

Practical Auditing, *A beginner's guide* (2023 Edition)

Presented By Israel Usidamen

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Brief profile of the presenter



Israel Usidamen

- Practiced audit for about 8 years before moving to the industry.
- Experienced finance professional having served as Financial Controller of a listed entity in Nigeria and currently leads the finance dept of a foremost downstream oil & gas company.
- Prize winner with **Institute of Chartered Accountants of Nigeria (ICAN).**
- Teaches financial and corporate reporting at Wyse Associates Limited.
- Co-Founder at Accounting Yard, a brand that seeks to bridge the gap between practical accounting and theoretical accounting.

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How does the audit process look?

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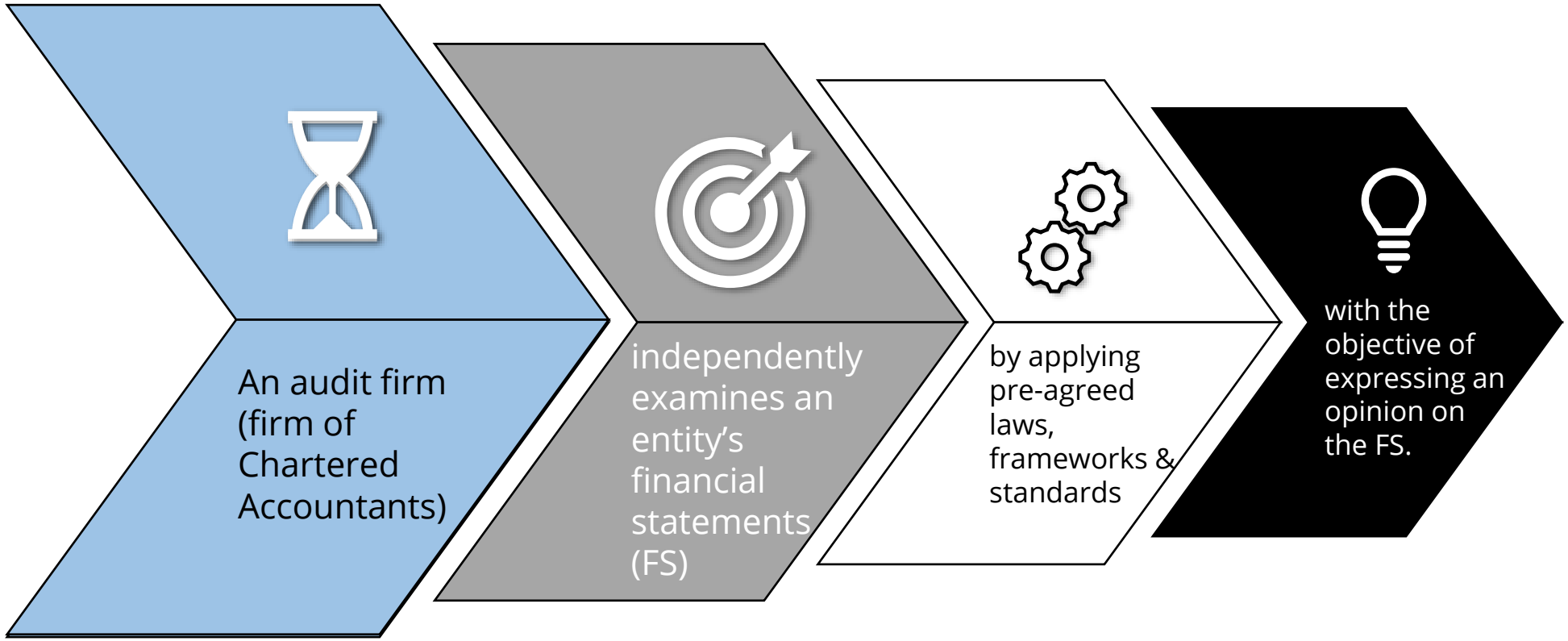
What is a financial statement audit?



We will be learning the audit approach required by the International Standards on Auditing (ISA) which is largely **risk based.**

Two parties are involved in the audit work: the auditor and the client.



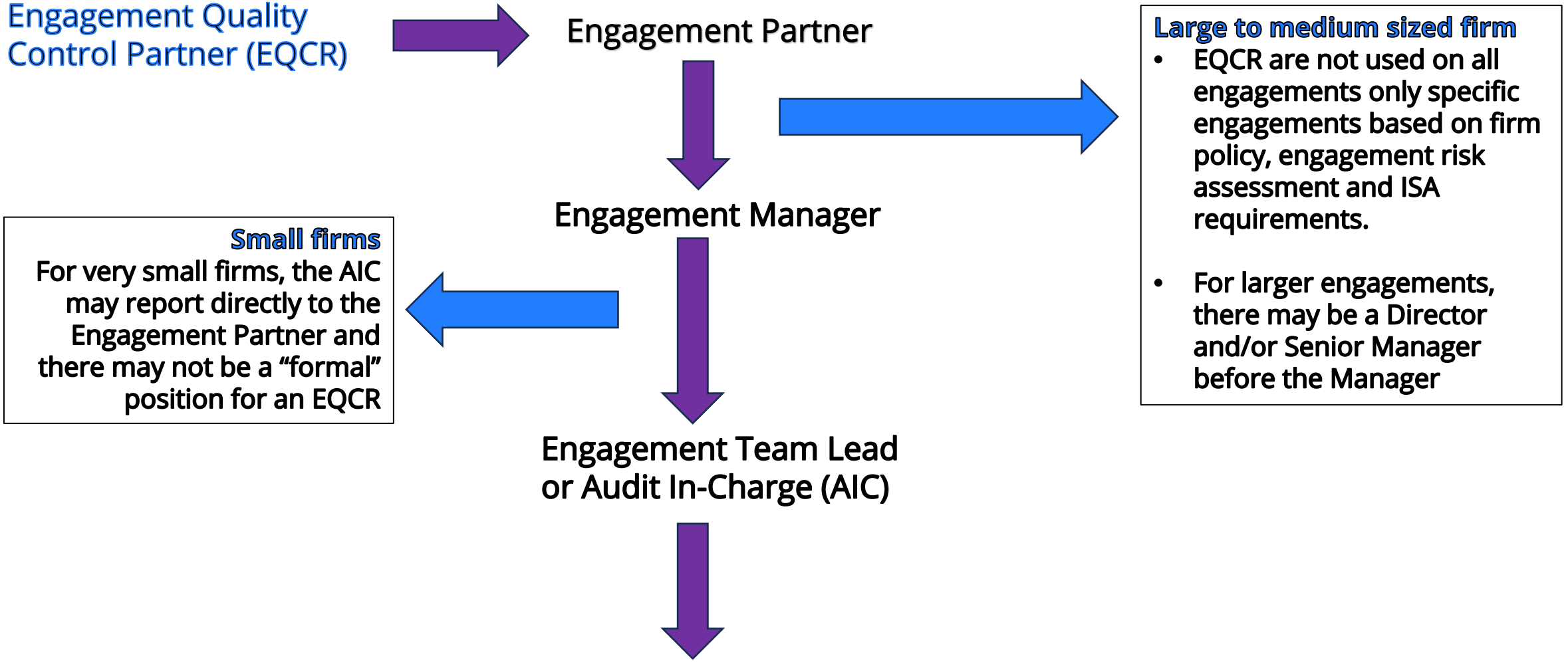
Audit firm

The Audit Team interfaces with the representatives of the Company (typically called “Client”). They work to gather evidence which form the basis for expressing their opinion.

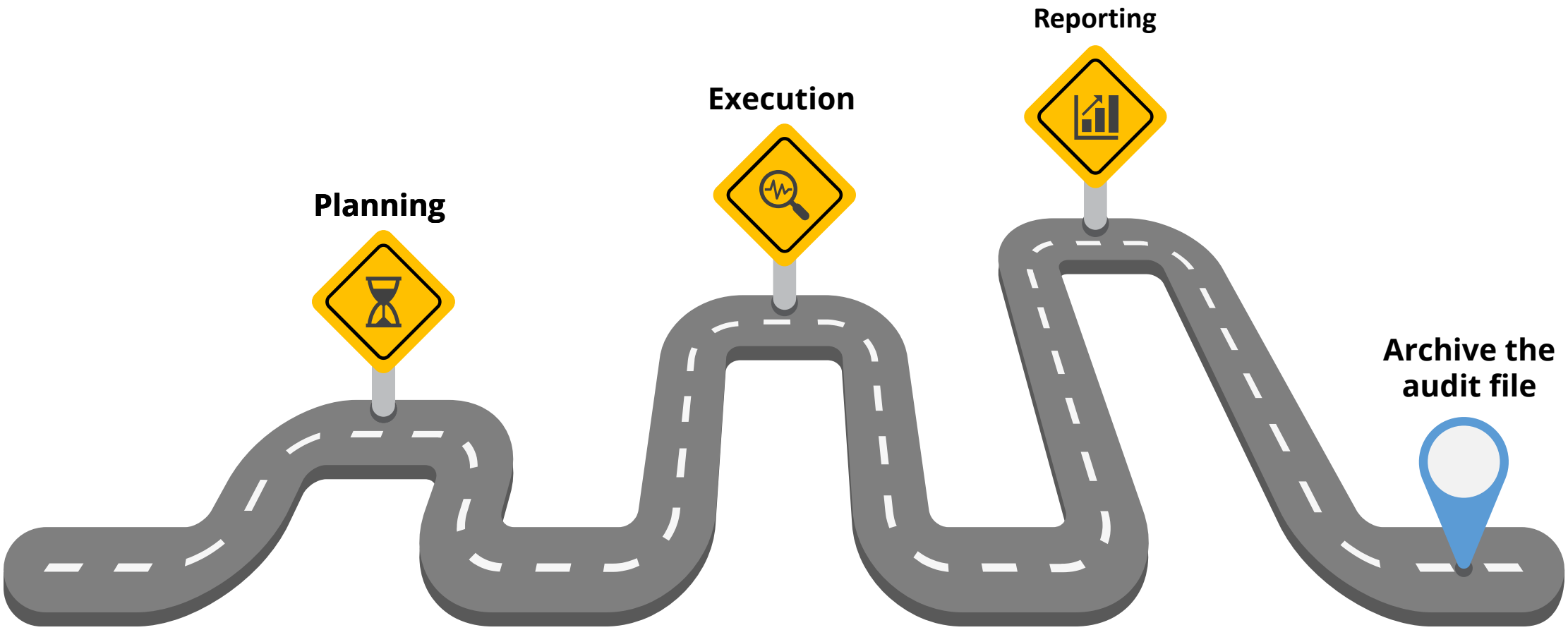
The Client

The Company being audited will be represented by their staff. The staff are to provide the trial balance and other information to enable the auditor carry out ther work.

Typical team structure (varies from one engagement to another)



Overview of an Audit carried out in accordance with the International Standards on Auditing (ISA)



Class discussion

You are the Managing Partner of a small firm with the following staff composition who are currently working on rounding up an engagement:

- 1 AIC
- 2 staff with less than 2 years' experience
- 1 Audit Trainee

Two of your clients have called you to commence their audit each with their respective deadlines:

- ❑ Company A – with revenue running into billions and large volume of transactions

- ❑ Company B – smaller than Company A with lesser transaction but a higher audit fee than Company A

How will you structure the teams?



