CPA专业方向师资培训 —— Day 7

Morning Session

21 August 2007

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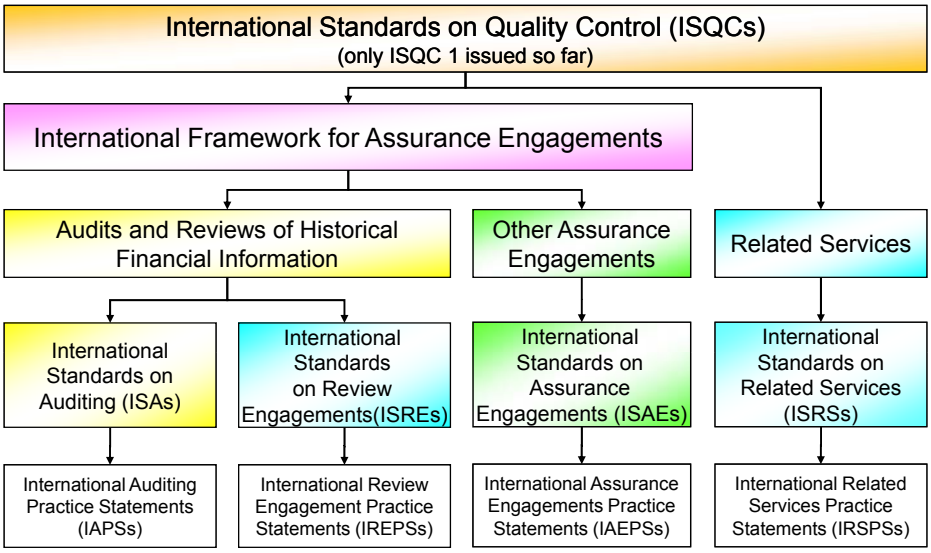
Overview



Overview

International Standards on Quality Control (ISQCs)
(only ISQC 1 issued so far)

International Framework for Assurance Engagements

Audits and Reviews of Historical Financial Information

International Standards on Auditing (ISAs)

International Auditing Practice Statements (IAPSs)

Overview

International Standards on Auditing (ISAs)

- ISA 200 – 299
  General Principles and Responsibilities
- ISA 300 – 499
  Risk Assessment & Response to Assessed Risks
- ISA 500 – 599
  Audit Evidence
- ISA 600 – 699
  Using Work of Others
- ISA 700 – 799
  Audit Conclusions and Reporting

Today's Agenda

International Standards on Auditing (ISAs)

- Audit Documentation (ISA 230)
- Audit Evidence (ISA 500)
- Audit Evidence: Specific Items (ISA 501)
- External Confirmations (ISA 505)

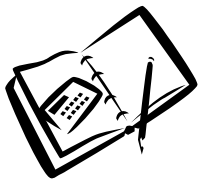
Today's Agenda

- Audit Documentation (ISA 230)

The Requirements of ISA 230

- The auditor should prepare, on a timely basis, **audit documentation** that provides:
  a) A sufficient and appropriate record of the basis for the auditor's report; and
  b) Evidence that the audit was performed in accordance with ISAs and applicable legal and regulatory requirements. (ISA 230.2)

Audit documentation" means the record of
- audit procedures performed,
- relevant audit evidence obtained, and
- conclusions the auditor reached
- also termed as "working papers" or "workpapers")



- Compliance with the requirements of ISA 230 together with the specific documentation requirements of other relevant ISAs is ordinarily sufficient to achieve the objectives in ISA 230.2.

Nature of Documentation

- Audit documentation includes:
  - Overall audit strategy and audit plan
  - Audit programs
  - Analysis and analytical procedures worksheets
  - Internal control questionnaires and evaluation questionnaires
  - Issues memoranda
  - Summaries of significant matters
  - Letters of confirmation
  - Letters of representation
  - Checklists
  - Correspondence (including e-mail) concerning significant matters
  - Abstracts or copies of the entity's records

Form, Content and Extent

"Experienced auditor" means an individual (whether internal or external to the firm) who has a reasonable understanding of (i) audit processes, (ii) ISAs and applicable legal and regulatory requirements, (iii) the business environment in which the entity operates, and (iv) auditing and financial reporting issues relevant to the entity's industry.

- The auditor should prepare the audit documentation so as to enable an **experienced auditor**, having no previous connection with the audit, to understand:
  a) The nature, timing, and extent of the audit procedures performed to comply with ISAs and applicable legal and regulatory requirements;
  b) The results of the audit procedures and the audit evidence obtained; and
  c) Significant matters arising during the audit and the conclusions reached thereon. (ISA 230.9)

Form, Content and Extent

- The form, content and extent of audit documentation depend on factors such as:
  - The nature of the audit procedures to be performed;
  - The identified risks of material misstatement;
  - The extent of judgment required in performing the work and evaluating the results;
  - The significance of the audit evidence obtained;
  - The nature and extent of exceptions identified;
  - The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained; and
  - The audit methodology and tools used.

Form, Content and Extent

- It is, however, neither necessary nor practicable to document every matter the auditor considers during the audit.
- Oral explanations by the auditor, on their own
  - do not represent adequate support for the work the auditor performed or conclusions the auditor reached,
  - but may be used to explain or clarify information contained in the audit documentation.

Form, Content and Extent

- In documenting the nature, timing and extent of audit procedures performed, the auditor should record the **identifying characteristics** of the specific items or matters being tested. (ISA 230.12)
- Recording the identifying characteristics serves a number of purposes, for example:
  - enables the audit team to be accountable for its work
  - facilitates the investigation of exceptions or inconsistencies.
- Identifying characteristics will vary with the nature of the audit procedure and the item or matter being tested.

Form, Content and Extent

Example

List the identifying characteristics of the following audit procedures:

Audit procedures	Identifying characteristics (auditor may identify/record)
Test of entity's own purchase orders	➔ The documents selected for testing by their dates and unique purchase order numbers
Review all items over a specific amount from a given population	➔ The scope of the procedure and identify the population, e.g. all journal entries over a specified amount from the journal register
Systematic sampling from a population of documents	➔ The documents selected by recording their source, the starting point and the sampling interval e.g. a systematic sample of shipping reports selected from the shipping log from 1 Apr. to 30 Sep., starting with report number 001234 and selecting every 25th report
Inquiries of specific entity personnel	➔ The dates of the inquiries and the names and job designations of the entity personnel
An observation procedure	➔ The process or subject matter being observed, the relevant individuals, their respective responsibilities, and where and when the observation was carried out

Form, Content and Extent

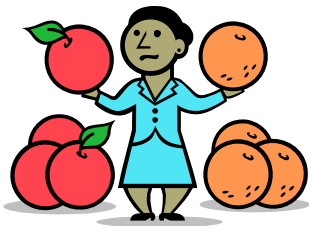
- The auditor should document discussions of **significant matters** with management and others on a timely basis. (ISA 230.16)
  - Significant matters include, amongst others:
    - Matters that give rise to significant risks
    - Results of audit procedures indicating
      a) that the financial information could be materially misstated, or
      b) a need to revise the auditor's previous assessment of the risks of material misstatement and the auditor's responses to those risks.
    - Circumstances that cause the auditor significant difficulty in applying necessary audit procedures.
    - Findings that could result in a modification to the auditor's report.

