KPMG

cutting through complexity

Procedures

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Contents

Directional testing

Concept of directional testing derives from principle of double entry bookkeeping for every debit there should be a corresponding credit; therefore any misstatement of a debit entry will also result in a misstatement of a credit entry.

All accounts are then tested for both understatement and overstatement

Cr entries – for understatement (liabilities and income)

Dr entries – for overstatement (assets and expenses):

Both are then tested for under- and overstatement

E.g., directly testing payables for understatement also allows indirect testing of expenses / cost of sales for understatment.

Corresponding assertions

Overstatement

The direction of testing is from the financial statements (where overstated item is recorded) to the supporting evidence.

- Occurrence
- Cut-off
- Accuracy
- Existence
- Valuation
- Classification and understandability
- Rights and obligations

Understatement

The direction of testing is from the source to financial statements.

More difficult as an appropriate source must be identified.

- Completeness
- Accuracy
- Cut-off

Test your understanding

You are testing an existence assertion of plant and equipment recorded in the financial statements.

You agreed balance in financial statements to a plant register (i.e. *from* the statement of financial position).

Then you selected material items (plus selection of others) from the register (as if a material item did not exist, or a material error was found) and traced to the physical asset (i.e. *to* evidence that the asset exists).

If the asset can not be found what type of misstatement it is?

A. Overstatement

B. Understatement

Factors to consider before choosing procedures

- **Audit risk**
- **Nature of internal controls and reliance on their effectiveness**
- **‘CAKE’ (Cumulative Audit Knowledge and Experience)**
- **Materiality**

Bank & cash

Reliable pieces of evidence:

- the bank confirmation letter;
- the bank reconciliation.

Audit procedures performed

- Obtain the company's bank reconciliation and cast to ensure arithmetical accuracy.
- Verify the reconciliation's balance per the cash book to the year end cash book.
- Trace all of the outstanding lodgements to the pre year-end cash book, post year-end bank statement and also to paying in book pre year-end.
- Trace all un-presented cheques through to a pre year end cash book and post year-end statement. For any unusual amounts or significant delays obtain explanations from management.

Bank & cash
Audit procedures (continued)

- Examine any old unpresented cheques to assess if they need to be written back into the purchase ledger as they are no longer valid to be presented.
- Obtain a bank confirmation letter from the company's bankers.
- Verify the balance per the bank statement to an original year end bank statement and also to the bank confirmation letter.
- Agree all balances listed on the bank confirmation letter to the company's bank reconciliations or the trial balance to ensure completeness of bank balances.
- Examine the bank confirmation letter for details of any security provided by the company or any legal right of set-off as this may require disclosure.
- Review the cash book and bank statements for any unusual items or large transfers around the year end, as this could be evidence of window dressing.
- Count the petty cash in the cash tin at the year end and agree the total to the balance included in the financial statements

Illustration. Bank reconciliation

Bank reconciliation as at 31 December 2012

	$
Balance per cash book	180,345.22
Add Unpresented cheques	2,223.46
Less Outstanding lodgements	(1,600.34)
Difference	1.34
Balance per bank statement	180,969.70

Bank confirmation letter

The bank confirmation letter provides **direct** confirmation of bank balances from the bank, which is:

- a third party,
- independent,
- written evidence
- and therefore very reliable.

The format of the letter is usually standard and agreed between the bank and auditor.

- The letter should be sent a minimum of two weeks before the client's year end.
- The letter should include enough information to allow the bank to trace the client.
- The bank should then forward on all details on all balances for the client; this will ensure completeness.
- Permission must have been given by the client for the bank to release this information to the auditors, as they too have a duty of confidentiality to their clients.

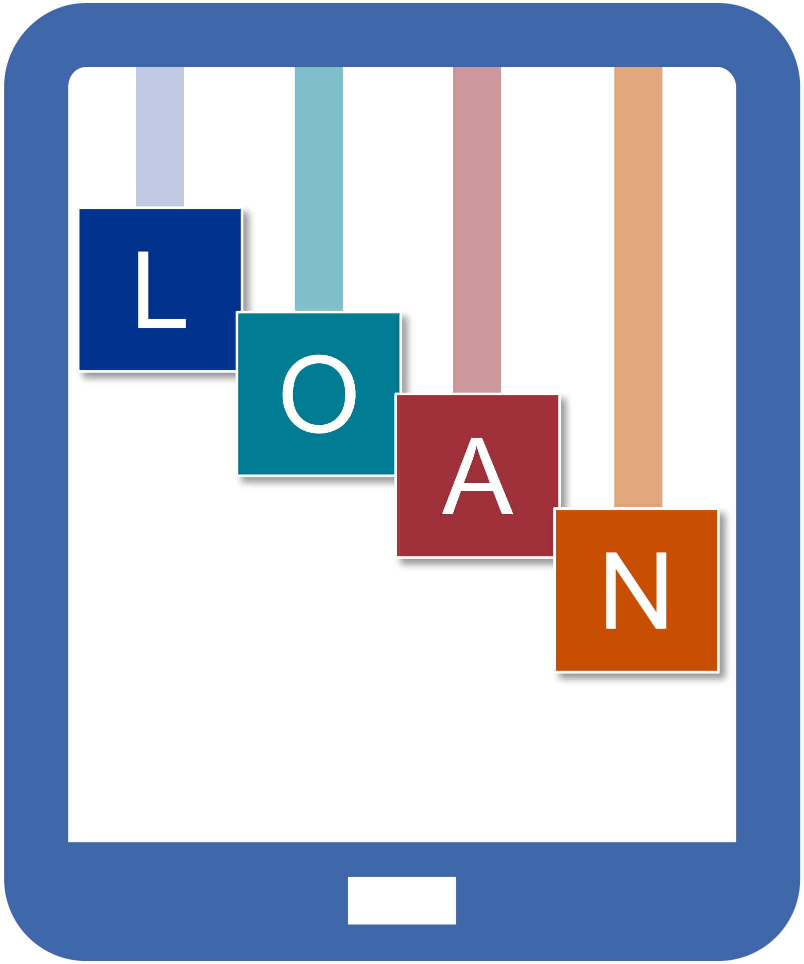
Bank confirmation letter (continued)