Introductory/Foundational concepts

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Introductory/Foundational concept



Pre-conditions of an audit

01



Financial reporting (FR) framework

There must be an acceptable financial reporting framework

The pre-conditions are satisfied and evidenced through the signing of the **Letter of Engagement** between the Auditor and the Client

02

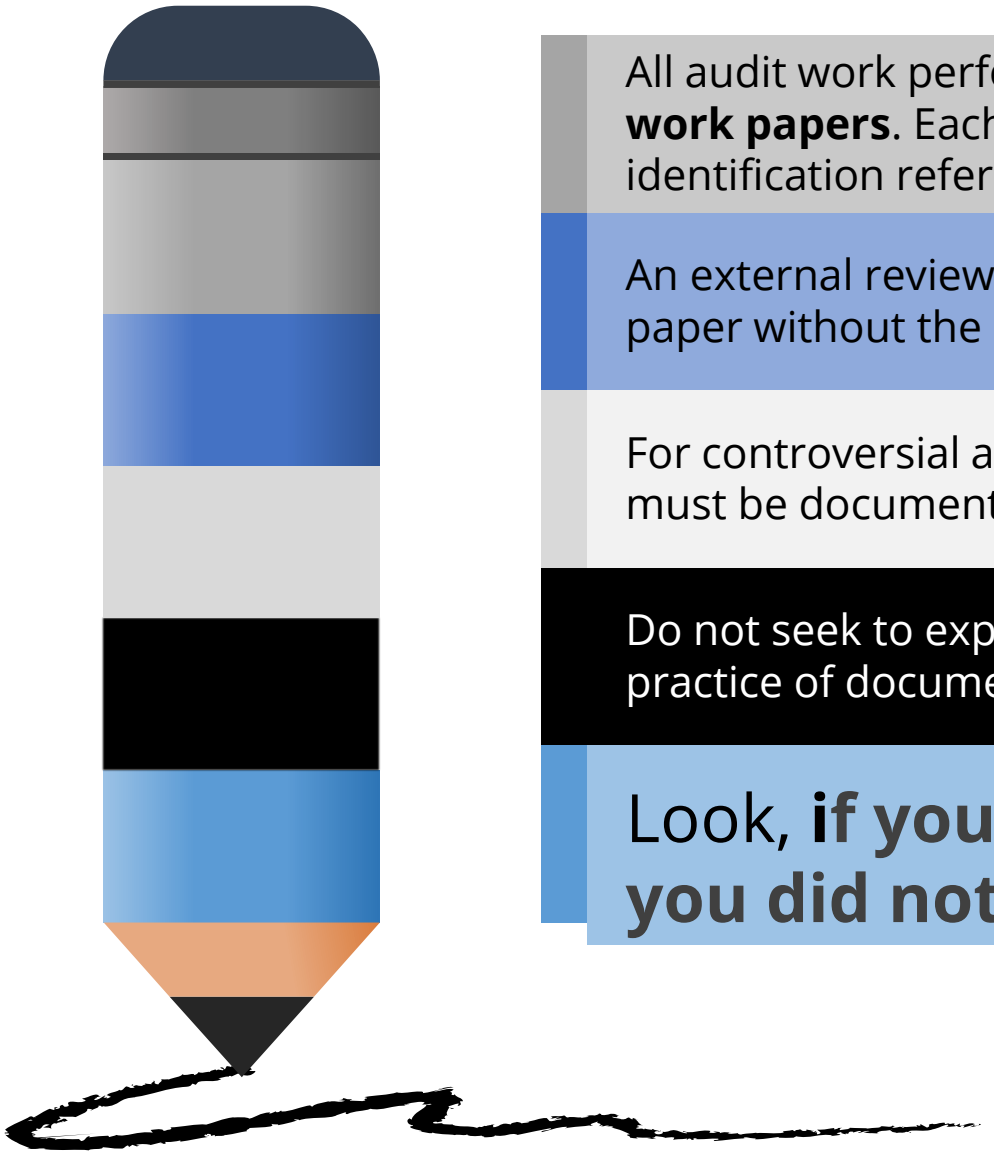


Mgt. responsibility

Mgt accepts its responsibility for:

- Preparation of FS in line with the acceptable FR framework.
- Internal controls
- Providing the auditor with access to required info and persons.

Documentation: If it is not documented, it is not done!



All audit work performed during the audit must be documented in **well-prepared work papers**. Each work paper must be properly named and have a unique identification reference.

An external reviewer should be able to review & understand the audit work paper without the auditor being physically present.

For controversial areas – judgements and reasons applied by the auditor must be documented!

Do not seek to explain your work with word of mouth. Perfect the practice of documenting clearly!

Look, **if you do not document it, then, you did not do it!**



Professional skepticism
(test everything before you accept it!)

- An attitude and a questioning mindset
- Being alert to possible indicators of misstatement due to fraud or error.
- Critical assessment of audit evidence.
- Do not just accept anything at face value, check for contradictory and corroboratory evidences.
- Approach every audit evidence with the mindset that there is a misstatement therein. Even if it relates to reviewing a team member's work.

Photo credit: Pixabay



Photo credit: Pixabay

Audit evidence (AE): Sufficient and appropriate

- Question: How do you satisfy your skepticism as an auditor throughout the audit & upon what basis do you express your opinion as an auditor?

Answer: You design and execute audit procedures to obtain **sufficient** and **appropriate** audit evidence. Not just any evidence!

- Sufficiency relates to quantity while appropriateness relate to quality (relevance and reliability)

- Procedures to help obtain audit evidence include:

1. Inspection of documents or items
2. Observation
3. External confirmation
4. Recalculation
5. Reperformance
6. Analytical procedure
7. Inquiry

- High quality (reliable) audit evidences include:

- AE obtained independently from a 3rd party or directly by the auditor.

- AE obtained from document (and not discussion alone) or from original.

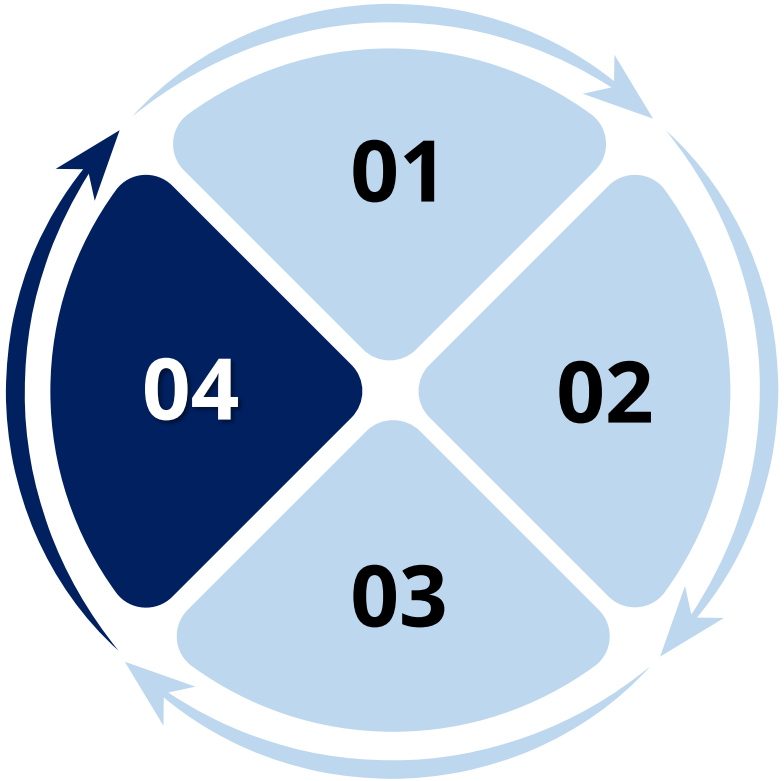
Review & Consultation

- Every preparer must do a thorough self-review on their work papers.
- Every workpaper must be reviewed by at least one person (other than the preparer).
- Consulting others does not indicate that you're not smart. It is not a sign of weakness.
- Team members should freely consult others where they do not understand. Even the Engagement Partner is expected to consult where appropriate.



Photo credit: Pixabay

Audit approaches



Substantive procedures approach

Focused on testing large volumes of transactions and account balances without any particular focus on specified areas of the FS.

Balance sheet approach

Applying substantive procedures to statement of financial position, with limited procedures on the income statement

System-based approach

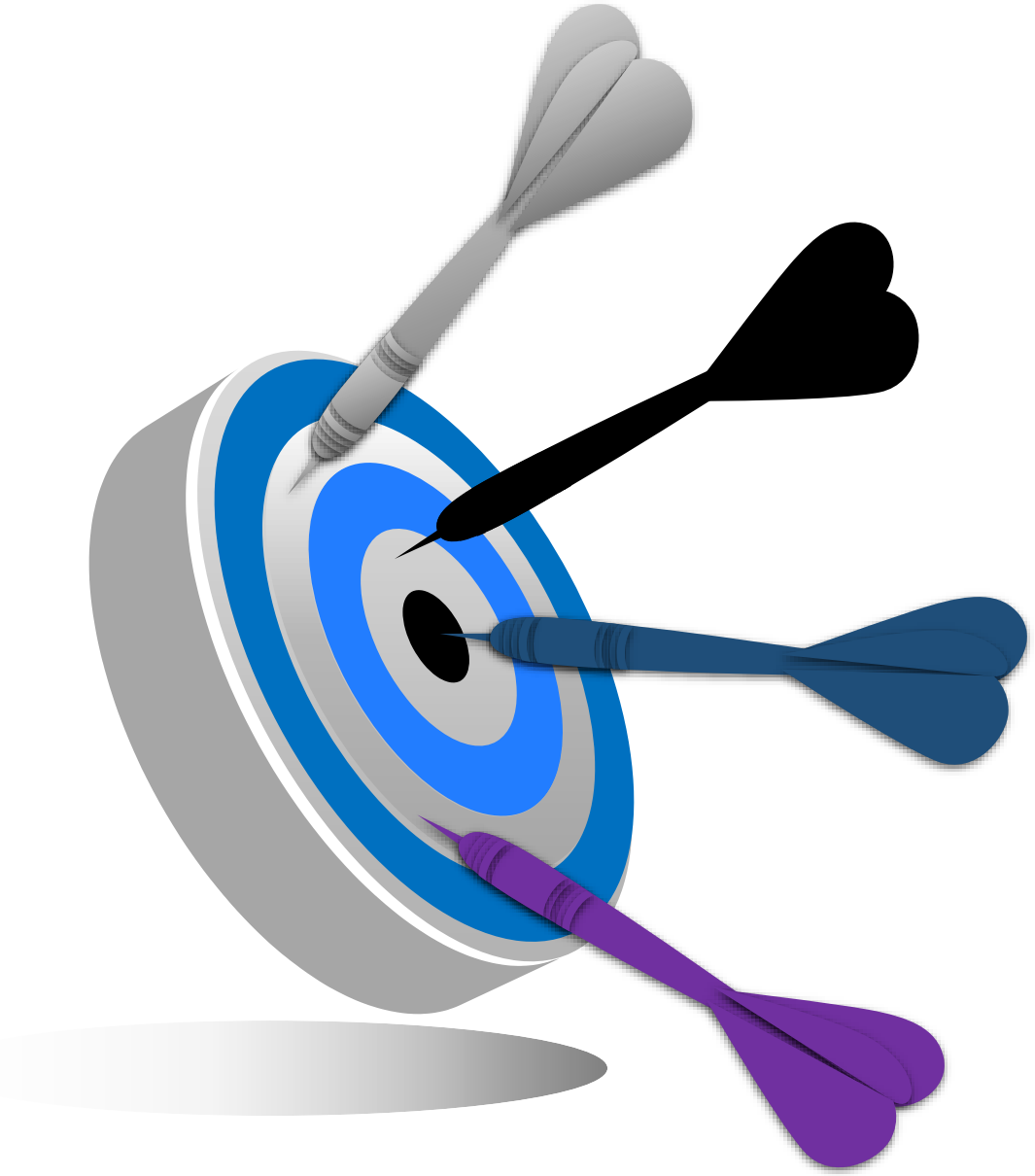
Focus on testing internal controls of an entity, and direct substantive procedures primarily to other areas

Risk-based approach (RBA)

Focus on only areas where there are “risk of material misstatements (RoMMs)”. **Also known as assertion-based approach.**

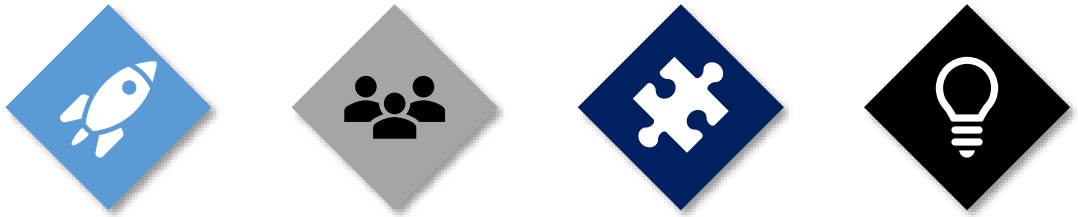
This is the focus of this course. It’s the approach applied by the International Standards on Auditing (ISAs).