Form, Content and Extent

- If the auditor has identified information that contradicts or is inconsistent with the auditor's final conclusion regarding a significant matter,
  - the auditor should document how the auditor addressed the contradiction or inconsistency in forming the final conclusion. (ISA 230.18)

Form, Content and Extent

- Where, in exceptional circumstances, the auditor judges it necessary to **depart from a basic principle or an essential procedure** that is relevant in the circumstances of the audit,
  - the auditor should document how the alternative audit procedures performed achieve the objective of the audit, and, unless otherwise clear, the reasons for the departure. (ISA 230.21)



Form, Content and Extent

- In documenting the nature, timing and extent of audit procedures performed, the auditor should record:
  a) Who performed the audit work and the date such work was completed; and
  b) Who reviewed the audit work performed and the date and extent of such review. (ISA 230.21)

Form, Content and Extent

- The audit documentation for a specific audit engagement is assembled in an audit file, which can be divided into:
  a. Permanent file
  b. Current file or current audit file
  c. System file

Permanent File

Current File

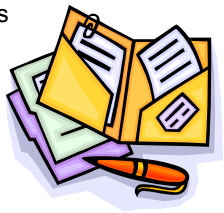
System File

Permanent File

Permanent file normally contains:

a. A permanent file index or checklist
b. Administrative information and special agreement with the entity
c. Copy of engagement letter and any amendments and updates
d. List of current files maintained for the entity
   - General background of the entity and statutory materials
   - History of share capital and reserves
   - Copies of important agreements and list of relevant law and regulation
   - List of important accounting matters
   - Notes of meeting, interview and correspondences
   - Summary of internal audit functions and reports of internal auditors
   - Previous letters to management and signed audited financial statements

Permanent File



Current File

Current file normally contains:

a. A file index
b. An overall audit strategy and an audit plan
c. Audit programme with tailored-made audit procedures
d. A set of financial statements
e. An audit report
f. Letter of management representation
g. Letter to the management and their reply or resolution
h. Representation on directors' remuneration
i. The entity's trial balance, management accounts, journal adjustment, and budget

Current File

Current File

Current file normally contains:

j. Schedules of each balance sheet items with audit procedures performed and findings and conclusion made
k. Schedules of each income statements items with audit procedures performed and findings and conclusion made
l. Disclosure checklist to comply with the Companies Ordinance, IFRSs, the specific industry requirements, such as Securities Ordinance
m. Copies or summary of minutes of board and general meeting
n. Worksheet for cash flows statements
o. Resolution on dividend proposed and/or declared
p. Audit materiality
q. A schedule of important statistics, copies of all communications with other people

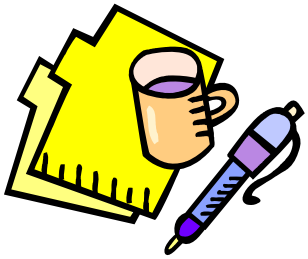
Current File

System File

System file or system audit file

– Usually contains the auditor's notes and procedures on the internal control and accounting system on an entity
– Often assembled in the interim visit and updated in the final visit

System File



System File

System file normally contains:

a. System review checklist
b. Notes on the control environment and risk assessment procedures
c. The notes on the entity's information and accounting system
d. A summary of identified internal control
e. The tests of control designed to ascertain the system and internal control
f. Evaluation notes on the internal control and control activities
g. Tests of control to ensure the effectiveness of the internal control
h. Findings and conclusion on each internal control tested
i. Letter to the management
j. Schedule on identified and assessed risks of material misstatement
k. Notes on issues to be followed-up on final visit
l. Update and follow-up made during the final visit and any revision on the risk assessment

System File

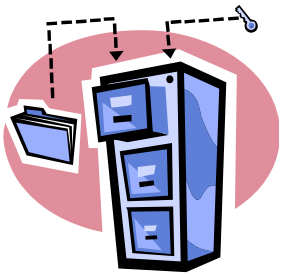
System File – ICQ

- An internal control questionnaire used to describe the internal control of a system of an entity.
  - enables the auditor to review and assess the existence and effectiveness of the entity internal control in a particular area
  - is also commonly used in documenting and evaluating a system

System File

Other Audit Documentation

- Audit manual
- Audit programme
- Audit planning, control and review worksheet
- Overall review and completion memorandum
- Time sheets
- Debriefing memorandum

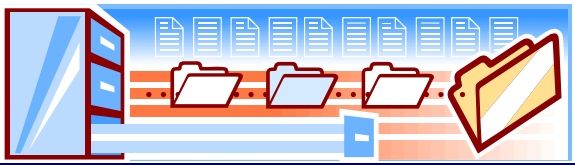


Assembly of Final Audit File

- ISA 230 requires that
  - the auditor should complete the assembly of the final audit file on a timely basis after the date of the auditor's report (ISA 230.25)
- ISQC 1 requires firms to establish policies and procedures for the timely completion of the assembly of audit files, and
  - indicates that **60 days** after the date of the auditor's report is ordinarily an appropriate time limit for such requirement (ISQC 1.73b)
- The completion of the assembly of the final audit file after the date of the auditor's report is an administrative process
  - that does not involve the performance of new audit procedures or the drawing of new conclusions

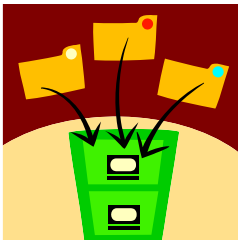
Assembly of Final Audit File

- ISA 230 has established a new requirement on retention of audit documentation and requires that
  - after the assembly of the final audit file has been completed, the auditor should not delete or discard audit documentation before the end of its **retention period** (ISA 230.28)
- ISQC 1 indicates:
  - the **retention period** for audit engagements ordinarily is **no shorter than five years** from the date of the auditor's report, or,
  - if later, the date of the group auditor's report (ISQC 1.73j)



Assembly of Final Audit File

- When the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed,
  - the auditor should, regardless of the nature of the modifications or additions, document:
    a. When and by whom they were made, and (where applicable) reviewed;
    b. The specific reasons for making them; and
    c. Their effect, if any, on the auditor's conclusions. (ISA 230.30)



Changes in Exceptional Cases

- When exceptional circumstances arise after the date of the auditor's report that require the auditor to perform new or additional audit procedures or that lead the auditor to reach new conclusions, the auditor should document:
  a) The circumstances encountered;
  b) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached; and
  c) When and by whom the resulting changes to audit documentation were made, and (where applicable) reviewed. (ISA 230.31)

Ownership of Documents

- No definite answers
- ISQC 1 states that:
  – Unless otherwise specified by law or regulation, engagement documentation is the property of the firm.
  – The firm may, at its discretion, make portions of, or extracts from, engagement documentation available to clients, provided such disclosure does not undermine the validity of the work performed, or, in the case of assurance engagements, the independence of the firm or its personnel. (ISQC1.73l)

Ownership of Documents

- General understanding depend on:
  1. Principal and principal relationship:
     - documents prepared, acquired or brought into being by the auditor solely for his own purpose as principal belong to the auditor
  2. Principal and agent relationship:
     - final documents specifically prepared for the client at his request belongs to the client
     - the auditor's drafts and office copy belong to the auditor

Today's Agenda

Audit Evidence (ISA 500)

International Standards on Auditing (ISAs)

Audit Evidence

- ISA 500 requires the auditor to obtain sufficient appropriate evidence to enable him to draw reasonable conclusions on which to base the audit opinion. (ISA 500.2)

Sufficient
- relates to the quantity of the audit evidence

Appropriateness
- refers to the quality of audit evidence in terms of its relevance and reliability to support for or detect a misstatement

Relevant

Reliable

- Audit evidence is
  - all the information used by the auditor in arriving at the conclusions on which the audit opinion is based, and
  - includes the information contained in the accounting records underlying the financial statements and other information.