Bank confirmation letter also holds the details on

- loans held,
- the amounts outstanding,
- accrued interest,
- any security provided in relation to those loans.

Additional procedures in relation to loan payables include:

- Review disclosures of interest rates, and the split of the loan between current and noncurrent.
- Review restrictive covenants (terms) in the loan agreement and the effect
- Recalculate interest accrual



Assertions for Account Balances

Assertion	Procedure
Existence	▪ Direct confirmation (bank letter) of balances and other ▪ relevant information from holding institution (e.g. bank). ▪ Direct confirmation of loans made and received. ▪ Cash till balances (retail trade) and petty cash counted.
Cut-off	▪ Cut-off testing incorporated with other cut-off procedures (receivables and payable). ▪ Bank reconciliation.
Rights	▪ Bank letter and other direct confirmation letters
Completeness	▪ Bank letter confirming all balances held (including overdrafts).
Presentation	▪ Disclosures in accordance with GAAP. ▪ Bank letter detail. ▪ Set-off (loans/overdrafts against deposits) only when legally entitled and agreement to do so in the bank contract. ▪ Checklist, knowledge and experience.

Test your understanding

Which assertions are tested for bank and cash in respect of classes of transactions (Profit and Loss account)?

A. Completeness

B. Existence

C. Occurrence

D. Cut-off

E. Presentation (allocation)

F. Accuracy

G. Valuation

Non-current assets

Areas to consider

Existing assets	Additions
Disposals and related profit/loss	Depreciation
Revaluations	Related disclosures

Existing assets
Audit procedures and assertions

Procedure	Assertion
Select a sample of assets from the non-current asset register and physically inspect them	
Select a sample of assets visible at the client's premises and inspect the asset register to ensure they are included	
Cast the non-current asset register totals and subtotals to ensure arithmetical accuracy	
Inspect assets for condition and usage to identify signs of impairment	
For leased assets, inspect the lease document to assess whether the lease is an operating or finance lease and appropriately treated (IAS 17)	
For revalued assets, inspect the valuer's report and agree the amount stated to the amount included in the general ledger and the financial statements	

Additions
Audit procedures and assertions

Procedure	Assertion
Obtain a breakdown of additions and agree to the non-current asset register	
Select a sample of additions and agree cost to supplier invoice	
Review the list of additions and confirm that they relate to capital expenditure	
Review the repairs and maintenance account in the general ledger for items of a capital nature	
Inspect supplier invoices, title deeds, and registration documents to ensure they are in the name of the client	
Analysis of the costs incurred on constructed assets and agree to supporting documentation	

Disposals
Audit procedures and assertions

Procedure	Assertion
Obtain a breakdown of disposals, cast the list and agree all assets removed from the non-current asset register	
Select a sample of disposals and agree sale proceeds to supporting documentation such as sundry sales invoices	
Recalculate the profit/loss on disposal and agree to the statement of profit or loss	

Depreciation charge
Audit procedures and assertions

Procedure	Assertion
Review the reasonableness of the depreciation rates	
Review the capital expenditure budgets for the next few years.	
Review profits and losses on disposal of assets disposed of in the year, to assess the reasonableness of the depreciation policies.	
Recalculate the depreciation charge for a sample of assets.	
Review the disclosure of the depreciation charges and policies in the draft financial statements and compare to the prior year.	
Re-perform depreciation calculation for revalued assets to ensure the charge is based on the new carrying value	
Perform a proof in total calculation for the depreciation charged for each category of assets, discuss with management if significant fluctuations arise	

Illustration

The depreciation charge for fixtures and fittings for the year ending 31 December 2012 included in the draft financial statements of Chamomile Co is $338,000 (to the nearest $000).

Chamomile Co's depreciation policy is to depreciate fixtures and fittings using the straight line method. The useful economic life for fixtures and fittings is defined as 10 years.