What are audit assertions?



Management's implicit claims.

Assertions are the **implicit claims** that mgt make about the FS. For example, mgt claim that revenue is complete and accurate, then, the auditor works to confirm these claims.



Work with more precision!

With assertions, the auditor can approach each account more precisely. For example, when the auditor assesses revenue (or any income statement item) for risk, the auditor will consider if such item is **complete** or **accurate**, or **recorded in the correct period** or **properly classified** or **accurate**.

Specific audit assertions

Account balances (Balance sheet items)

1. Completeness: does each SFP item contain “all” applicable transaction, event or conditions.
2. Rights & Obligation: right to obtain benefit from each asset and obligation to settle each liability.
3. Existence: the SFP items truly exist as at year end.
4. Valuation & allocation: are all SFP items correctly measured and have allocations been properly done e,g,, allocating overheads to inventory?

Classes of transactions (income statement items)

- ✓ Occurrence: did the transactions recorded really happen?
- ✓ Completeness: has the client recorded all the transactions that took place during the year?
- ✓ Accuracy: has each transaction been recorded at their correct amount?
- ✓ Cut-off: have transactions been recorded in the correct accounting period?
- ✓ Classification: have transactions been classified into the correct account?

Presentation & Disclosures

- ✓ Accuracy & valuation: disclosures are accurate and properly valued.
- ✓ Classification & understandability: proper classification in a clear manner to promote understandbility to the users of FS
- ✓ Completeness: Transactions, events, balances have been completely disclosed.
- ✓ Occurrence: Transactions, events, balances, and other financial records have occurred and are related to the entity.

Test your understanding

- As a team member, you have been assigned the task of testing the client's payroll cost. The client has provided you with the full year payroll schedule. After receiving it, what will you do with it? How are you sure that it is reliable?

- While trying to understand why the payroll cost increased from CU2bn last year to CU3.5bn this year, you discussed with the Payroll Officer on the number of staff, she informed you that the Company had a total number of 50 employees as at year end out of which 14 of them joined newly during the year. After receiving this information from her, what will you do with it?

- After circularizing the GT Bank, they confirmed a balance of CU20bn, however, the client's GT Bank balance was CU18.2bn. What will you do? Which of the balances would you rely on until the difference is resolved?

- After circularizing GT Bank, they confirmed a balance of CU20bn, however, the client's GT Bank balance was CU18.2bn (assuming no reconciling items). What will you do? Which of the balances would you rely on until the difference is resolved?

- While reviewing the work paper on testing inventory prepared by your subordinate, you observed that he didn't state or include any document to show that he observed the year end stock count. After clarifying on phone, he still insisted that he observed the stock count. From an audit work standpoint, do you think he observed the stock count?

- The client stated in their books that they have a building in Lokoja worth CU5bn. What procedure would you have carried out to obtain evidence that the building existed at year end?

- The Company's General Counsel (i.e., Head of Legal) informed you that there were no legal case during the year and no ongoing cases as at year end. Do you believe him? What will you do to resolve your doubts?

Audit risk

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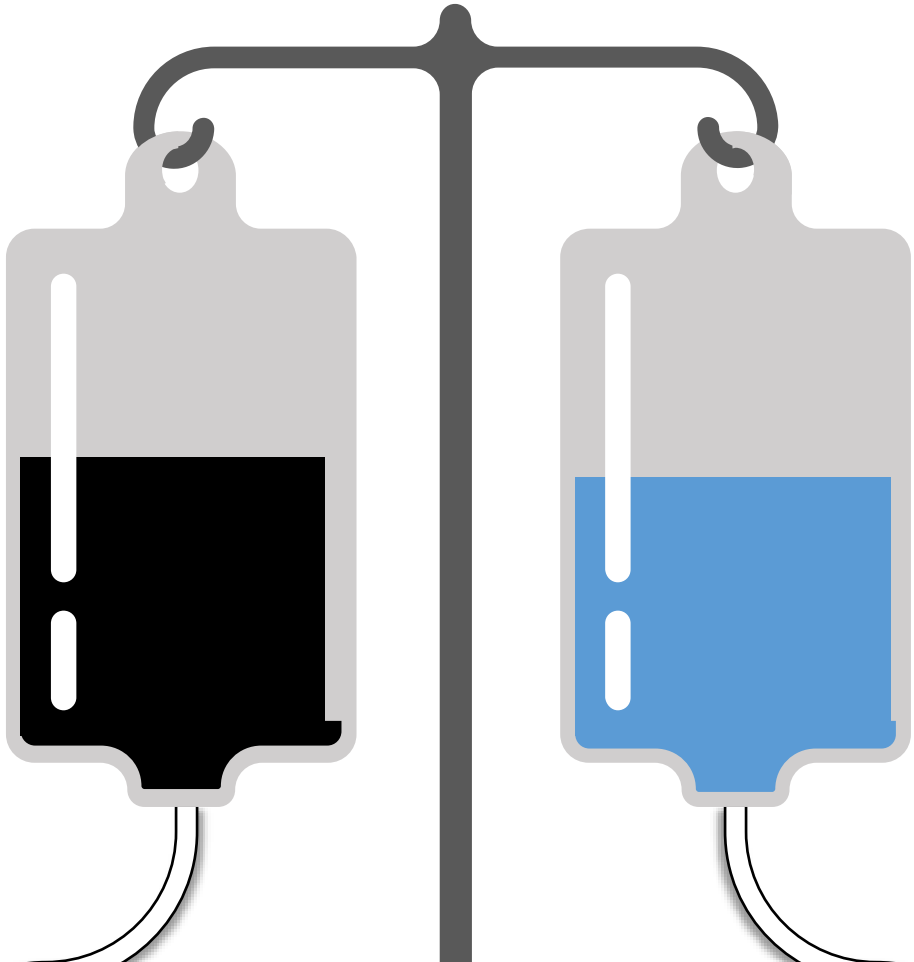
Audit risk (what can go wrong) in a financial statement audit.

Audit risk = Risk of material misstatement (RoMM) + Detection risk

Risk of material misstatement (RoMM)

This is broken down into:

- ✓ **Inherent risk (IR):** these risks "naturally" (by default) already exist **in the FS assertions** assuming no controls.
- ✓ **Control risk (CR):** the risk that controls may not prevent, detect or correct a misstatement **in an FS assertion**.



Detection risk

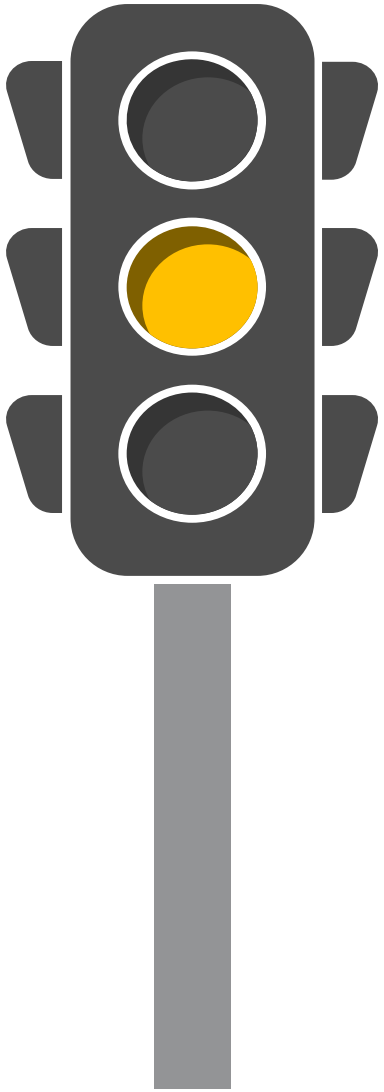
The risk that the auditor's procedures will not detect a misstatement that exists **in an assertion** that could be material (individually or when aggregated with other misstatements).

Audit risk Vs Business risk



Overarching question: when the risk actualises, what will happen? Will it cause any figure in the FS to go wrong?

How do inherent risks look like?



Example of documentation of inherent risk

- Remember that if it is not documented, it is not done. If you claim to have identified risks, then, show it in your work paper!

- See an example of an inherent risk documentation:

There is a risk that the Company's revenue may not be "complete"

- You can see how the risk associates what can go wrong in revenue with an assertion. That's how an inherent risk looks.

- Now let's take a look at an example of how this was done in an actual work paper

Introduction to control risks: A tip of the iceberg (See video and practical work paper where we tested a control)

1. What is a control?

Simply put, this is "something" put in place by the Company to help prevent or detect or correct errors.

2. Example of a control

Before sending the monthly payroll to Finance Dept for further checks and salary payment, the Head of HR reviews the payroll by comparing last month payroll with the current month's payroll. Any difference between both months are identified and further analysed by the HR Officer to avoid errors in the payroll.



3. What is the control risk?

Control risk always lie in the following:

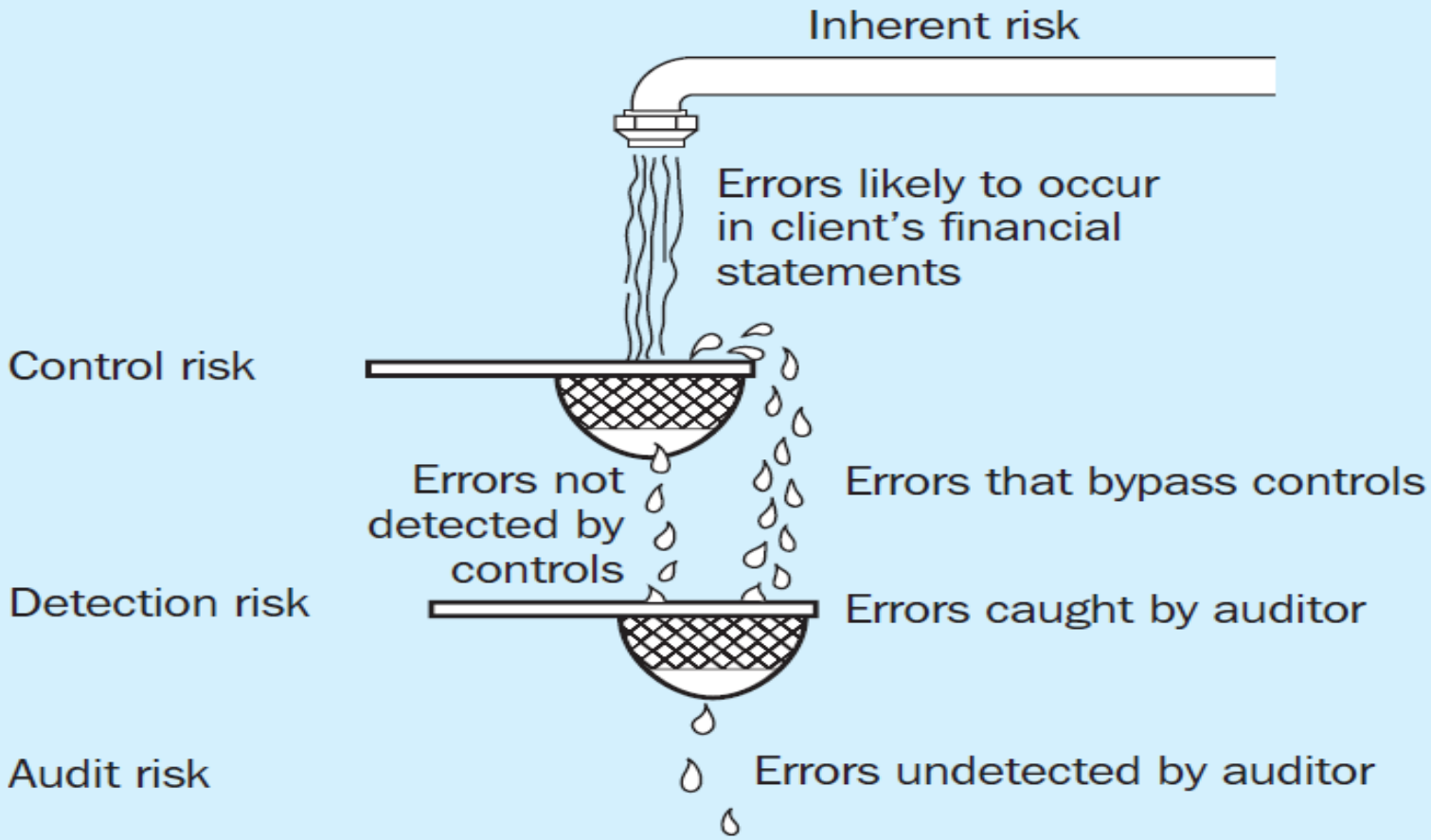
1. The control may not be properly "DESIGNED".
2. If properly designed, the control may not be IMPLEMENTED as designed.
3. The control may not OPERATE EFFECTIVELY throughout the period of relevance (e.g., throughout the year within which it is implemented)