Audit Evidence

- Audit evidence, which is cumulative in nature,
  - Includes audit evidence obtained from audit procedures performed during the course of the audit
  - May include audit evidence obtained from other sources, such as
    - previous audits and
    - a firm's quality control procedures for client acceptance and continuance.

Sufficient

Appropriateness

Relevant

Reliable

Audit Evidence

- The quantity of audit evidence needed is affected
  - by the risk of misstatement (the greater the risk, the more audit evidence is likely to be required) and
  - by the quality of such audit evidence (the higher the quality, the less may be required).

Relevant

Reliable

- Accordingly, the sufficiency and appropriateness of audit evidence are interrelated.
- However, merely obtaining more audit evidence may not compensate for its poor quality.

Audit Evidence – Relevant

Example

1. A given set of audit procedures
   - may provide audit evidence that is relevant to certain assertions, but not others.

   Inspection of records related to the collection of receivables after the period end
   - may provide audit evidence regarding both existence and valuation,
   - although not necessarily the appropriateness of period-end cutoffs.

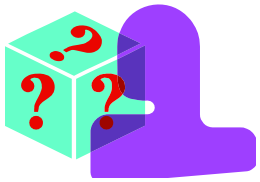
2. Audit evidence obtained from different sources or of a different nature
   - that is relevant to the same assertion.

   Analysing the aging of accounts receivable and the subsequent collection of receivables
   - to obtain audit evidence relating to the valuation of the allowance for doubtful accounts.

3. Obtaining audit evidence relating to a specific assertion
   - is not a substitute for obtaining audit evidence regarding another assertion.

   Evidence relating to the physical existence of inventory
   - is not a substitute for evidence regarding the valuation of inventory.

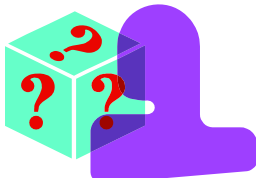
Audit Evidence – Reliable



- The reliability of audit evidence
  - is influenced by its source (internal or external) and by its nature (visual, documentary or oral) and
  - is dependent on the individual circumstances under which it is obtained.
- Even when audit evidence is obtained from sources external to the entity, circumstances may exist that could affect the reliability of the information obtained.
  - For example, audit evidence obtained from an independent external source may not be reliable if the source is not knowledgeable.

Audit Evidence – Reliable

Example



- Audit evidence is more reliable when
  - it is obtained from independent sources outside the entity
  - the related controls imposed by the entity are effective (for evidence generated internally)
  - it is obtained directly by the auditor
    - e.g. observation of the application of a control, as compared with inquiry about the application of a control (obtained indirectly or by inference)
  - it exists in documentary form, whether paper, electronic, or other medium
    - e.g. a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed
  - when it is provided by original documents (as compared with those provided by photocopies or facsimiles)

Audit Evidence

- When information produced by the entity is used by the auditor to perform audit procedures,
  - the auditor should obtain audit evidence about the accuracy and completeness of the information. (ISA 500.11)

Assertions and Audit Evidence

- In preparing the financial statements that give a true and fair view in accordance with the applicable financial reporting framework,
  - management implicitly or explicitly makes assertions, regarding
    - the recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures.

Assertions and Audit Evidence

- ISA 500 requires the auditor to use assertions for
  - classes of transactions,
  - account balances, and
  - presentation and disclosures

  in sufficient detail to form a basis for
  - the assessment of risks of material misstatement and
  - the design and performance of further audit procedures. (ISA 500.16)

Class of Transactions

Account Balances

Presentation and Disclosure

Assess the Risk of Material Misstatement

Develop **Overall Response** for financial statement level risks ↔ Design **Further Audit Procedures** for assertion level risks

Assertions and Audit Evidence

- Assertions used by the auditor fall into the following categories:
  - About Classes of Transactions and Events for the period under audit
    - Occurrence
    - Completeness
    - Accuracy
    - Cutoff
    - Classification
  - About Account Balances at the period end
    - Existence
    - Rights and obligations
    - Completeness
    - Valuation and allocation
  - About Presentation and Disclosure
    - Occurrence and rights and obligations
    - Completeness
    - Classification and understandability
    - Accuracy and valuation

Class of Transactions

Account Balances

Presentation and Disclosure

Audit Procedures

- To obtain audit evidence, audit procedures are performed to

Risk Assessment Procedures

a) obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and assertion levels;

Test of Controls

b) when necessary or when the auditor has determined to do so, test the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level; and

Substantive Procedures

c) Detect material misstatements at the assertion level
   - Substantive procedures include
     - tests of details of classes of transactions, account balances, and disclosures and
     - substantive analytical procedures

Audit Procedures

Risk Assessment Procedures

The auditor always performs risk assessment procedures to provide a satisfactory basis for the assessment of risks at

- the financial statement and
- the assertion levels.

Risk assessment procedures by themselves

- do not provide sufficient appropriate audit evidence on which to base the audit opinion,
- however, are supplemented by
  - further audit procedures in the form of tests of controls, when necessary, and substantive procedures.

Audit Procedures

Test of Controls

Tests of controls are necessary in two circumstances.

- When the auditor's risk assessment includes an expectation of the operating effectiveness of controls,
  - the auditor is required to test those controls to support the risk assessment.
- In addition, when substantive procedures alone do not provide sufficient appropriate audit evidence,
  - the auditor is required to perform tests of controls to obtain audit evidence about their operating effectiveness.

Audit Procedures

Substantive Procedures

- The auditor plans and performs substantive procedures to be responsive to the related assessment of the risks of material misstatement, which includes the results of tests of controls, if any.
- The auditor's risk assessment is judgmental, however, and may not be sufficiently precise to identify all risks of material misstatement.
- Further, there are inherent limitations to internal control, including
  - the risk of management override,
  - the possibility of human error and
  - the effect of systems changes.
- Therefore, substantive procedures for material classes of transactions, account balances, and disclosures **are always required** to obtain sufficient appropriate audit evidence.

Audit Evidence

Risk Assessment Procedures

Test of Controls

Substantive Procedures

- The auditor uses one or more types of the following audit procedures:
  - Inspection (of records/documents or assets)
  - Observation
  - Inquiry
  - Confirmation
  - Recalculation
  - Re-performance or
  - Analytical procedures
- These audit procedures, or combinations thereof, may be used as risk assessment procedures, tests of controls or substantive procedures, depending on the context in which they are applied by the auditor.

Today's Agenda

International Standards on Auditing (ISAs)

Audit Evidence: Specific Items (ISA 501)

1. Inventory and Physical Inventory Counting

Inventory and Inventory Counting

- Inventories are often significant to an entity
- Inventory quantity and value are not derived from the double entry system:
  - Quantity ascertained at year-end by counting
  - Different types of inventories in several locations
  - Assessment of inventory condition is a matter of opinion
  - Valuation methods are many and various
  - Different methods may lead to different values
- Physical inventory count is an important aspect of internal control
- While quantities of inventories is not part of the double entry system, the inventory records without physical inventory count cannot be relied completely.