Required: Create an expectation of what total depreciation for fixtures and fittings should be for year ending 31 December 2012.

Extract from Chamomile Co financial statements

	Land & buildings	Fixtures, fittings & equipment	Motor vehicles	Total
	$000	$000	$000	$000
Cost at 1 January 2012	3,000	2,525	375	5,900
Additions	–	1,050	75	1,125
Disposals	–	(300)	–	(300)
Cost at 31 December 2012	3,000	3,275	450	6,725

Solution

The total cost of fixtures and fittings in the draft financial statements of Chamomile Co is $3,275,000 (to the nearest $000).

We can set an expectation for total depreciation for fixtures and fittings for the year ending 31 December 2012 as

$3,275,000/10: $328,000 (to the nearest $000).

The difference ($10,000) is only 3% more than our expectation, and we can therefore conclude that depreciation is true and fair.

Suggest possible reasons for the difference of 3%?

Intangible assets
Development costs (IAS 38 Intangible assets)

IAS 38 Development costs are only capitalised when: the technical feasibility of the asset for sale or use can be demonstrated and the costs can be measured reliably

Procedure	Assertion
Obtain a breakdown of costs capitalised. Agree to the amount included in the financial statements and for a sample agree invoices or timesheets	Valuation Accuracy
Inspect board minutes for any discussions relating to the intended sale or use of the asset	Occurrence
Discuss the details of the project with management and Inspect project plans and other documentation, to evaluate compliance with IAS 38 criteria	Valuation Accuracy Existence
Inspect budgets to confirm financial feasibility	Existence

Other intangible assets

Procedure	Assertion
Inspect purchase documentation for purchased intangible assets	Existence Rights and obligations Accuracy
Inspect specialist valuer's report and agree the amount stated to the amount included in the general ledger and the financial statements	Valuation

Note**:** audit procedures for ammortisation are similar to those for depreciation.

Inventory

- The inventory count - is the main source of evidence.

According to ISA 501 “*Audit evidence – specific considerations for selected” items* auditor should attend physical inventory count as along as it is material to the financial statements.

Who is responsible to perform stock count?

The inventory count is the responsibility of the client. The auditor attends the count to help obtain sufficient appropriate evidence to form an opinion as to whether inventory is free from material misstatement

Audit procedures for inventory count

Before inventory count

During inventory count

After inventory count

Before inventory count

- Contact client to obtain a copy of the inventory count instructions, to understand how the count will be conducted and assess the effectiveness of the count process.
- Review prior year working papers to understand the inventory count process and identify any issues that would need to be taken into account this year.
- Book audit staff to attend the inventory counts.
- Ascertain whether any inventory is held by third parties, and if applicable determine how to gather sufficient appropriate evidence.
- Consider the need for using an expert to assist in valuing the inventory being counted.
- Send a letter requesting direct confirmation of inventory balances held at year end from any third party warehouse providers used regarding quantities and condition.

Illustration

The following is an extract from Garden and Co (G&C) inventory count instructions.

(1) A finance manager must manage the inventory count.

(2) No goods are to be received or despatched during the inventory count.

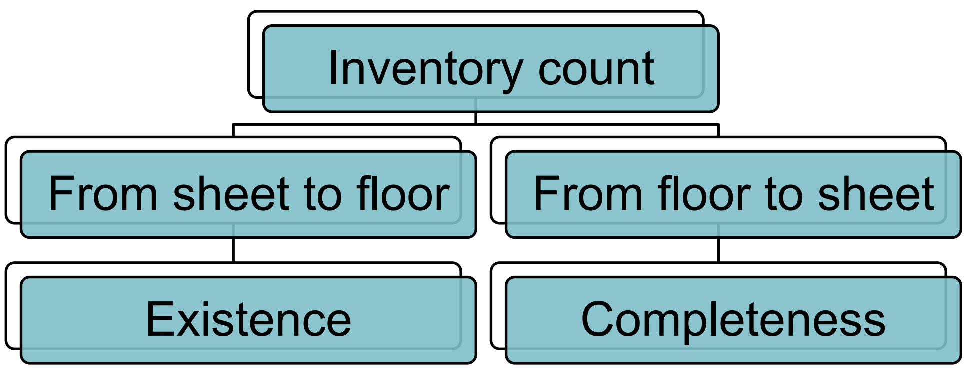
(3) Each team will consist of two members of staff from the finance department.

Required: discuss the reasons for each of the processes described in inventory count instructions of G&C.

№	Reason
(1)	A suitably trained and senior individual should be responsible for the count to ensure that any issues can be resolved on a timely basis.
(2)	Inventory records could be misstated if product lines are missed or double counted due to movements in the warehouse.
(3)	Segregation of duties between those who have day-to-day responsibility for inventory and those who are checking it prevents errors and fraud being hidden by the warehouse team.