Relationship amongst inherent, control and detection risks

(Diagram was extracted from Principles of auditing by Rick Hayes, Roger Dassen, Arnold Schilder and Philip Wallage.)

ILLUSTRATION 6.12

Components of Audit Risk[25]



Class activity

For each of the following risks, identify the correct assertion(s) they relate to:

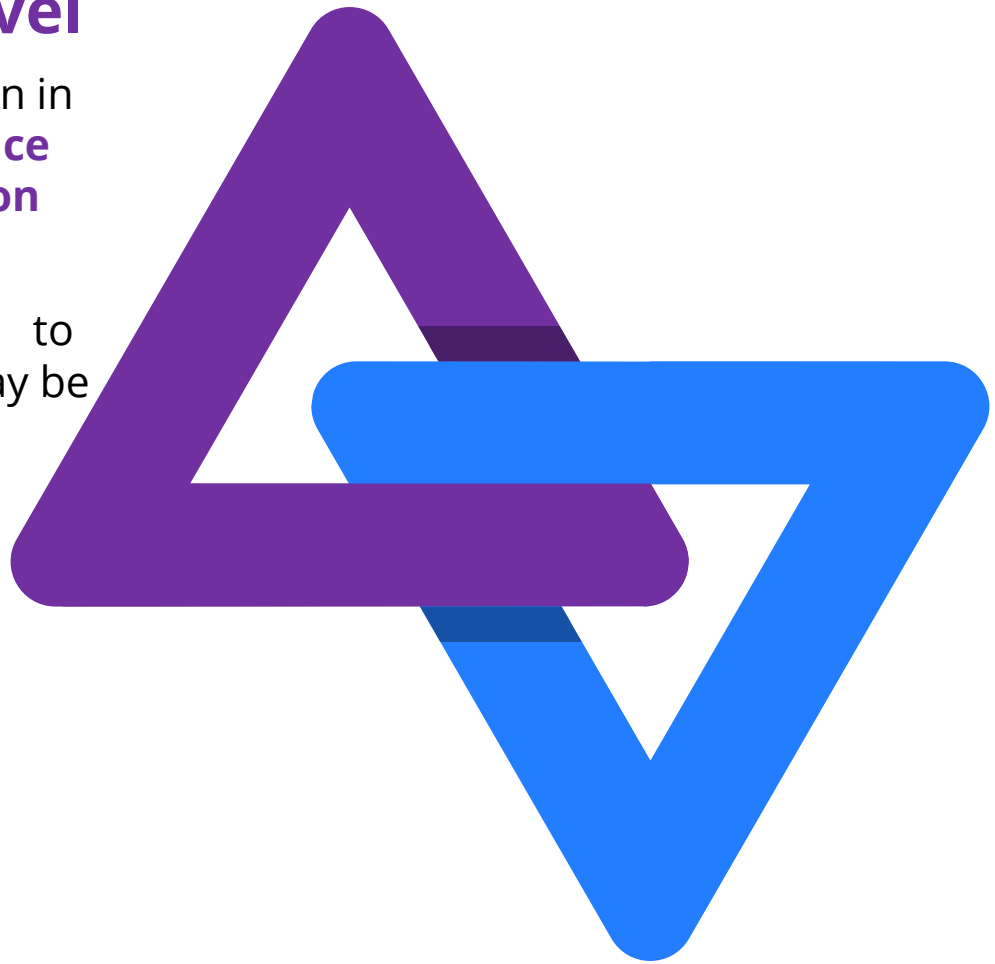
S/N	Risks identified	Assertions affected
.1	There is a risk that payroll costs may not be accurately recorded.	Accuracy of payroll costs
2	There is a risk that revenue may not be recorded in the correct accounting period.	Cut-off
3	There is a risk that PPE may not be properly measured at fair value per the revaluation model in IAS 16.	Valuation
4	There is a risk the expected credit loss may not be properly measured in accordance with IFRS 9.	Valuation
5	There is a risk that deferred tax assets are not recoverable.	Rights, Valuation
6	There is a risk that cash and cash equivalents are not complete.	Completeness
7	There is a risk that administrative expenses may be recorded into the wrong accounts.	Classification
8	There is a risk that trade receivables contain customers who don't owe the Company.	Rights, Valuation

RoMMs at the assertion and financial statement levels.

RoMM at assertion level

This is a risk that affect an assertion in a specific **account balance (balance sheet item)** or **class of transaction (income statement item)**.

Assertion level RoMMs are specific to an account. For example, there may be a misstatement in inventory as a specific line item.



RoMM at FS level

This is a risk that will cause misstatements **"all over the financial statements".** They are not specific to one item. If they happen, they will affect the FS **as a whole**.

A playful example – if a bladder bursts while butchering a chicken, the **whole** of the meat may likely become bitter! It doesn't affect only one part of the meat.

Test your understanding – distinguish between audit and business risks

- There is a risk that the Company may not be able to meet its annual budgeted production level of 95%
- There is a risk that trade payable may not be complete
- There is a risk that the raw materials purchased may be of low quality.
- There is a risk that the Company's sales representatives may not meet their revenue target
- There is a risk that the contractual sales price may not be accurately computed.
- There is a risk that the interest rate used in computing interest expense may not be correct
- There is a risk that the legal cases disclosed as part of contingent liabilities may not be complete
- There is a risk that raw material prices will increase due to fluctuations in FX rate.
- There is a risk that the Company's landed property may not be properly valued
- There is a risk that the exchange differences may be inaccurate due to use of wrong FX rate.

Test your understanding – Documenting your risks

Have any of the following risks been correctly documented? If no, state the error(s) in the documentation and profer the correct documentation:

- There is a risk that revenue does not exist.
- There is a risk that trade payable is incomplete.
- There is a risk that revenue is inaccurate.
- There is a risk that payroll cost is not properly valued.
- There is a risk that trade receivables is not accurate.
- There is a risk that the Company's trade payable did not occur.

Take home

For each of the following risks, identify if they're at the assertion level or financial statement level

S/N	Risks identified	At what level	Assertion affected (if applicable)
1	There is a risk that administrative expenses may not be accurately recorded.		
2	There is a risk that revenue includes transactions that did not take place during the year under review		
3	There is a risk that provisions may not include all the applicable obligations.		
4	There is a risk that the financial statements may be **wrongly** prepared on a going concern basis.		
5	Considering management's unique position, there is a risk of fraud relating to management override of controls.		
6	There is a risk that fair value of investment property disclosed in the financial statements may not be correct.		

Audit Planning

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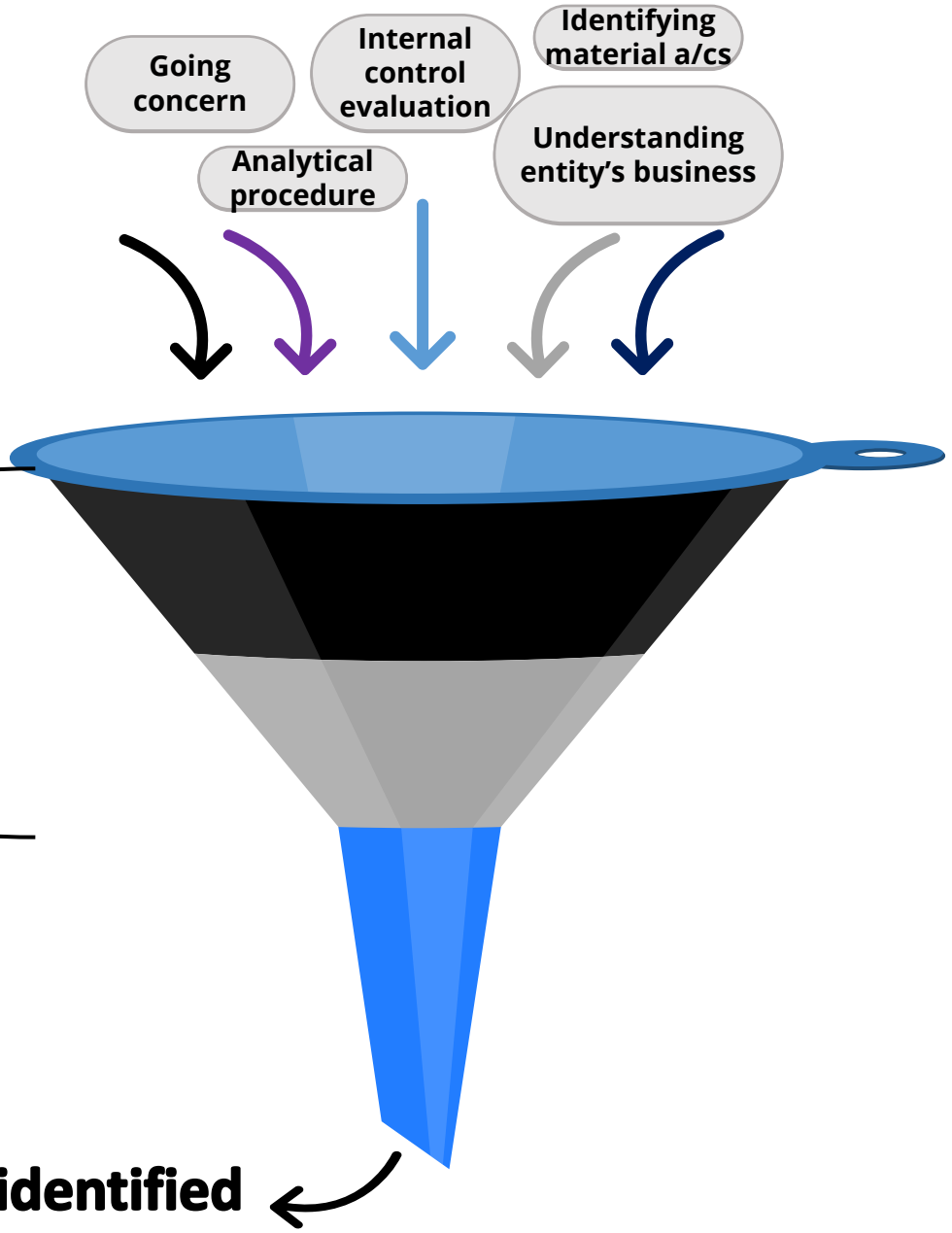
Key Planning Activities

- ✓ Acceptance or continuance decision before signing the Letter of Engagement (including engagement risk assessment/management)
- ✓ Understanding the entity:
  - ➢ Ownership and governance structure
  - ➢ Industry
  - ➢ Laws & legislations
  - ➢ Business processes (revenue, expenditure, treasury, financial reporting etc.)
  - ➢ Strategies
- ✓ Engagement team planning meeting (led by the Partner)
- ✓ Planning meeting with the client
- ✓ **Determine materiality** 
- ✓ Understanding (entity level) internal control (components of internal control under the COSO Framework)
- ✓ Control testing
- ✓ Analytical Procedure at planning
- ✓ Going concern at planning
- ✓ **Assess inherent risks and identify material FS items & disclosures.** 
- ✓ **Design responses (or audit procedures) for RoMMs identified through all the above audit work** 
- ✓ Prepare an Audit Planning Memorandum (APM)

Planning activities are done with the end objective of identifying RoMMs (What can go wrong in the FS?).