The Requirements under ISA 501

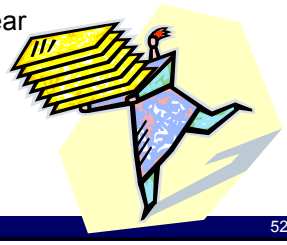
- When inventory is material to the financial statements,
  - the auditor should obtain sufficient appropriate audit evidence regarding its **existence** and **condition** by attendance at physical inventory counting unless impracticable. (ISA 501.5)

The Requirements under ISA 501

- The auditor's attendance serves as a test of controls or substantive procedure over inventory depending on the auditor's risk assessment and planned approach.
  - Such attendance enables the auditor
    - to inspect the inventory,
    - to observe compliance with the operation of management's procedures for recording and controlling the results of the count and
    - to provide audit evidence as to the reliability of management's procedures.

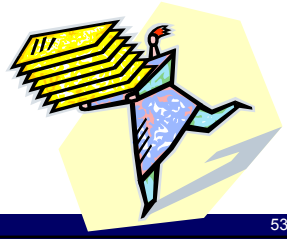
Planning Before Attendance

- In planning the attendance, the auditor considers and reviews the following related to inventories:
  - The risk of material misstatement, the materiality, the nature of the internal control, the location and the timing of the count
  - Whether adequate procedures by the entity and whether an expert's assistance is needed
  - Previous year's inventory files and relevant audit documentation
  - The entity's plan on counting for the current year



Planning Before Attendance

- In planning the attendance, the auditor consider and review the following related to inventories:
  - The entity's instruction on physical inventory count
    - Evaluate the adequacy and suggest improvements
  - The nature and volume of inventories held for the year
  - Inventories in public warehouse and other locations
  - The staffing on attendance
  - Briefing to the audit staff involved the attendance
  - The test counts to be performed



Planning – Counting Procedures

- Good set of physical inventory count procedures consists of:
  a. Proper organization and planning
  b. Proper person responsible for overall control
  c. Sufficient and competent staff
  d. Distribute physical inventory count instructions (in writing) to all staff and locations involved
  e. Proper physical arrangement of inventories for counting
  f. Establish methods of determining and checking quantities

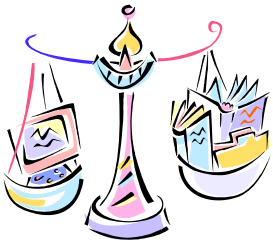
Planning – Counting Procedures

- Good set of physical inventory count procedures consists of:
  - g. Identification of high value items for counting
  - h. Defective, damaged, obsolete and slow moving inventories properly located and listed
  - i. Identification of identification of property, plant and equipment and loose in each location
  - j. Inventories held for third parties or not belonged to the entity properly located and listed in the count record
  - k. The issue of blank inventory count sheets and the return of completed and unused inventory count sheets should be properly controlled and documented

Planning – Counting Procedures

- Good set of physical inventory count procedures consists of:
  - l. Sequence checking performed on inventory count sheets
  - m. Proper cut-off arrangements for goods received and delivered
  - n. Avoid inventory movement during the count
  - o. Goods with special problems or other issues should be properly located and handled
  - p. Ensure that all inventories are counted once only
  - q. Identification of work in progress for verification
  - r. Investigation of discrepancies in the physical inventory count and consider the implication on the records

During Attendance

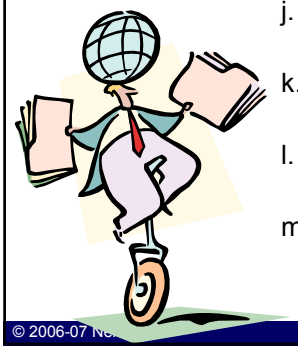


- The purpose of the attendance is limited to
  - observe the client's physical inventory count and/or
  - perform test counts.
- It is not to participate in, assist in or supervise but to observe.

During Attendance – Procedures

a. Observe that the physical inventory count procedures properly followed and carried out
b. Test counts sample inventory items in accordance with the planning and document the details for follow-up actions
c. Observe the client's procedures in identifying damaged, obsolete and slow moving inventories
d. Note damaged, obsolete or slow-moving items
e. Identify any consignments or customer inventory included on client's premises
f. Review the cut-off situation and procedures and obtain necessary cut-off information

During Attendance – Procedures



g. Verify the sequence of inventory count sheets
h. Document the sequence of inventory count tags used
i. Investigate any discrepancies between the result of the client's counts and of the auditor's counts and recount in the presence of both parties
j. Document the procedures performed, say the test counts
k. Investigate the reasons for any significant discrepancies noted
l. Ensure the final inventory listing reflects inventory count results
m. Obtain copies of a sample of inventory count sheets for subsequent checking and comparison.

After Inventory Count

- After the physical inventory count, the auditors should perform the following follow-up audit procedures:
  a. Perform cut-off procedures
  b. Obtain final inventory listing from the client
  c. Check arithmetic accuracy of the final inventory list
  d. Check the final inventory listing accurately reflecting the results of the actual inventory counts
  e. Follow up the issues identified during the attendance
  f. Discuss any problems noted in the attendance with management and consider the implication and further action

Inventory Held By Third Parties

- Ordinarily obtain direct confirmation from the third party as to the quantities and condition of the inventory held by third parties
- Depending on materiality of this inventory the auditor would also consider the following:
  - The integrity and independence of the third party
  - Observing, or arranging for another auditor to observe, the physical inventory count
  - Obtaining another auditor's report on the adequacy of the third party's internal control
  - Inspecting documentation regarding inventory held by third parties

Perpetual Inventory System

- Perpetual system updates inventory records continuously and may determine the quantity of inventory without physical count
- The auditor considers the following for reliance on the system:
  a. Consider the risk of material misstatement to the inventory
  b. Evaluate the perpetual inventory system
  c. Perform any necessary test of controls
  d. Ensure physical inventory count performed periodically
  e. Consider attending such physical inventory count at least once a year to observe count procedures and perform test counts

Attendance Not at Period End

- If unable to attend the physical inventory count on the date planned due to unforeseen circumstances, the auditors should
  - take or observe some physical counts on an alternative date and,
  - when necessary, perform audit procedures on intervening transactions. (ISA 501.6)

Attendance Not at Period End

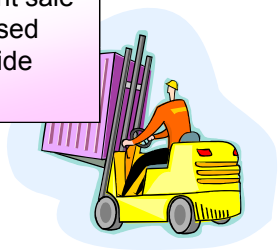
- Adequate for audit purposes only when the entity has designed and implemented controls over changes in inventory .
- Year-end total is obtained by adjusting sales and purchases in the intervening period
  - the intervening period refers to the period between the physical inventory count date and the year-end date.
- The auditor would determine whether, through the performance of appropriate audit procedures, changes in inventory between the count date and period end are correctly recorded.

Attendance Not at Period End

Example

- Where attendance is impracticable, due to factors such as the nature and location of the inventory, the auditor should
  - consider whether alternative procedures provide sufficient appropriate audit evidence of existence and condition to conclude that the auditor need not make reference to a scope limitation. (ISA 501.7)

For example, documentation of the subsequent sale of specific inventory items acquired or purchased prior to the physical inventory count may provide sufficient appropriate audit evidence.