During inventory count

Procedure	Assertion
Observe the count to ensure that the instructions are being followed	
Attend the inventory count (if one is to be performed) at the third party warehouses to review the controls in operation	Existence Completeness
Ensure that goods held on behalf of third parties is segregated and recorded separately	Rights & Obligations
Inspect the inventory being counted for evidence of damage or obsolescence that may affect the net realisable value	Valuation
Record details of the last deliveries prior to the year end	Cut-off
Obtain copies of inventory count sheets at the end of the inventory count, ready for checking against final inventory listing after the inventory count	



After inventory count
Final audit procedures

Procedure	Assertion
Trace the items counted during the inventory count to the final inventory list to ensure it is the same as the one used at the year-end and to ensure that any errors identified during counting procedures have been rectified.	Accuracy Completeness
Cast the list (showing inventory categorised between finished goods, WIP and raw materials) to ensure arithmetical accuracy and agree totals to financial statement disclosures	Accuracy
Inspect purchase invoices for a sample of inventory items to agree their cost	Accuracy Occurrence
Inspect post year-end sales invoices for a sample of inventory items to determine if the net realisable value is reasonable. This will also assist in determining if inventory is held at the lower of cost and net realisable value has been used	Valuation
Inspect the ageing of inventory items to identify old/slow-moving amounts that may require provision, and discuss these with management	Valuation
Recalculate work-in-progress and finished goods valuations using payroll records for labour costs and utility bills for overhead absorption	Valuation

After inventory count
Final audit procedures (continued)

Procedure	Assertion
Calculate inventory turnover/days and compare this to prior year, to assess whether inventory is being held longer and therefore requires greater provision	Valuation
Calculate gross profit margin and compare this to prior year, investigate any significance differences that may highlight an error in costs of sales and closing inventory	Valuation
Trace the goods received immediately prior to the year-end to year-end payables and inventory balances	Cut-off
Trace goods despatched immediately prior to the year-end to the nominal ledgers to ensure the items are removed from inventory and a sale (and receivable where relevant) has been recorded	Cut-off
Inspect any reports produced by the auditors of third party warehouses in relation to the adequacy of controls over inventory	
Inspect any documentation in respect of third party inventory.	Rights & Obligations
Inspect the ageing of inventory items to identify old/slow-moving amounts that may require provision, and discuss these with management	Valuation

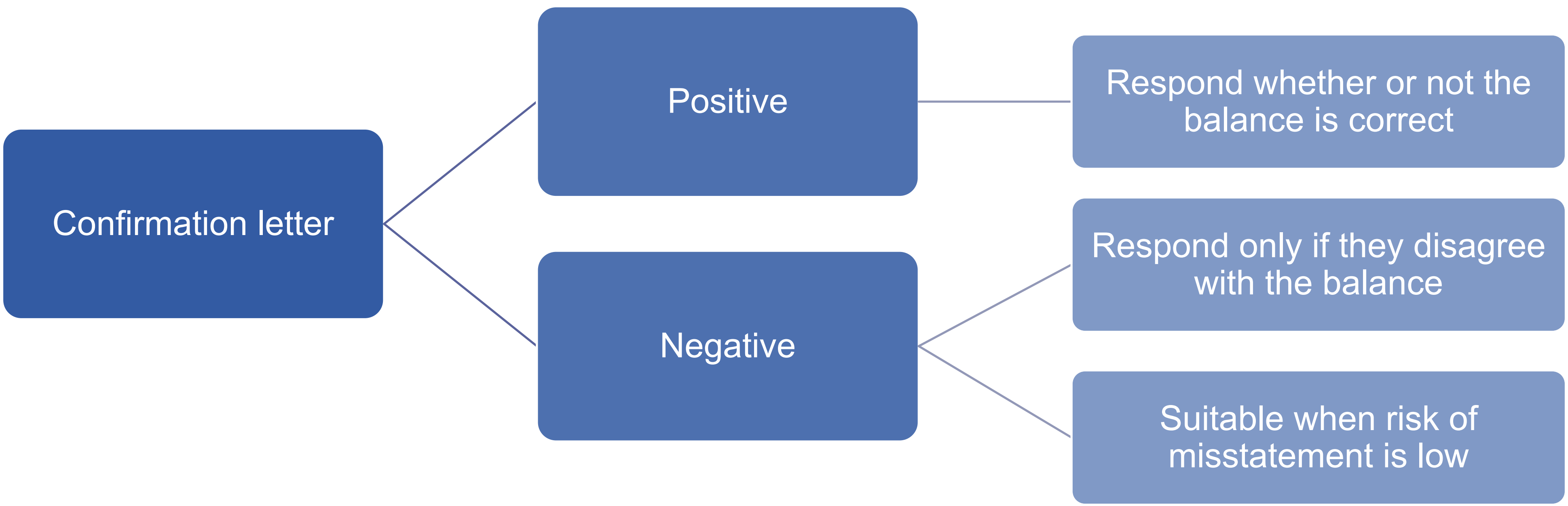
After inventory count
Final audit procedures (continued)