Key Planning Activities are diligently carried out with the objective of identifying RoMMs



A risk of misstatement (RoM) is 1st identified before it is assessed as a RoMM

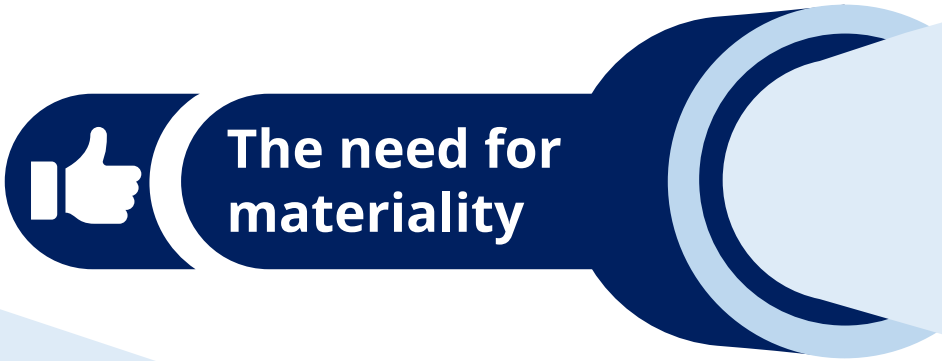
Class activity & take home

For each of the observations made during planning, identify and document appropriate RoMs:

S/N	Observations	Risk identified (See video recording for detailed illustration)
1	While assessing the entity's going concern status, the auditor observed that a key management personnel who was pivotal to driving sales had resigned. The auditor also observed that the Company had consistently incurred operating losses for the past 5 years, the Company had a negative working capital and equity.	
2	The allowance for doubtful debt balance reduced from N200m to N5m between prior year and the current year.	
3	Share capital increased from N1m to N7m.	
4	During the year, the Company increased the useful life of a major item of PPE from 4 years to 8 years. The Company now gives out these assets to employees after 8 years.	
5	The Company violated a key financial covenant and defaulted in paying interest and principal for Q4.	
6	Customers place order using a mobile app and update the app when they receive the product. Revenue is automatically recognised only when a customer updates the app to confirm that the product has been received.	

Determining materiality.

Determining materiality is **not a mathematical exercise**. It requires assessment & judgement.



Financial statements are prepared for users' consumption. Materiality allows the auditor focus on only items and misstatements that can affect the decision of the user. If not for materiality, auditors will chase everything, even an error of 1 kobo!



1. Select appropriate benchmark
2. Apply input factor
3. Determine overall materiality
4. Determine performance materiality
5. Calculate Clearly Trivial Threshold (CTT)

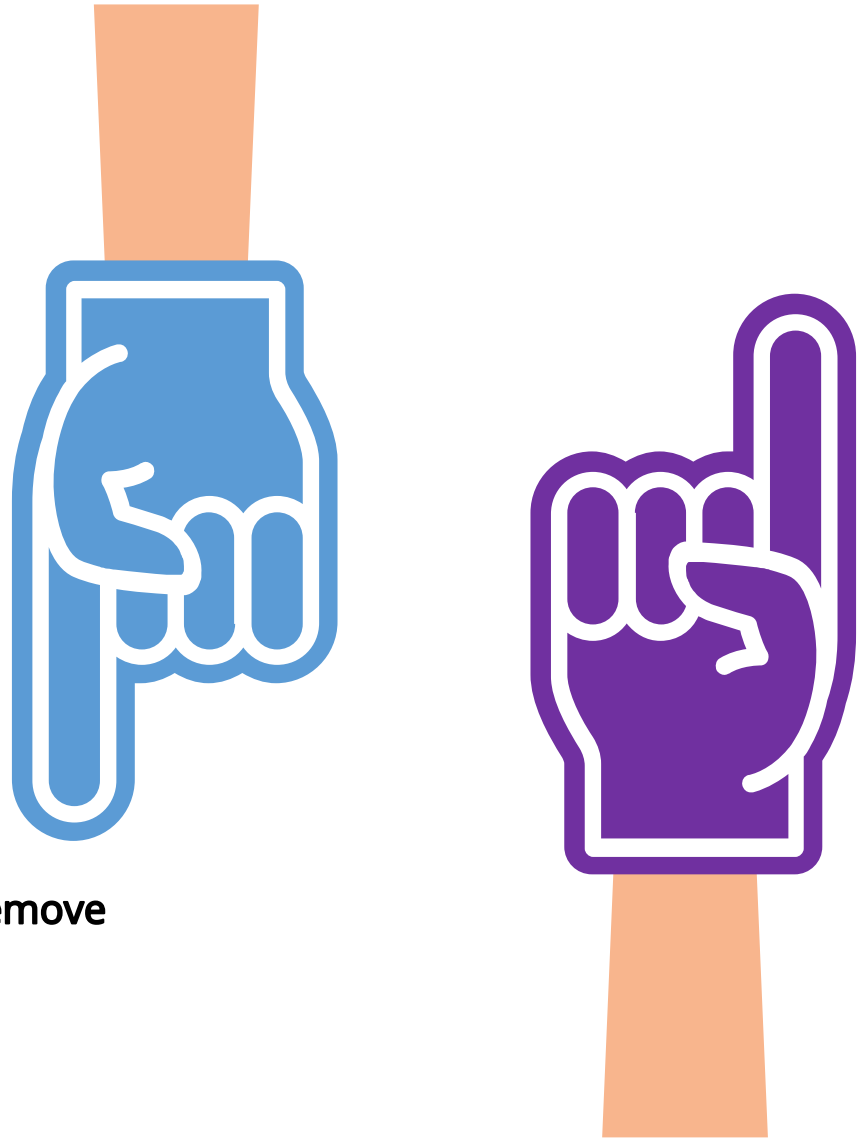
Determining materiality: selecting benchmark and input factor

Selecting appropriate benchmark

Factors to consider:

- ☒ The elements of FS
- ☒ Items that users tend to focus on.
- ☒ Nature of the entity – lifecyle, industry, economic environment.
- ☒ Ownership structure and the way it is financed
- ☒ Relative volatility

Benchmark can also be normalized to remove unusual items



Input factor

This is the percentage to be applied on the benchmark in order to determine materiality.

Factors to consider include:

- ☑ There is a relationship between the percentage and the chosen benchmark.
- ☑ Perceived engagement risk may affect the percentage selected
- ☑ Evaluation of the entity level internal controls.

Input factor determination methods

01

- ✓ 5% of pre-tax income
- ✓ 0.5% of total assets
- ✓ 1% of shareholders' equity
- ✓ 1% of total revenue

Single rule method

02

- ✓ 2% to 5% of gross profit (if ≤N20m)
- ✓ 1% to 2% of gross profit (if GP is >N20m but < N100m)
- ✓ 0.5% to 1% of GP (if GP >N100m, <N1b
- ✓ 0.5% of gross profit (if gross profit is more than N1b)

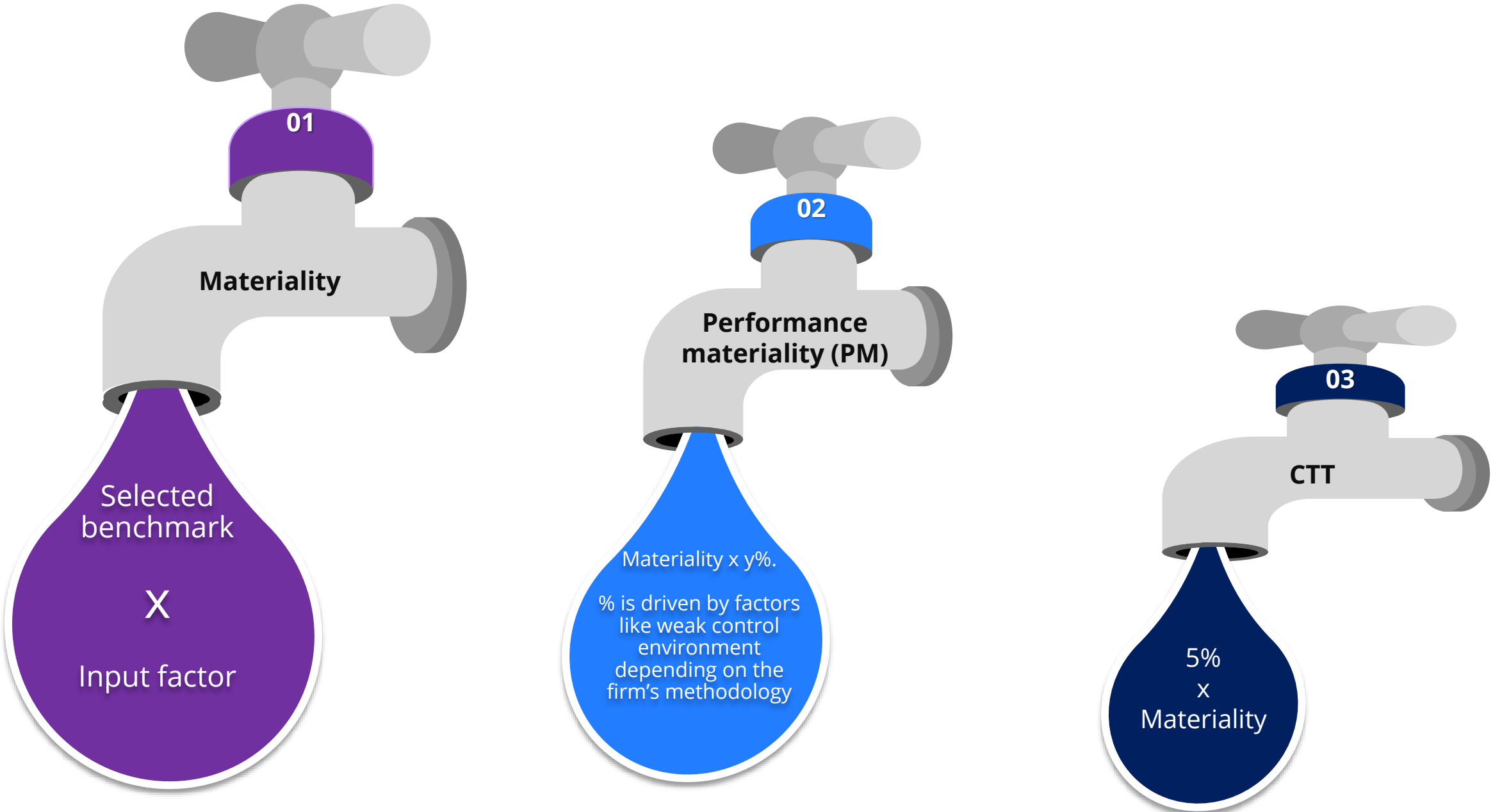
Variable size methods

03

- ✓ 0.5% to 1% of total revenue
- ✓ 1% to 2% of total assets
- ✓ 1% to 2% of GP
- ✓ 2% to 5% of shareholders' equity
- ✓ 5% to 10% of profit before tax