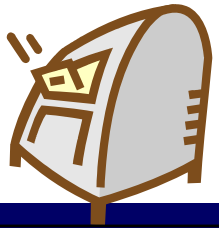
Today's Agenda

International Standards on Auditing (ISAs)

External Confirmations (ISA 505)

The Requirements of ISA 505

- The auditor should determine
  - whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence at the assertion level.
- In making this determination, the auditor should consider
  - the assessed risk of material misstatement at the assertion level and
  - how the audit evidence from other planned audit procedures will reduce the risk of material misstatement at the assertion level to an acceptably low level. (ISA 505.2)



The Requirements of ISA 505

Example

- Other examples of situations where external confirmations may be used include the following:
  - Bank balances and other information from bankers.
  - Accounts receivable balances.
  - Stocks held by third parties at bonded warehouses for processing or on consignment.
  - Property title deeds held by lawyers or financiers for safe custody or as security.
  - Investments purchased from stockbrokers but not delivered at the balance sheet date.
  - Loans from lenders.
  - Accounts payable balances.

External Confirmations – Reliable

- The reliability of the audit evidence obtained by external confirmations depends, among other factors, upon the auditor applying appropriate audit procedures in
  - designing the external confirmation request,
  - performing the external confirmation procedures, and
  - evaluating the results of the external confirmation procedures.
- Factors affecting the reliability of confirmations include
  - the control the auditor exercises over confirmation requests and responses,
  - the characteristics of the respondents, and
  - any restrictions included in the response or imposed by management.

External Confirmations – Reliable

- The higher the auditor's assessment of risk,
  - ➢ the more reliable and relevant is the audit evidence sought by the auditor from substantive procedures.
- Consequently as the assessed risk of material misstatement increases,
  - ➢ the auditor designs substantive procedures to obtain more reliable and relevant audit evidence, or more persuasive audit evidence, at the assertion level.
- In these situations, the use of confirmation procedures may be effective in providing sufficient appropriate audit evidence.

Assertions and Confirmations

- ISA 500 requires the use of assertions in
  - assessing risks and
  - designing and performing audit procedures in response to the assessed risks.
- ISA 500 categorizes the assertions into those relating to
  - classes of transactions,
  - account balances, and
  - disclosures.
- While external confirmations may provide audit evidence regarding these assertions,
  - the ability of an external confirmation to provide audit evidence relevant to a particular assertion varies.

Assertions and Confirmations

Example

Comment on the ability of the following confirmation in addressing the assertions.

1. External confirmation of an account receivable

- It provides reliable and relevant audit evidence regarding the existence of the account as at a certain date and the operation of cutoff procedures.
- However, it does not ordinarily provide all the necessary audit evidence relating to the valuation assertion, since it is not practicable to ask the debtor to confirm detailed information relating to its ability to pay the a/c.

2. External confirmation for goods held on consignment

- It is likely to provide reliable and relevant audit evidence to support the existence and the rights and obligations assertions
- It might not provide audit evidence that supports the valuation assertion.

Assertions and Confirmations

Example

- The relevance of external confirmations to auditing a particular assertion is also affected by the objective of the auditor in selecting information for confirmation.
- Suggest ways the external confirmation can be used to address the completeness assertion for accounts payable.

> - For completeness assertions, the auditor needs to obtain audit evidence that there is no material unrecorded liability.
> - Accordingly, sending confirmation requests to an entity's principal suppliers asking them to provide copies of their statements of account directly to the auditor, even if the records show no amount currently owing to them, will usually be more effective in detecting unrecorded liabilities than selecting accounts for confirmation based on the larger amounts recorded in the accounts payable subsidiary ledger.

Design Confirmations

- The auditor should tailor external confirmation requests to the specific audit objective. (ISA 505.17)
- When designing the request, the auditor considers
  - the assertions being addressed
  - the factors that are likely to affect the reliability of the confirmations. Factors such as
    - the form of the external confirmation request,
    - prior experience on the audit or similar engagements,
    - the nature of the information being confirmed, and
    - the intended respondent
  - The type of information respondents will be able to confirm readily
    - since it may affect the response rate and the nature of the audit evidence obtained

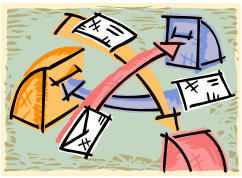
Positive & Negative Confirmations

Example

The auditor may use positive or negative external confirmation requests or a combination of both

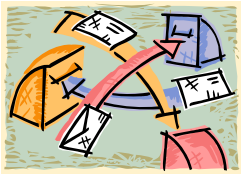
- Positive confirmation to a debtor:
  - The trade debtor is asked to confirm whether he agrees with the recorded balance or state in what respect he disagrees.
- Negative confirmation to a debtor:
  - The trade debtor is asked to reply only if he does not agree with the recorded balance.
- A positive confirmation provides more reliable evidence than a negative confirmation.

Management Requests



- When the auditor seeks to confirm certain balances or other information, and management requests the auditor not to do so, the auditor should
  - consider whether there are valid grounds for such a request and
  - obtain audit evidence to support the validity of management's requests.
- If the auditor agrees to management's request not to seek external confirmation regarding a particular matter,
  - the auditor should apply alternative audit procedures to obtain sufficient appropriate audit evidence regarding that matter. (ISA 505.25)

Management Requests



- If the auditor does not accept the validity of management's request and is prevented from carrying out the confirmations,
  - there has been a limitation on the scope of the auditor's work and
  - the auditor should consider the possible impact on the auditor's report. (ISA 505.26)

Characteristics of Respondents

- The reliability of audit evidence provided by a confirmation is affected by the respondent's
  - competence,
  - independence,
  - authority to respond,
  - knowledge of the matter being confirmed, and
  - objectivity.
- For this reason, the auditor attempts to ensure, where practicable, that the confirmation request is directed to an appropriate individual.

Characteristics of Respondents

Example

- Whom should be addressed when confirming a covenant relating to an entity's long-term debt?

- When confirming that a covenant related to an entity's long-term debt has been waived,
  - the auditor may direct the request to an official of the creditor who has knowledge about the waiver and has the authority to provide the information.

External Confirmation Process

- When performing confirmation procedures, the auditor should maintain control over
  - the process of selecting those to whom a request will be sent,
  - the preparation and sending of confirmation requests, and
  - the responses to those requests. (ISA 505.30)

External Confirmation Process

- Control is maintained over communications between
  - the intended recipients and
  - the auditor

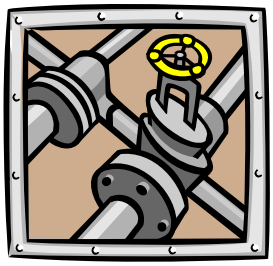
  to minimize the possibility that the results of the confirmation process will be biased because of the interception and alteration of confirmation requests or responses.
- The auditor ensures
  - that it is the auditor who sends out the confirmation requests,
  - that the requests are properly addressed, and
  - that it is requested that all replies are sent directly to the auditor.
- The auditor considers whether replies have come from the purported senders.

