutoff

This means that transactions and events have been recorded in the correct accounting period – for example, if goods are delivered prior to year end, they are included in the cost of goods sold, not inventory.

## STEP 2: IDENTIFY THE AUDIT PROCEDURE

	Explanation	Example of substantive procedure relating to valuation of property, plant and equipment (PPE)
1	Choose the assertion that will be tested	Choose an assertion from Completeness, Valuation and allocation, Rights and obligations and Existence if you are testing the period-end balance of PPE; valuation of non-current assets is the assertion tested
2	Identify the risk that will cause a material misstatement in the financial statements – the audit risk is the total value of PPE that may be misstated due to over-valuation/ undervaluation of PPE	One risk relates to the revalued assets not representing fair values, thus under/ overstating PPE

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<p><b>3</b></p>	<p>Think of the audit procedures that should be performed in order to avoid the risk mentioned in step 1 (refer to 'AEIOU' below)</p>	<p>The auditor will agree the availability of a revaluation report (a source document for the revaluation) and confirm that the value mentioned in the valuation report matches the amount at which the PPE is revalued and shown in the financial statements.</p> <p>Furthermore, the auditor will recalculate the revaluation surplus in accordance with the provisions of IAS 16, <i>Property, Plant and Equipment</i> to confirm the correctness of the accounting entries relating to revaluation surplus. The amount added to revaluation surplus should be the difference between the net book value of PPE and the revalued amounts.</p> <p>The auditor should agree the assumptions used in the report for reasonableness. For example, the value per square feet in the valuation report should be similar to the value per square feet of other similar properties in that locality.</p> <p>There are many more procedures that will apply to this risk.</p>
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Follow the above method for testing other assertions too.

### Choose audit procedures from AEIOU

- A: **A**nalytical procedures
- E: **E**nquiry and confirmation directly from a third party – ie inquiry
- I: **I**nspection of records and assets
- O: **O**bservation
- U: **U** recalculation and reperformance

### STEP 3: NOTE THE FOLLOWING WHILE WRITING DOWN THE AUDIT PROCEDURE

#### 1 Write it clearly

Audit procedures should be written in such a way that even a junior auditor will be able to understand what is to be done. For example, avoid vague procedures like 'check goods received notes'. This is vague as it does not explain what is to be examined in the goods received notes. Is it the description of items received, the quantity received or the name of the vendor?

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### 2 Write down the reason for performing the audit procedure

The audit procedure 'check goods received notes' does not mention why the goods received notes are to be checked. Instead, write the audit procedure as: 'agree the description of items and the quantities ordered mentioned on the goods received note with the descriptions on the purchase orders raised on the vendor'. This confirms that the entity has procured goods based on an authorised purchase order.

### 3 Use audit terminology

Use terminology relating to audit like 'cast', 'agree', 'trace', etc.

- Use the word 'cast' to mean totalling up a list – for example, 'cast the trial balance'.

Use the words 'agree' or 'trace' to mean matching information from two documents/ records – for example, 'agree the total sales of the sales day book to the general ledger account'; or 'trace a sample of trade payables to the purchase invoices, to confirm the existence of the rights to the goods purchased'.

### A complete audit procedure would read as follows:

The auditor will agree a sample of items from the inventory sheets to the raw material inventory<sup>1</sup> to ensure that the inventory recorded on the sheets actually exists<sup>2</sup>. This will confirm the assertion of existence of inventory as an asset in the financial statements<sup>3</sup>.

*(1 = the audit procedure; 2 = the reason for the audit procedure; 3 = the assertion).*

If the above mentioned procedure is written as 'The auditor will check a sample of items from the inventory sheets to the raw material inventory', it is incomplete as it does not mention why the audit procedure is being performed.

## COMMON ERRORS THAT MUST BE AVOIDED

The examiner's reports mention various errors that candidates make while writing audit procedures. Here is a summary of the common errors.

While writing audit procedures, avoid the following:

- Writing an audit procedure without explaining the reason for the procedure** – for example, 'The auditor will check a sample of items from the inventory sheets to the inventory.'
- Stating an assertion word as a reason for performing a procedure** – for example, 'confirming the occurrence of sales'.

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- c) Writing what the internal control system should do rather than stating the audit procedure** – for example, ‘for all goods received, there should be a goods received note raised’.
- d) Writing vague procedures** – for example, ‘check the invoice’, ‘check the goods received note’, etc. These procedures are inappropriate as they do not mention what is to be checked and the reason for checking them.
- e) Quoting incorrect assertions** – for example, ‘tracing details from the purchase orders to the goods received notes in order to confirm existence of the goods’ – the completeness assertion would apply here.
- f) Including procedures that cannot be carried out** – for example, ‘agree individual items of physical inventory to the sales invoice’. It will not be possible to agree the physical goods to the sales invoice as the goods will already be sold.
- g) Including procedures that are incorrect** – for example, ‘agree details from the purchase orders (like description of items ordered, quantities ordered) to the goods held in the inventory store’. This is an incorrect audit procedure as goods received notes (not purchase orders) are used to update inventory.
- h) Writing impractical procedures** – for example, suggesting a segregation of duties between the person authorising petty cash vouchers, recording petty cash vouchers and dispensing the petty cash.
- i) Writing irrelevant audit procedures** – for example, when you are asked to write audit procedures relating to depreciation of a non-current asset, it will be inappropriate to provide general audit procedures relating to audit of non-current assets.

Audit procedures are a vital part of Paper F8 and Paper FAU. Therefore, you need to practise explaining the audit procedures as suggested above in order to perform well in the exam.

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