Range method

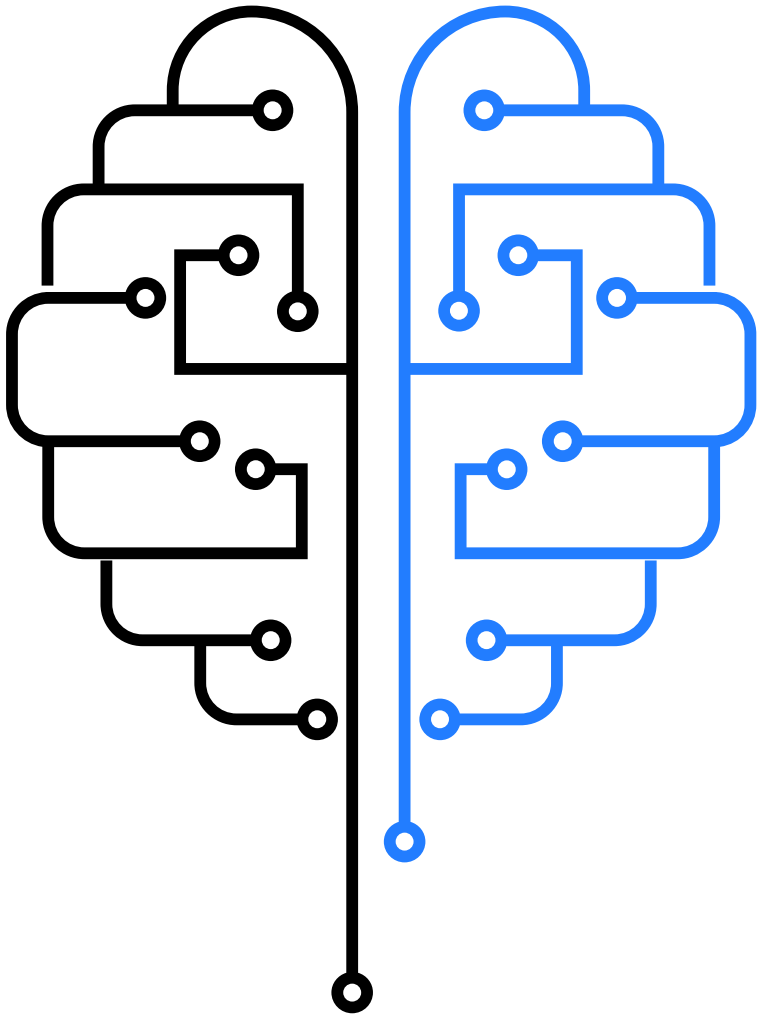
Determining materiality: materiality, performance materiality and CTT



Understanding performance materiality and CTT

Performance materiality

- ✓ A lower level of materiality which serve as a further "ceiling" to "push back" misstatements from hitting overall materiality!
- ✓ A % (e.g., 65%, 75% or 80%) is applied to materiality to determine PM.
- ✓ % selected is driven by auditors understanding of the entity and the firm's policy around this.
- ✓ It is used to identify risk areas; perceived extent of work required and determine sample size at the level of testing FS items.



Clearly Trivial Threshold

The level below which misstatements are deemed to be trivial. It is usually used when testing specific accounts.

For example, if the CTT at planning was determined as N2m and during testing, an error of N200k was identified in payroll cost, the auditor may overlook this error because it is below the CTT.

Class activity & take home

Determine materiality, PM & CTT. Document rationale as practicable as possible.

S/N	Observations
1	A listed company (PBT is N30.2m, Revenue = N175.6m, Total assets = N1.4b)
2	A Company currently has only one customer, it's revenue from that customer is determined by marking up her total expenses by 10% i.e., if total expenses is N100m, revenue will be recorded as N110m. (Rev is N83.9m, total exp is N76.27m & total assets is N134.5m)
3	A Company is heavily financed by debt. Debt occupies 92% of its total capital structure. (Total equity = N43.94m, Loan debt = N505.26m, Total assets = N600m)
4	A listed entity with relatively volatile profit before tax (Revenue = N400m, PBT = N52m, Total assets = N12.3b)
5	A start-up company that is yet to commence generating revenue. The Company incurs both OpEx and CapEx as it actively works towards completing the developments of its Fintech Mobile App. (OpEx = N300m, Total long-term asset = N3.43b, total assets = N4.21b)

Putting it into practice!

Now, let’s create a work paper to determine materiality!

Overview of inherent risk assessment (this course focuses on RoMMs at the assertion level



1. Understand the entity – industry, business & environment.

People fear what they don't understand. You cannot add value, if you don't understand the business.

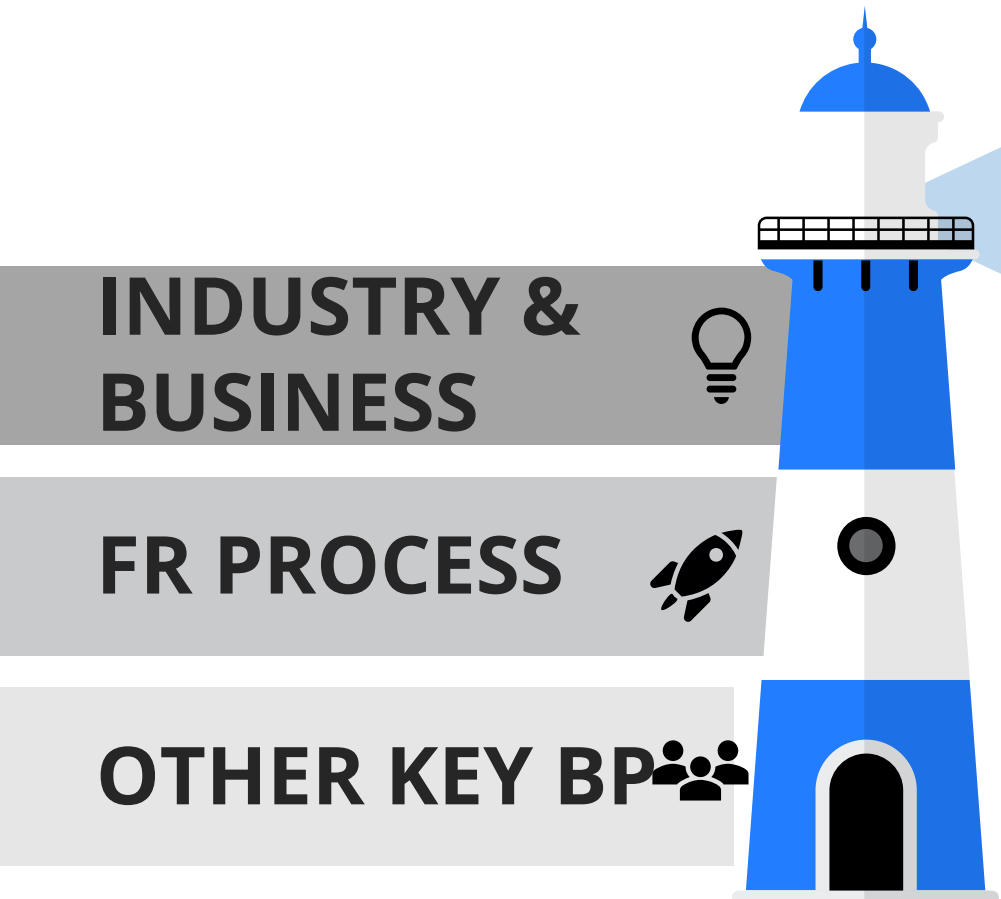
2. Identify RoMMs

There are already "inherent" **risks of misstatement (RoM)** in the accounts. You cannot wish them away! You can only assess them to identify the ones that are **risk of material misstatements (RoMMs).**

3. Design responses

After identifying the RoMMs, design substantive procedures (and control testing procedures, if applicable) that would test the accounts to see if these material misstatements truly exist.

Assessing inherent risk – minimum knowledge requirement



1. Industry & the business

The items peculiar to that industry. Understand the industry/business so much that you can confidently speak about it.

Peculiarities are mostly driven by **the nature of the business, operations and laws/legislations.**

2. FR process

- ✓ How the GL is structured.
- ✓ How the TB flows into the note line items.
- ✓ Detailed nature of each note line items.
- ✓ Reason for the difference between prior year & current year note line items
- ✓ All significant accounting standards.

3. Other key BP

- ✓ How does the company generate revenue and manage credit risk?
- ✓ How does the company incur expenditure (expenses and CapEx)

From RoM to RoMM – likelihood and magnitude assessment.

The fact that the risk is “inherent” means that it already exists, you cannot wish it away! So, it is first regarded as a “Risk of Misstatement (RoM)”. Out of all the RoMs, the auditor extracts the “RoMMs” based on 2 key factors – “likelihood of misstatement” and “magnitude (the quantitative impact if it happens)”. If the likelihood & misstatement are very low/remote, the risk will remain a RoM, otherwise, the risk will be upgraded to a RoMM for further audit work.

01

Likelihood

To evaluate this, consider factors like:

- ✓ History of such error during past audits
- ✓ Complexity/subjectivity in the account.
- ✓ How skilled the staff is.
- ✓ If there is a new standard, law or regulation relating to that item.
- ✓ If it involves significant judgement and estimates.
- ✓ If the staff in charge is new to the role.
- ✓ Significant changes in the Company’s structure
- ✓ Does it involve related parties?
- ✓ Non-routine transactions
- ✓ Whether transactions are manually processed or automated.
- ✓ Volume of transactions.

02

Magnitude

- ✓ Volume of transactions.
- ✓ Quantitative significance of the account in relation to PM.
- ✓ The value of any reliably estimated misstatement. E.g., if tax was computed on an old rate of say 2% and the new rate is 2.5%, we may be looking at a misstatement of 0.5% x taxable profit.
- ✓ Some of the items listed under likelihood may also affect magnitude. They’re interrelated.

Class discussion & take home

Assess if each of the following RoMs should be upgraded to RoMMs or remain RoM (there are no right or wrong answers, what is important is to have a solid rationale backing up your judgement). Assuming materiality = N300m and PM is N270m. The balance in each of the accounts as at year end has also been stated below:

S/N	Observations
1	There is a risk that payroll costs may not be accurately recorded. (Staff cost = N650m)
2	There is a risk that share capital balance may be wrong. (assuming this is an existing company with no issue or buy-back of shares during the year). (Share capital = N10m)
3	There is a risk that the deferred tax liability may not be properly valued (DT liability balance = N265m)
4	There is a risk that expected credit loss may not be based on reasonable and supportable assumptions (N100m).
5	There is a risk that accrued expenses may not be based on reasonable and supportable assumptions (N20m)
6	There is a risk that revenue may not be accurately recorded (N30b).
7	There is a risk that revenue may not be correctly recognised (N30b).
8	There is a risk that current tax computation may not be accurate (Nil).
9	There is a risk that the trade payable may not be complete (34m).
10	There is a risk that inventory may not be correctly measured (N1.2b)
11	There is a risk that prepayment may not be correctly valued (N7.5m)

Grading RoMMs into levels – the higher the grade, the more audit work is required



1 SIGNIFICANT RISK

- ✓ Risk of fraud.
- ✓ There is a **presumed** risk of fraud on revenue recognition.
- ✓ Accounts with significant judgement/estimates e.g., impairment assessment may sometimes be regarded as significant.
- ✓ Extremely complex accounts e.g., derivatives
- ✓ Certain FS level RoMMs. E.g., on some occasions, auditor may assess a going concern risk as being significant.
- ✓ New accounting standards that are complex

2 HIGH RISK

- ✓ For complex areas.
- ✓ High level of judgement/estimates.
- ✓ New accounting standards with moderate level of complexity.
- ✓ Accounts with an history of errors during past audits.