External Confirmation Process

- Common confirmation process is as follows:
  a. Obtain client's agreement and co-operation
  b. Obtain complete ledger
  c. Select a confirmation method (positive and/or negative)
  d. Determine an appropriate audit sampling technique and select a sample
  e. Confirmation can be prepared by client but checked by the audit or
  f. Request confirmation directly returned to auditor
  g. Auditor arrange the confirmation himself
  h. Retain copy of confirmation sent
  i. Consider to ways to improve the response rate of the positive confirmation requests
  j. Receive and evaluate replies
  k. Follow up on returned "undelivered" conformations
  l. Perform alternative audit procedures where no response is received to a positive confirmation request

External Confirmation Process

- The auditor should perform alternative audit procedures where no response is received to a positive external confirmation request.
- The alternative audit procedures should be such as to provide audit evidence about the assertions that the confirmation request was intended to provide. (ISA 505.31)



Results of External Confirmation

- When the auditor forms a conclusion that the confirmation process and alternative audit procedures have not provided sufficient appropriate audit evidence regarding an assertion,
  - the auditor should perform additional audit procedures to obtain sufficient appropriate audit evidence. (ISA 505.34)

- The auditor should evaluate whether the results of the external confirmation process together with the results from any other audit procedures performed, provide sufficient appropriate audit evidence regarding the assertion being audited. (ISA 505.36)
- In conducting this evaluation the auditor considers the guidance provided by ISA 330 and ISA 530, "*Audit Sampling and Other Means of Testing*".

Confirmation Not at Year End

- Confirmation may be carried out at dates other than the period end
  - It occurs only when internal control is very strong and inherent risk is low.
  - The auditor is required to
    - review and test transactions occurred in the intervening period
    - obtains sufficient appropriate audit evidence that transactions relevant to the assertion in the intervening period have not been materially misstated.

CPA专业方向师资培训 —— Day 7

End of Morning Session

21 August 2007

Full version of the slides can be found in
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CPA专业方向师资培训 —— Day 7

Afternoon Session

21 August 2007

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CPA(US) FCCA FCPA(Practising) MSCA

Overview

International Standards on Auditing (ISAs)

- ISA 200 – 299
  General Principles and Responsibilities
- ISA 300 – 499
  Risk Assessment & Response to Assessed Risks
- ISA 500 – 599
  Audit Evidence
- ISA 600 – 699
  Using Work of Others
- ISA 700 – 799
  Audit Conclusions and Reporting

Today's Agenda

Simple but Comprehensive

Critical and New Issues

Templates and Examples

Analytical Procedures (ISA 520)

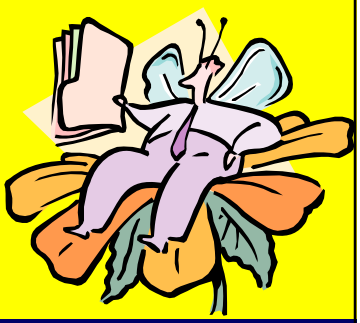
Audit of Accounting Estimates (ISA 540)

Auditing Fair Value Measurements and Disclosures (ISA 545)

Using the Work of an Expert (ISA 620)

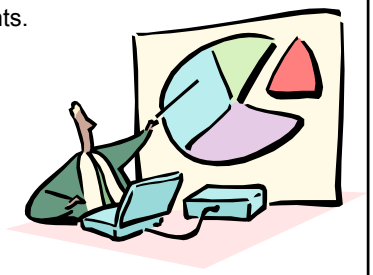
Today's Agenda

Analytical Procedures (ISA 520)



Analytical Procedures

- Analytical procedures
  - Means evaluations of financial information made by a study of plausible relationships among both financial and non-financial data
  - also encompass the investigation of identified fluctuations and relationships that
    - are inconsistent with other relevant information or
    - deviate significantly from predicted amounts.



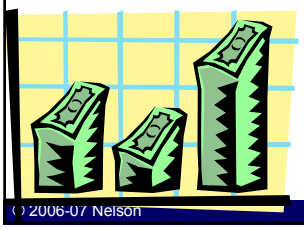
Analytical Procedures

Example

- Analytical procedures include the consideration of comparisons of the entity's financial information with, for example:
  - Comparable information for prior periods.
  - Anticipated results of the entity, such as budgets or forecasts, or expectations of the auditor, such as an estimation of depreciation.
  - Similar industry information, such as a comparison of the entity's ratio of sales to accounts receivable with industry averages or with other entities of comparable size in the same industry.
- Analytical procedures also include consideration of relationships:
  - Among elements of financial information that would be expected to conform to a predictable pattern based on the entity's experience, such as gross margin percentages.
  - Between financial information and relevant non-financial information, such as payroll costs to number of employees.

Analytical Procedures

- Various methods may be used in performing the audit procedures.
  - These range from simple comparisons to complex analyses using advanced statistical techniques.
- Analytical procedures may be applied to
  - consolidated financial statements,
  - financial statements of components (such as subsidiaries, divisions or segments) and
  - individual elements of financial information.
- The auditor's choice of audit procedures, methods and level of application is a matter of professional judgment.



Analytical Procedures

- Analytical procedures are used for the following purposes:

Risk Assessment Procedures

a) As risk assessment procedures to obtain an understanding of the entity and its environment.

Substantive Procedures

b) As substantive procedures when their use can be more effective or efficient than tests of details in reducing the risk of material misstatement at the assertion level to an acceptably low level.

Overall Review

c) As an overall review of the financial statements at the end of the audit.

The Requirements of ISA 520

Risk Assessment Procedures

Overall Review

ISA 520 specifically requires that

- The auditor should apply analytical procedures
  - as risk assessment procedures to obtain an understanding of the entity and its environment and
  - in the overall review at the end of the audit. (ISA 520.2)

As Risk Assessment Procedures

Risk Assessment Procedures

- The auditor should apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment. (ISA 520.8)
- Application of analytical procedures
  - may indicate aspects of the entity of which the auditor was unaware and
  - will assist in assessing the risks of material misstatement in order to determine the nature, timing and extent of further audit procedures.
- Analytical procedures applied as risk assessment procedures use both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.

In Overall Review

Overall Review

- The auditor should apply analytical procedures at or near the end of the audit
  - when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity. (ISA 520.13)
- The conclusions drawn from the results of such audit procedures are intended to
  - corroborate conclusions formed during the audit of individual components or elements of the financial statements and
  - assist in arriving at the overall conclusion as to the reasonableness of the financial statements.

In Overall Review

Overall Review

- However, they may also identify a previously unrecognized risk of material misstatement.
  - In such circumstances, the auditor may need to re-evaluate the planned audit procedures, based on the revised consideration of assessed risks for all or some of the classes of transactions, account balances, or disclosures and related assertions.

As Substantive Procedures

Substantive Procedures

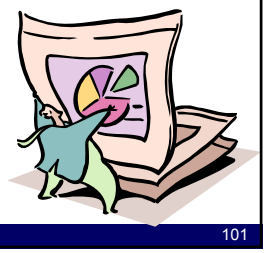
- Analytical procedures may be used as substantive procedures (not compulsory but an option).
- When designing and performing analytical procedures as substantive procedures, the auditor will need to consider a number of factors such as the following:
  - The suitability of using substantive analytical procedures given the assertions.
  - The reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed.
  - Whether the expectation is sufficiently precise to identify a material misstatement at the desired level of assurance.
  - The amount of any difference of recorded amounts from expected values that is acceptable.