Procedure	Assertion
Recalculate work-in-progress and finished goods valuations using payroll records for labour costs and utility bills for overhead absorption	Valuation
Calculate inventory turnover/days and compare this to prior year, to assess whether inventory is being held longer and therefore requires greater provision	Valuation
Calculate gross profit margin and compare this to prior year, investigate any significance differences that may highlight an error in costs of sales and closing inventory	Valuation
Trace the goods received immediately prior to the year-end to year-end payables and inventory balances	Cut-off
Trace goods despatched immediately prior to the year-end to the nominal ledgers to ensure the items are removed from inventory and a sale (and receivable where relevant) has been recorded	Cut-off
Inspect any reports produced by the auditors of third party warehouses in relation to the adequacy of controls over inventory	All assertions
Inspect any documentation in respect of third party inventory	Completeness

Receivables

Focus	Valuation
Direct testing	Receivables overstatement
Indirect testing	Revenue overstatement

One of the main sources of evidence is circularization procedure.



Confirmation letters

ISA 505 “*External confirmations”* requires the auditor to maintain control over external confirmation requests when using external confirmations as a source of audit evidence.

This can be achieved by:

- the auditor preparing the confirmation letters and determing the information to be requested and the information that should be included in the request
- the auditor selecting the sample of external parties to obtain confirmation from
- the auditor sending the requests to the confirming party

Receivables
Audit procedures

Procedures	Assertion
Perform a positive receivables circularisation of a representative sample of year-end balances, for any non-replies, with the Client's permission, send a reminder letter to follow-up	Existence Rights & Obligations Accuracy
Review after date cash receipts and follow through to pre year-end receivable balances	Existence Rights & Obligations Valuation
Calculate average receivable days and compare this to prior year, investigate any significant differences	Valuation
Review the reconciliation of the sales ledger control account to the sales ledger list of balances	
Select a sample of goods despatched notes (GDN) before and just after the year end and follow through to the sales invoice to ensure they are recorded in the correct accounting period	Existence (cut-off)
Review a sample of post year-end credit notes to identify any that relate to pre year-end transactions to ensure that they have not been included in receivables	Existence (occurrence)

Receivables
Audit procedures (continued)

Procedures	Assertion
Select a sample of year-end receivable balances and agree back to valid supporting documentation of GDN and sales order	Existence Accuracy
Review board minutes to assess whether there are any material disputed receivables that may require write off	Valuation Rights & Obligations
Inspect the aged receivables report to identify any slow moving balances, discuss these with the credit control manager to assess whether an allowance or write down is necessary	Valuation and allocation
For any slow moving/aged balances review customer correspondence to assess whether there are any invoices in dispute	Valuation Rights & Obligations
Review the sales ledger for any credit balances and discuss with management whether these should be reclassified as payables	Valuation of AR Completeness of AP

Prepayments
Audit procedures

Prepayments are services or goods for which a company has paid in advance.

Procedure	Assertion
Review the level of prepayments in comparison to prior year	Valuation
For a sample of prepayments, inspect bank statements to ensure payment has been made	Existence Accuracy
For a sample of prepayments, inspect invoices to ensure payment relates to goods or services not yet received	Existence
For a sample of prepayments, recalculate the amount prepaid to confirm mathematical accuracy	Accuracy

Payables & Accruals
Audit procedures

Focus	Completeness
Direct testing	Understatement of payables
Indirect testing	Understatement of cost of sales

Procedure	Assertion
For a sample of trade payables balances, obtain supplier statements and reconcile these to the purchase ledger balances, and investigate any reconciling items	Accuracy
Obtain a listing of trade payables from the purchase ledger and agree to the general ledger and the financial statements	Accuracy Classification & Understandability
Obtain the list of accruals from the client, cast it to confirm mathematical accuracy and agree to the general ledger and the financial statements	Accuracy Classification & Understandability
Ensure payables and accruals are included in financial statements as current liabilities	Classification

Payables & Accruals
Audit procedures (continued)

Procedure	Assertion
Reconcile the total of purchase ledger accounts with the purchase ledger control account, and cast the list of balances and the purchase ledger control account	Completeness Accuracy
Review the list of trade payables and accruals against prior years to identify any significant omissions	Completeness
Review after date payments, if they relate to the current year then follow through to the purchase ledger or accrual listing	Completeness
Review after date invoices to ensure no further items need to be accrued	Completeness
Enquire of management their process for identifying goods received but not invoiced or logged in the purchase ledger and ensure that it is reasonable	Completeness
Select a sample of goods received notes before the year-end and follow through to inclusion in the year-end payables balance	Cut-off of purchases

Payables & Accruals
Audit procedures (continued)

Procedure	Assertion
Calculate the trade payable days and compare to prior years, investigate any significant differences	Valuation
Select a sample of payable balances and perform a trade payables' circularisation, follow up any non-replies and any reconciling items between balance confirmed and trade payables' balance	Existence Accuracy
Review the purchase ledger for any debit balances, for any significant amounts discuss with management and consider reclassification as current assets	Valuation of AP Completeness of AR
Recalculate a sample of accrued costs by reference to contracts and payment schedules (e.g. loan interest)	Accuracy

Provisions

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires an entity to recognise a provision if:

- a present obligation has arisen as a result of a past event;
- a payment is **probable** ('more likely than not'); and
- the amount can be estimated reliably.