3 LOW RISK

These are for less-complex accounts with little or no history of errors. For example, accounting for most payroll costs (monthly salary) and admin. expenses are usually simple

Class discussion & take home

Grade the following RoMMs (there are no right or wrong answers, it is important to have a solid rationale backing up your judgement):

S/N	Observations
1	There is a risk that payroll costs may not be accurately recorded
2	There is a risk that the share-based payment balance may not be correctly measured.
3	There is a risk that the deferred tax liability may not be properly valued.
4	There is a risk that expected credit loss may not be based on reasonable and supportable assumptions.
5	There is a risk that accrued expenses may not be based on reasonable and supportable assumptions.
6	There is a risk that revenue may not be accurately recorded.
7	There is a risk that revenue may not be correctly recognised.
8	There is a risk that current tax computation may not be accurate.
9	There is a risk that the trade payable may not be complete.
10	There is a risk that inventory may not be correctly measured.

Design audit procedures to address the RoMMs

- ✓ Now that we have identified the RoMMs, what do we do with them? Throw them away? No! We must now design **good** substantive procedures to test the affected accounts and satisfy ourselves if the material misstatements truly exists.
- ✓ If the auditor does not plan on relying on controls, the auditor can go straight to substantive procedures!
- ✓ If the auditor wishes to rely on control to reduce the level of substantive testing, then, the auditor will have to design procedures to test the "associated" controls.
- ✓ There are 2 types of substantive procedures that can be designed: Substantive Analytical Procedure (SAP) or Test of Details (ToD). See next section to understand in-depth.

✓ On a final note, you should have a work paper that brings: all the RoMMs together, the affected accounts, whether we are relying on controls, the audit procedures for each. See the folder for an example (excel document "All RoMMs").

Class discussion & take home

For each of the following RoMMs, design a substantive audit test procedure to address the risk **(this class discussion should be done after the participants must have understood the 2 types of substantive procedures as learnt from the next section)**

S/N	Observations
1	There is a risk that payroll costs may not be accurately recorded
2	There is a risk that the share-based payment balance may not be correctly measured.
3	There is a risk that the deferred tax liability may not be properly valued.
4	There is a risk that expected credit loss may not be based on reasonable and supportable assumptions.
5	There is a risk that accrued expenses may not be based on reasonable and supportable assumptions.
6	There is a risk that revenue may not be accurately recorded.
7	There is a risk that revenue may not be correctly recognised.
8	There is a risk that current tax computation may not be accurate.
9	There is a risk that the trade payable may not be complete.
10	There is a risk that inventory may not be correctly measured.

Putting it into practice!

Now, let’s create a work paper to assess inherent risk and design audit procedures!

Execution

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Key points about substantive testing

1. Check inside the accounts

The misstatements are inherent in the accounts, so we need to go directly into the accounts and check for the misstatements. Going directly into (i.e., detailed tests of transactions & balances) the accounts to check for misstatement is what ST does.

The procedure will state its **nature**, **timing** & **extent**.

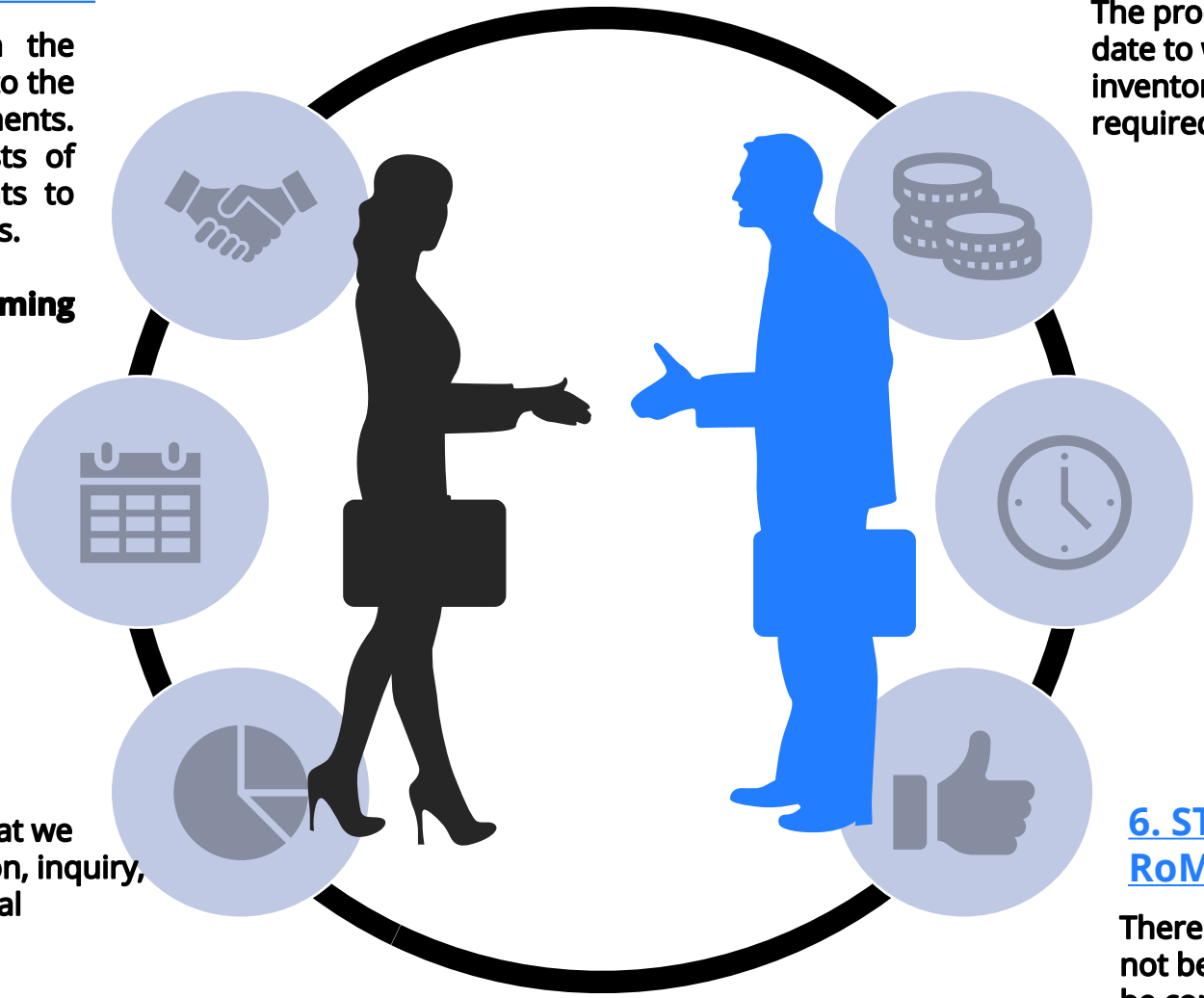
2. Types of substantive procedure

- ✓ Test of Details (ToD)
- ✓ Substantive Analytical Procedure (SAP):

3. Nature of the procedure

The procedure should clearly state what we would be doing: inspection, observation, inquiry, confirmation, recalculation, or analytical procedure (SAP).

The nature of the procedure is the most important aspect of designing an appropriate procedure



4. Timing of the procedure

The procedure should clearly state the period or date to which the audit evidence applies. E.g., inventory balance will be tested by obtaining required information **"as at year end"**.

5. Extent of the procedure

Relates to the quantity to be tested.

The higher the degree of the RoMM, the more the extent of work. For example, to test payroll costs, we may request for the payroll schedule from Jan-Dec because we have graded the RoMM of incomplete payroll cost as a high RoMM – *so we need to do more work*. But if the RoMM was low, we may just perform only a SAP without requesting the payroll schedule

6. ST alone can't address certain RoMMs

There are some RoMMs that ST alone may not be able to address, so ST may need to be combined with test of controls.

SAP Vs ToD – further understanding



SUBSTANTIVE ANALYTICAL PROCEDURE (SAP)

1. Determine the suitability of particular SAP for given assertions.
2. Obtain required data and evaluate reliability of such data
3. Make use of the data obtained to develop an expectation of recorded amounts or ratios.
4. Obtain the client's recorded amount
5. Compare your developed expectation in 3 the client's recorded amount in 4.
6. Determine a threshold above which differences between 3 & 4 would require investigation. If your tolerable threshold is N30m and the difference is N45m, further investigation may be required.

SAP is usually used to large, uniform and highly predictable/non-complex population.



TEST OF DETAILS (ToD)

This involves obtaining direct evidence to satisfy an objective by either observing or inspecting or confirming or recalculating. Examples:

- ✓ Observing year end stock count to obtain evidence that inventory exists, and the quantity recorded by the client is complete.
- ✓ Selecting sample(s) from the population of travel expenses and inspecting the invoices/supporting documents for each sample .
- ✓ Requesting confirmation of bank, customer and vendor balances
- ✓ Recalculating the interest expense for the year and comparing with the client's TB

Used when sampling is necessary or when recalculation can be done based on specific formulars or for observation

Go back to design your procedures!

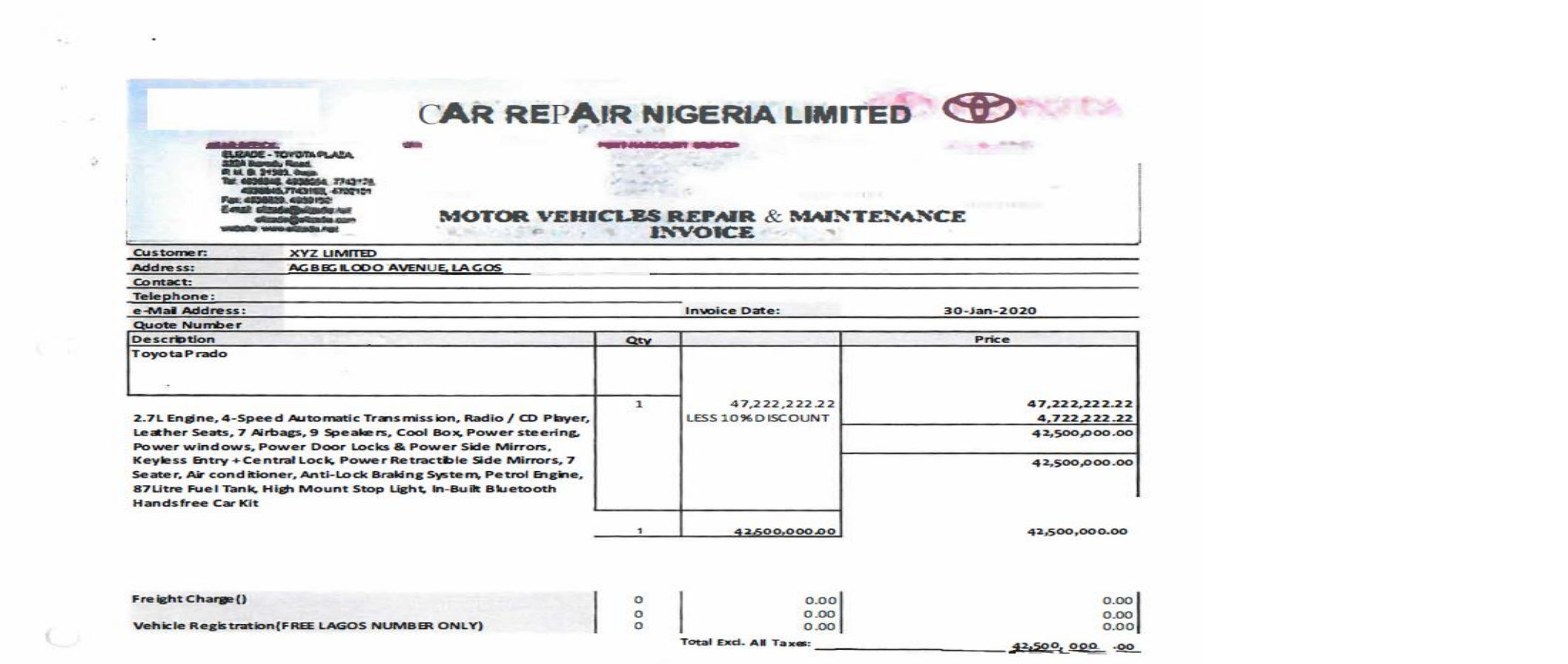
Now, that you understand substantive procedures, you can now return to design appropriate procedures for your RoMMs!