Application Approach

- General approach in applying analytical procedures
  1. Identify the areas to be analyzed and determine the purpose and timing of the procedures
  2. Develop the auditor's expectations or predicted results
  3. Compare and study the entity's information
  4. Investigate any significant fluctuations or any unexpected variation
  5. Evaluate the results of the analytical procedures

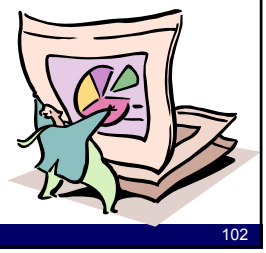
Investigating Unusual Items

- When analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts,
  - the auditor should investigate and obtain adequate explanations and appropriate corroborative audit evidence. (ISA 520.17)



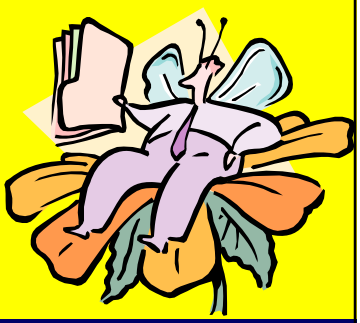
Investigating Unusual Items

- The investigation of unusual fluctuations and relationships ordinarily begins with inquiries of management, followed by:
  a) Corroboration of management's responses, for example, by comparing them with the auditor's understanding of the entity and other audit evidence obtained during the course of the audit; and
  b) Consideration of the need to apply other audit procedures based on the results of such inquiries, if management is unable to provide an explanation or if the explanation is not considered adequate.



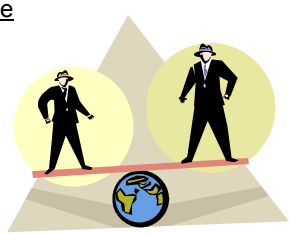
Today's Agenda

Audit of Accounting Estimates (ISA 540)



What is Accounting Estimate?

- **Accounting estimate** means
  - an approximation of the amount of an item in the absence of a precise means of measurement.
- Management is responsible for making accounting estimates included in financial statements.
  - These estimates are often made in conditions of uncertainty regarding the outcome of events that have occurred or are likely to occur and involve the use of judgment.



What is Accounting Estimate?

- When accounting estimates are involved,
  - the risk of material misstatement is greater
- In some cases the auditor may determine that the risk of material misstatement related to an accounting estimate is a significant risk
  - a significant risk would require special audit consideration

What is Accounting Estimate?

Example

- Suggest some examples of accounting estimate.

Examples of accounting estimate include:

- Allowances to reduce inventory to their estimated realizable value
- Impairment loss on trade receivable
- Depreciation on property, plant and equipment and their estimated useful lives
- Accrued revenue
- Deferred tax
- Provision for a loss from a lawsuit
- Losses on construction contracts in progress
- Provision to meet warranty claims

What is Accounting Estimate?

- The determination of an accounting estimate may be simple or complex depending upon the nature of the item.
- Accounting estimates
  - may be determined as part of the routine information system relevant to financial reporting operating on a continuing basis, or
  - may be non-routine, operating only at period end.

- The uncertainty associated with an item, or the lack of objective data may make the item incapable of reasonable estimation,
  - in which case the auditor needs to consider whether the auditor's report needs modification to comply with ISA 701, "Modifications to the Independent Auditor's Report."

The Requirements of ISA 540

- The auditor should obtain sufficient appropriate audit evidence regarding accounting estimates. (ISA 540.2)
- The auditor should design and perform **further audit procedures**
  - to obtain sufficient appropriate audit evidence as to whether the entity's accounting estimates are reasonable in the circumstances and, when required, appropriately disclosed. (ISA 540.8)

Gain an Understanding of the Entity (incl. environ. & int. controls)

→ Assess the Risk of Material Misstatement

→ Design Further Audit Procedures for assertion level risks

Responsive to Assessed Risk

- The auditor's understanding of the entity and its environment, including its internal control,
  - assists the auditor in identifying and assessing the risks of material misstatement of the entity's accounting estimates.
- An understanding of the procedures and methods, including relevant control activities, used by management in making the accounting estimates is important for the auditor
  - to identify and assess risks of material misstatement
  - in order to design the nature, timing and extent of the further audit procedures.

Gain an Understanding of the Entity (incl. environ. & int. controls)

Assess the Risk of Material Misstatement

Design Further Audit Procedures for assertion level risks

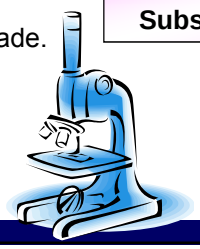
Responsive to Assessed Risk

- The auditor should adopt one or a combination of the following approaches in the audit of an accounting estimate:
  1. Review and test the process used by management to develop the estimate;
  2. Use an independent estimate for comparison with that prepared by management; or
  3. Review of subsequent events which provide audit evidence of the reasonableness of the estimate made. (ISA 540.10)

Test Management's Process

Compare Independent Estimate

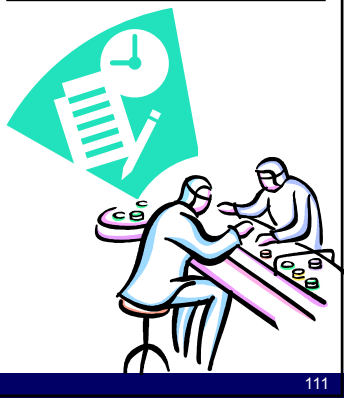
Review Subsequent Events



1. Test Management's Process

- The steps ordinarily involved in reviewing and testing of the process used by management are:
  a) Evaluation of the data and consideration of assumptions on which the estimate is based;
  b) Testing of the calculations involved in the estimate;
  c) Comparison, when possible, of estimates made for prior periods with actual results of those periods; and
  d) Consideration of management's approval procedures.

Test Management's Process



1. Test Management's Process

Evaluation of Data and Consideration of Assumptions

- In respect of the data, the auditor would
  – evaluate whether the data on which the estimate is based is accurate, complete and relevant
  – seek audit evidence from sources outside the entity
  – evaluate whether the data collected is appropriately analyzed and projected to form a reasonable basis for determining the accounting estimate

Test Management's Process

1. Test Management's Process

Example

- Entity A estimates the provision for inventory obsolescence by reference to anticipated future sales.
- What kinds of internal and external information can Melody CPA be based to audit the estimated provision?

- When examining a provision for inventory obsolescence calculated by reference to anticipated future sales,
  - Melody CPA may examine internal data such as past levels of sales, orders on hand and marketing trends,
  - It can also seek audit evidence from industry-produced sales projections and market analyses from external sources.

1. Test Management's Process

Evaluation of Data and Consideration of Assumptions

- In respect of the assumptions, the auditor would
  - evaluate whether the entity has an appropriate base for the principal assumptions used in the accounting estimate, such as government statistics, say inflation rate
  - consider whether the assumptions are
    - reasonable in light of actual results in prior periods
    - consistent with those used for other accounting estimates
    - consistent with management's plans which appear appropriate

Test Management's Process

Pay attention to those which are sensitive to variation, subjective, susceptible to material misstatement

For complex estimates involving specialised techniques, the work of an expert may be relied upon

1. Test Management's Process

Comparison of Previous Estimates with Actual Results

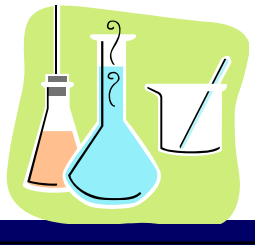
- When possible, the auditor would compare accounting estimates made for prior periods with actual results of those periods to assist in:
  a) Obtaining audit evidence about the general reliability of the entity's estimating procedures and methods, including relevant control activities;
  b) Considering whether adjustments to estimating formulae may be required; and
  c) Evaluating whether differences between actual results and previous estimates have been quantified and that, where necessary, appropriate adjustments or disclosures have been made.