If payment is ***only possible***, a contingent liability must be disclosed in the notes to the financial statements.

Provisions
Audit procedures

Procedure	Assertion
Enquire with the directors or inspect relevant supporting documentation to confirm a present obligation at the year-end	Existence
Inspect relevant board minutes to ascertain whether payment is probable	Existence
Obtain a breakdown of the items to be provided for and cast it	Accuracy
Recalculate the provision and agree components of the calculation to supporting documentation	Accuracy Completeness
Review the post year-end period to identify whether any payments have been made, compare actual payments to the amounts provided to assess whether the provision is reasonable	Valuation
Obtain a written representation from management to confirm the completeness of the provision. If applicable, enquire with the client's solicitors about the likely outcome and chances of payment	Completeness
Review the disclosure of the provision to ensure compliance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*	Classification and understanding

Test your understanding

The statement of financial position shows that Garden & Co has RUR 360,000 provisions for the year ended 31 December 2013. The majority of the provision relates to provisions for warranties (RUR 300,000). However, RUR 60,000 of the provision relates to a claim made by an ex-employee of Garden & Co who is claiming for unfair dismissal.

Required:

Suggest possible audit procedures in relation to this provision.

Solution

Among possible audit procedures can be the following:

- Enquire with the directors when the employee was dismissed in order to confirm that a present obligation exists at the year end.
- Review correspondence with the employee to verify that the employee was dismissed before the year end.
- Inspect relevant board minutes to ascertain whether it is probable that the payment will be made to the employee.
- Enquire with the solicitors on the merits of the unfair dismissal case and the likely payment.
- Obtain a breakdown of the costs to be provided for and cast it to ensure completeness.
- Recalculate the provision to confirm completeness and agree components of the calculation to supporting documentation, e.g. fee estimate from Murray Co's solicitors, claim received from ex-employee.
- Review the post year-end period to identify whether any payments have been made to the solicitors or ex-employee, compare actual payments to the amounts provided to assess whether the provision is reasonable.
- Obtain a written representation from management to confirm the completeness of the provision.
- Review the disclosure of the provision to ensure compliance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*

Share capital, reserves & director's remuneration

Share capital	■ Agree authorised share capital and nominal value disclosures to underlying shareholding agreements/statutory constitution documents. ■ Inspect cash book for evidence of cash receipts from share issues. ■ Inspect board minutes to verify issue of share capital during the year.
Directors remuneration	■ Obtain a schedule of director's remuneration and agree to financial statement disclosures. ■ Inspect payroll records and agree wages, bonuses, and pension contributions. ■ Inspect bank statements to verify the amounts actually paid to directors. ■ Inspect board minutes for discussion and approval of directors' bonus announcements or other additional remuneration.
Reserves	■ Agree opening reserves to prior-year closing reserves and reconcile movements and movements in reserves to supporting documentation.
Dividends	■ Inspect board minutes to agree dividends proposed before the year-end. ■ Inspect bank statements to agree dividends paid before the year-end. ■ Inspect dividend warrants to agree dividend payment.

Statement of profit or loss

Purchases and other expenses

- Recalculate discounts and sales tax applied for a sample of large purchase invoices (**Accuracy**).
- Select a sample of purchase orders and agree these to the GRNs and purchase invoices through to inclusion in the purchases ledger (**Accuracy, Occurrence, Classification**).

Revenue

- Recalculate discounts and sales tax applied for a sample of large sales invoices: verifies accuracy.
- Select a sample of customer orders and agree these to the dispatch notes and sales invoices through to inclusion in the sales ledger: verifies completeness.

Statement of profit or loss

Payroll:

- Agree the total wages and salaries expense per the payroll system to the general ledger and the financial statements.
- Recalculate the gross and net pay for a sample of employees, and agree to the payroll records.
- Reperform calculation of statutory deductions to confirm whether correct deductions for this year have been included within the payroll expense.
- Select a sample of joiners and leavers, agree their start/leaving date to supporting documentation, recalculate that their first/last pay packet was accurately calculated and recorded.
- For salaries, agree the total net pay per the payroll records to the bank transfer listing of payments and to the cashbook. For wages, agree the total cash withdrawn for wage payments equates to the weekly wages paid plus any surplus cash subsequently banked

Test your understanding

Total payroll for the year ending 31 December 2012 was RUR 1,220,000 (to the nearest RUR'000). At this time Garden & Co had 34 employees.

Total payroll for the year ending 31 December 2013 included in the draft financial statements of Garden & Co is RUR 1,312,000 (to the nearest RUR'000).

Garden & Co now has 37 employees.

All employees received a 5% payrise on 31 March 2013.

Required: create an expectation of what total payroll will be for year ending 31 December 2013.

Solution:

The average annual salary per employee in 2012 was $35,882 (RUR 1,220,000/34). We know that all employees received a payrise for 9 months of 2013 of 5%. The average value of this payrise is therefore RUR150 per employee in 2013 (5%×RUR 35,882/12).