Sampling and preparing your substantive testing work paper.

This is best learnt through the video recording of the session. Kindly refer to the video recording where we illustrated audit sampling and sample selection practically using the Monetary Unit Sampling (MuS).

Class work (presenter should first illustrate one example before giving this to the class).

During the 2020 audit of XYZ Ltd, you subjected the repairs and maintenance account to sampling. You requested for the invoice for one of your samples and the client provided you with the invoice below. Now, document the audit work you will perform assuming the assertion/RoMM relates to accuracy and occurrence of repairs and maintenance costs.



CAR REPAIR NIGERIA LIMITED

ELEGADE - TOYOTA PLAZA

MOTOR VEHICLES REPAIR & MAINTENANCE
INVOICE

Customer:	XYZ LIMITED
Address:	AGBEGILODO AVENUE, LAGOS
Contact:	
Telephone:	
e-Mail Address:	
Quote Number	

Invoice Date: 30-Jan-2020

Description	Qty		Price
Toyota Prado			
2.7L Engine, 4-Speed Automatic Transmission, Radio / CD Player, Leather Seats, 7 Airbags, 9 Speakers, Cool Box, Power steering, Power windows, Power Door Locks & Power Side Mirrors, Keyless Entry + Central Lock, Power Retractible Side Mirrors, 7 Seater, Air conditioner, Anti-Lock Braking System, Petrol Engine, 87Litre Fuel Tank, High Mount Stop Light, In-Built Bluetooth Handsfree Car Kit	1	47,222,222.22 LESS 10% DISCOUNT	47,222,222.22 4,722,222.22 42,500,000.00
	1	42,500,000.00	42,500,000.00
Freight Charge ()	0	0.00	0.00
	0	0.00	0.00
Vehicle Registration(FREE LAGOS NUMBER ONLY)	0	0.00	0.00
		Total Excl. All Taxes:	42,500,000.00

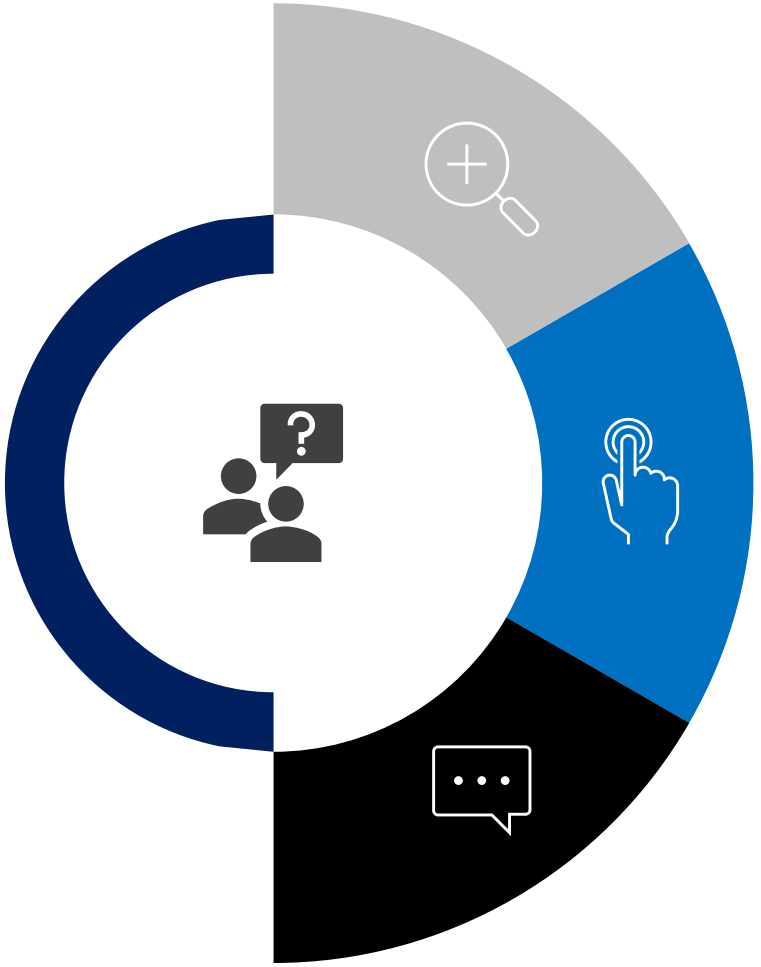
Putting it into practice!

Now, let’s create work papers to test specific account balances and classes of transactions!

Accumulating & evaluating misstatements – the basics
(the presenter should only focus on basic knowledge, no need to go advanced about evaluating misstatement in this module).

Above CTT?

- ✓ Compare the misstatement with the CTT.
- ✓ If the misstatement is above CTT, obtain an understanding of what caused the misstatement as this may be a key management letter point
- ✓ Proceed to discuss and agree the misstatement with the client.
- ✓ Propose an audit journal to correct it and **accumulate** it as part of your list/summary of misstatements.
- ✓ For some immaterial differences, you can request the client to propose an adjustment for it and you can also seek to know the cause of such differences as they may be arising from deficiencies in internal control.
- ✓ Some misstatements, though lower than CTT, may be material **"by nature".**
- ✓ Accumulate all **uncorrected misstatement** (including the ones from prior year)**.** If they're above materiality, request management to make corrections.



Types of misstatements

1. Factual misstatement

Misstatements about which there is no doubt. E.g., a vendor invoice recorded as N45m instead of N54m.

2. Judgemental misstatements

Differences arising from the judgements of management that auditors consider unreasonable or inappropriate.

3. Projected misstatements.

Auditor's best estimate of misstatements in populations, involving the projection of misstatements identified in audit samples to the entire populations from which the samples were drawn **(watch video for more about dealing with projected misstatements)**.

Class discussion: evaluating misstatements

For each of the following misstatements: explain the steps you will take after identifying it and state the type of misstatement it is.

S/N	Observations
1	Interest expense was recalculated and a difference of N30m was identified. The difference was caused by the fact that the client did not update the loan schedule to reflect the LIBOR rate from June – December. CTT is N4m.
2	5 samples out of a population of 92 was selected, and a misstatement of N1m was identified in one of the samples. Total population is N700m and samples selected represents totals N200m. CTT is N2m
3	Based on historical pattern, the auditors have determined that an appropriate range for allowance for obsolete inventory is between CU1.9m and CU2.5m. The entity has recorded a provision of N1.4m, hence, a misstatement of CU0.5m (CU1.9m – CU1.4m). CTT CU0.1m
4	**Total population: CU50,000,000 (456 items)** 1. Specific items separated (because their values were higher than PM) prior to sampling: CU8.9m (10 items). Misstatements identified by testing = CU3.4m 2. The remaining 446 items were subjected to sampling: value of items included in sample = CU4.74m. Misstatements in items sampled = CU1.29m

Reporting

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Key Reporting Activities

- ✓ Going concern evaluation at conclusion
- ✓ Subsequent event test
- ✓ Concluding Analytical procedure
- ✓ Revised materiality
- ✓ Litigation summary
- ✓ Detailed FS Review
- ✓ Cash flow workings
- ✓ TB FS Tie-in
- ✓ Audit report (sample)
- ✓ Management letter
- ✓ Management representation letter

Key financial statements review activities

Discuss & agree all Audit Journals with the client

Post AJEs into the ext. TB to derive audited TB

Agree audited TB to the client's FS

Prepare cash flow workings to check correctness of SCF



Cast & cross cast the FS

Check correctness of referencing and cross referencing

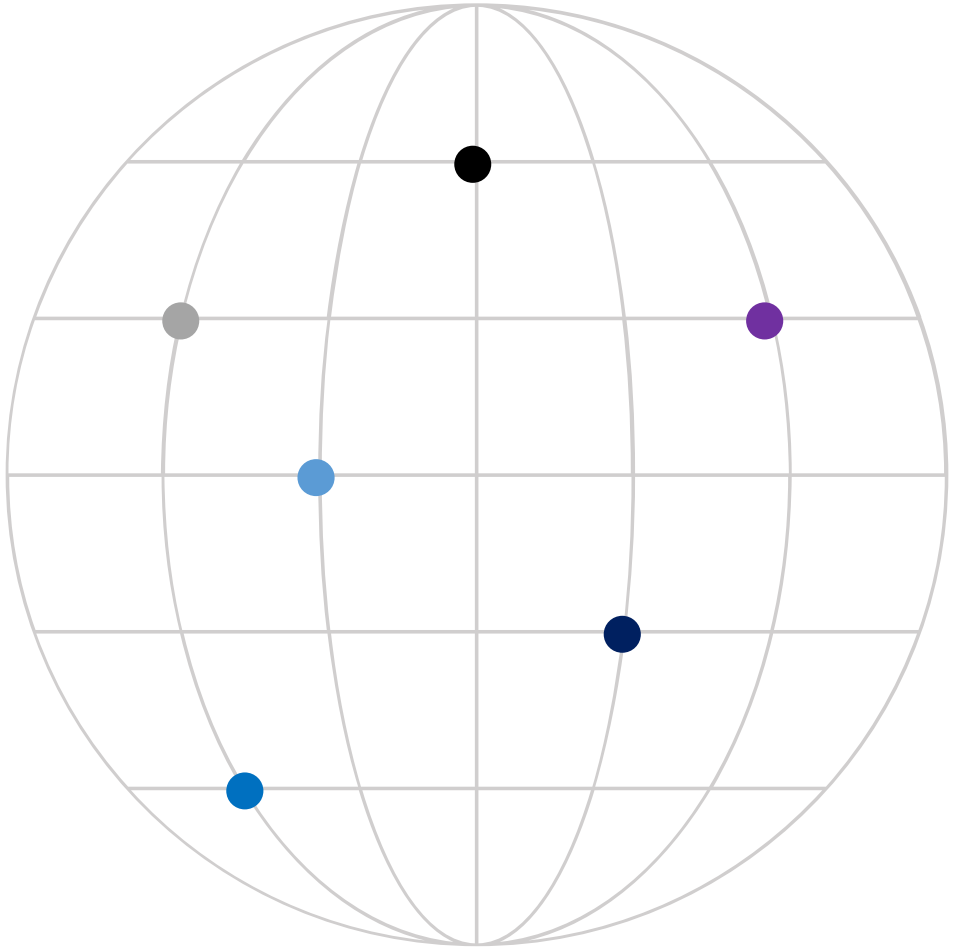
Review disclosures for correctness (in line with accounting standards/understanding of the entity) and completeness

Management letter points

Weakness in internal controls and findings must be communicated to management. Any significant deficiencies/findings will also be communicated to those charged with governance.

1. Observation or description of issue

2. Implication



3. Recommendation

4. Management reponse

Class discussion: documenting management letter points

For each of the following observation, document implication and value-adding recommendations.

S/N	Observations
1	We observed that Personal Income Tax was computed by applying 10% on gross salary without proper reference to the formular stipulated by the law.
2	Absence of an accurate trade receivables schedule, aging analysis, documented credit policy.
3	Lack of review of interest expense on overdraft charged by the bank.
4	Absence of invoices and supporting documents for expense items (for an observation as this, provide breakdown or key examples of such).
5	Inventory count is only performed once in a year.

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