The average salary for 2013 should therefore equal RUR 36,032 (RUR 35,882+RUR 150).

We can set an expectation for total payroll for the year ending 31 December 2013 as 37×RUR 36,032: $1,333,184.

The difference ($21,184) is less than 1.6% more than our expectation, and we can therefore conclude that the payroll cost is true and fair.

Accounting estimates

ISA 540 “*Auditing Accounting Estimates”* requires the auditor to***:***
Obtain an understanding of how management identify those transactions, events or conditions that give rise to the need for an estimate.

Suggest possible audit procedures for accounting estimates?

- Enquire of management how the accounting estimate is made and the data on which it is based.
- Determine whether events occurring up to the date of the auditor’s report (after the reporting period) provide audit evidence regarding the accounting estimate.
- Review the method of measurement used and assess the reasonableness of assumptions made.
- Test the operating effectiveness of the controls over how management made the accounting estimate.
- Develop an expectation of the possible estimate (point estimate) or a range of amounts to evaluate management’s estimate.
- Review the judgements and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias.
- Evaluate overall whether the accounting estimates in the financial statements are either reasonable or misstated.
- Obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates and estimation uncertainty (e.g. contingent liabilities) are reasonable
- Obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable

Accounting estimates – Smaller entities

Lower risk

- Smaller entities may well be engaged in activity that is relatively simple.
- However, this will not be true for small, where there is a high level of expertise in a particular field

Direct control by owner managers

- Is a strength because they know what is going on and have the ability to exercise real control.
- On the other hand, they can also manipulate the figures or put private transactions ‘through the books’.

Simpler systems

- Smaller entities are less likely to have sophisticated IT systems. This is an advantage in that many of the bookkeeping errors associated with smaller entities may now be less prevalent.

Evidence implications

- The normal rules concerning the relationship between risk and the quality and quantity of evidence apply irrespective of the size of the entity.
- The quantity of evidence may well be less than for a larger organisation.
- It may be more efficient to carry out 100% testing in a smaller organisation.

Accounting estimates – Smaller entities
Problems

Management override a key director or manager have significant power and authority which means that controls are lacking in the first place or they are easy to override.

No segregation of duties a limited number of accounts clerks who process information, therefore directors should authorise and review all work performed.

Less formal approach have simple systems and very few controls due to the trust and the lack of complexity.

Related party transactions

Related party is a person or entity that has control or significant influence, directly or indirectly over the reporting entity

ISA 550 “Related parties”

Difficult to audit because:

- The relationship between the parties may be very complicated.
- Related party transactions may not be on normal commercial terms.
- Related party transactions may not have documentation to support them.
- Related party transactions are material by nature (i.e. regardless of the value of a related party transaction, if it is not presented fairly or disclosed adequately, the financial statements will be materially misstated).

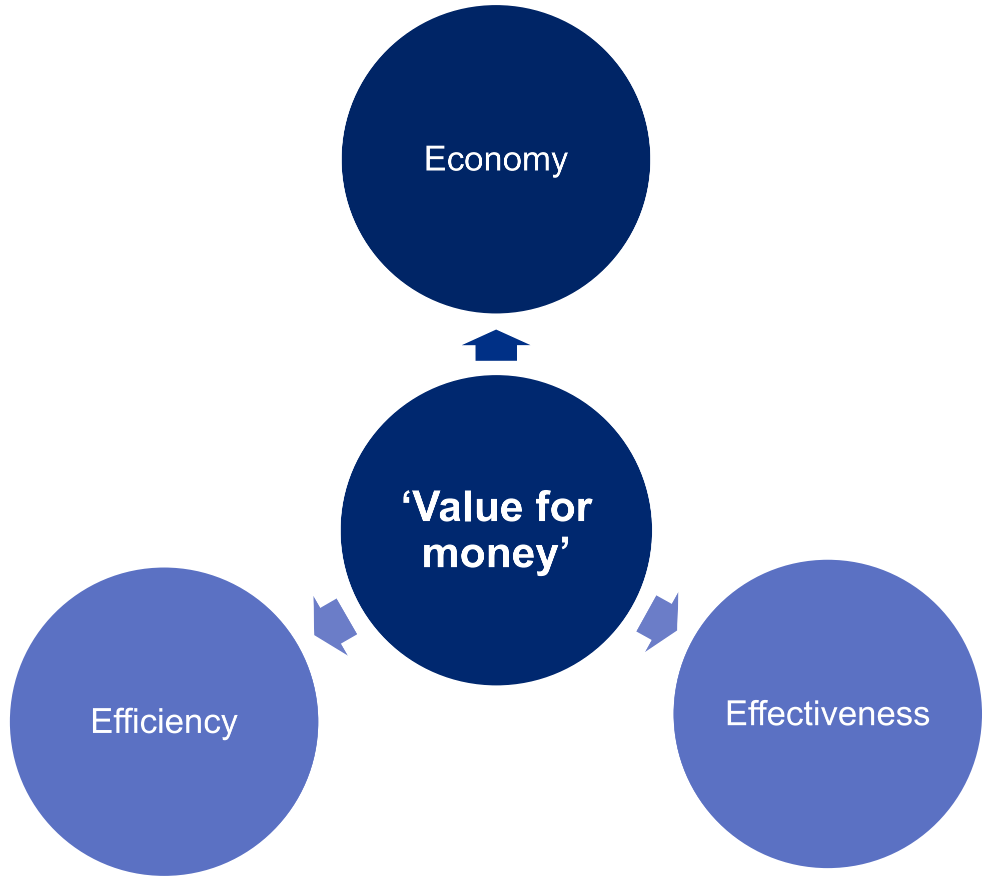
Accounting estimates – Not-for-profit organisations (NFP)

Characteristics:

- Profit maximisation is not the goal.
- Do not have external shareholders.
- Do not distribute dividends.

'NFP' entities may have weaker systems due to:

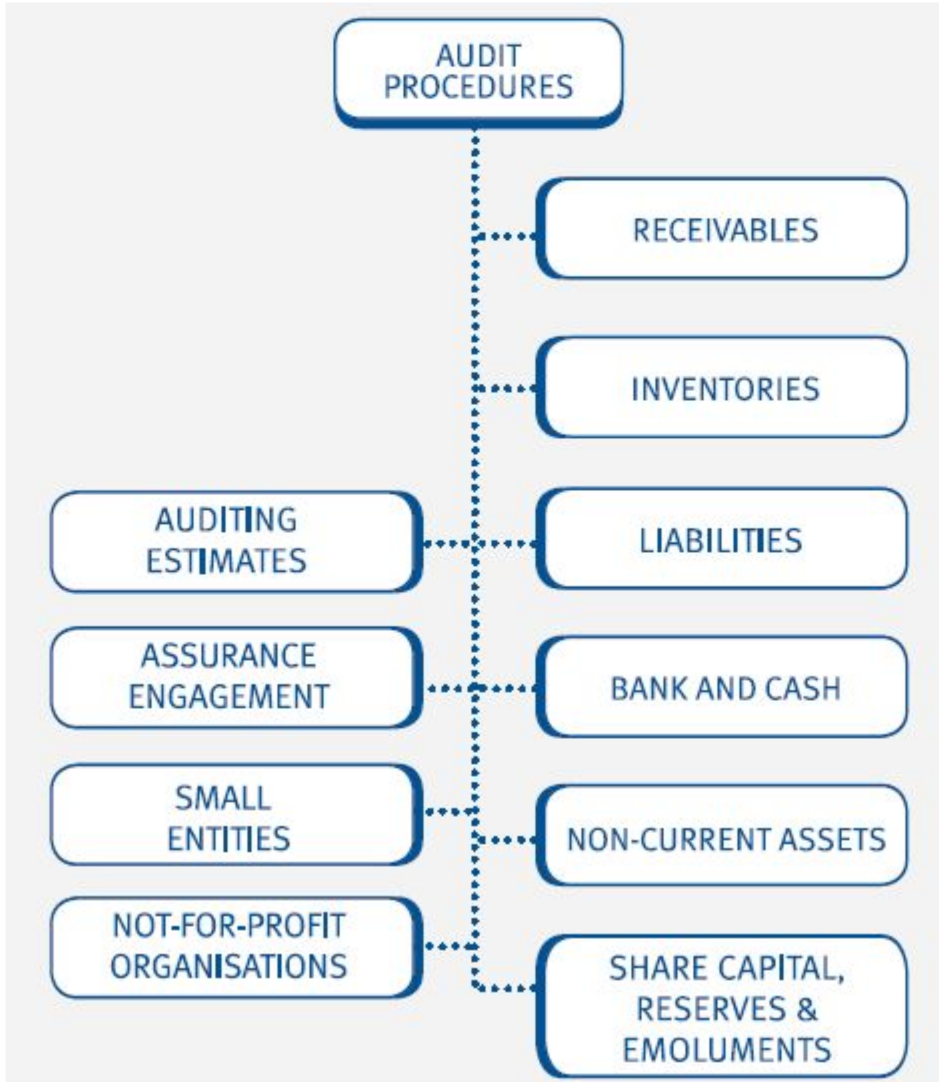
- lack of segregation of duties, as the organisation will be restricted with the amount of staff;
- the use of volunteers, who are likely to be unqualified and have little awareness of the importance of controls;
- the use of less formalised systems and controls.



Accounting estimates – Not-for-profit organisations (NFP)
Audit implications

- Testing tends to concentrate on substantive procedures where control systems are lacking. In the absence of documentary evidence procedures rely heavily on analytical review, enquiry and management representation.
- The volumes of transactions in not for profit organisations may be lower than a private one, therefore auditors may be able to test a larger % of transactions.
- Ultimately, if sufficient appropriate evidence is not available the auditor will have to modify their audit report.

Summary (visual reference)



KPMG

cutting through complexity

THANK YOU!