Test Management's Process

2. Compare Independent Estimate

- The auditor
  – may make or obtain an independent estimate and compare it with the accounting estimate prepared by management,
  – would ordinarily evaluate the data, consider the assumptions and perform audit procedures on the calculation procedures used in its development.
  – compare accounting estimates made for prior periods with actual results of those periods.

Compare Independent Estimate



3. Review Subsequent Events

- Transactions and events which occur after period end, but prior to completion of the audit, may provide audit evidence regarding an accounting estimate made by management.
  - The auditor's review of such transactions and events may reduce, or even remove, the need for the auditor to review and perform audit procedures on the process used by management to develop the accounting estimate or to use an independent estimate in assessing the reasonableness of the accounting estimate.

Review Subsequent Events

Evaluate Results of Procedures

- The auditor should make a final assessment
  - of the reasonableness of the entity's accounting estimates based on the auditor's understanding of the entity and its environment and
  - whether the estimates are consistent with other audit evidence obtained during the audit. (ISA 540.24)

Evaluate Results of Procedures

- When there is a difference between
  - the auditor's estimate of the amount best supported by the available audit evidence and
  - the estimated amount included in the financial statements,

  the auditor would determine whether such a difference requires adjustment.

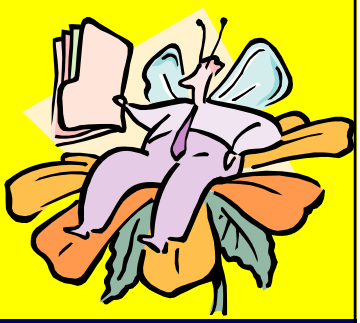
- If the auditor believes the difference is unreasonable, management would be requested to revise the estimate.
- If management refuses to revise the estimate,
  - the difference would be considered a misstatement and would be considered with all other misstatements in assessing whether the effect on the financial statements is material.

Evaluate Results of Procedures

- The auditor
  - would also consider whether individual differences which have been accepted as reasonable are biased in one direction,
    - so that, on a cumulative basis, they may have a material effect on the financial statements In such circumstances,
  - would evaluate the accounting estimates taken as a whole.

Today's Agenda

Auditing Fair Value Measurements and Disclosures (ISA 545)



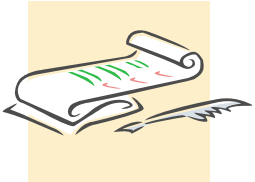
ISA 545 Fair Value Measurement

Points for Discussion

1. Introduction
2. Understanding the Entity's Process
3. Evaluating the Appropriateness of Fair Value Measurements and Disclosures
4. Using the Work of an Expert
5. Audit Procedures Responsive to Assessed Risks
6. Disclosures about Fair Values
7. Evaluating the Results of Audit Procedures
8. Management Representations
9. Communication with Those Charged with Governance

1. Introduction

- Fair value measurements of assets, liabilities and components of equity may arise from both
  - the initial recognition and measurement, and
  - the subsequent measurement.
- Changes in fair value measurements that occur over time may be treated in different ways under different financial reporting frameworks, and under IFRSs, changes in fair value are accounted for
  - in equity in some IFRSs and
  - in income statement in some other IFRSs.



1. Introduction

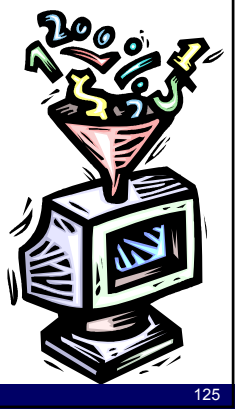
Example

List some IFRSs which requires or allows fair value measurement.

- IFRS requires fair value at initial measurement
  - Financial assets — IAS 39
  - Agriculture — IAS 41
  - Share-based payments — IFRS 2
  - Business combinations — IFRS 3
- IFRS requires/allows fair value at subsequent measurement
  - Property, plant and equipment — IAS 16
  - Impairment of assets — IAS 36
  - Intangible assets — IAS 38
  - Financial assets — IAS 39
  - Investment property — IAS 40
  - Agriculture — IAS 41
  - Share-based payments — IFRS 2
  - Non-current assets held for sale — IFRS 5

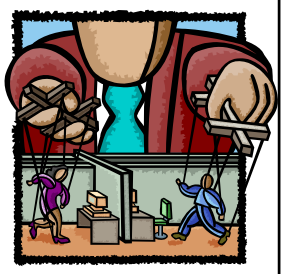
1. Introduction

- The auditor should obtain sufficient appropriate audit evidence that fair value measurements and disclosures are in accordance with the entity's applicable financial reporting framework, such as IFRSs. (ISA 545.3)
- While ISA 545 provides guidance on auditing fair value measurements and disclosures, audit evidence obtained from other audit procedures also may provide audit evidence relevant to the measurement and disclosure of fair values.
  - For example, inspection procedures to verify existence of an asset measured at fair value also may provide relevant audit evidence about its valuation, such as the physical condition of an investment property.



1. Introduction

- Management is responsible for making the fair value measurements and disclosures included in the financial statements.
- As part of fulfilling its responsibility, management needs to
  - establish an accounting and financial reporting process for determining the fair value measurements and disclosures,
  - select appropriate valuation methods,
  - identify and adequately support any significant assumptions used,
  - prepare the valuation and
  - ensure that the presentation and disclosure of the fair value measurements are in accordance with the entity's applicable financial reporting framework.

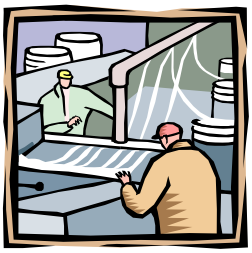


2. Understand the Entity's Process

- As part of the understanding of the entity and its environment, including its internal control,
  - the auditor should obtain an understanding of the entity's **process for determining fair value measurements and disclosures** and of the **relevant control activities**
    - **sufficient** to identify and assess the risks of material misstatement at the assertion level and to design and perform further audit procedures. (ISA 545.10)

2. Understand the Entity's Process

- After obtaining an understanding of the entity's process for determining fair value measurements and disclosures,
  - the auditor should identify and assess the risks of material misstatement at the assertion level related to the fair value measurements and disclosures in the financial statements to determine the nature, timing and extent of the further audit procedures. (ISA 545.14)



3. Evaluate Appropriateness

- The auditor should evaluate whether the fair value measurements and disclosures in the financial statements are in accordance with the entity's applicable financial reporting framework. (ISA 545.17)
- The auditor should
  - obtain audit evidence about management's intent to carry out specific courses of action, and
  - consider its ability to do so,

  where relevant to the fair value measurements and disclosures under the entity's applicable financial reporting framework. (ISA 545.22)

It may affect the appropriateness of the entity's use of fair value in some financial reporting framework

3. Evaluate Appropriateness

Example

- Suggest audit procedures in respect of management's intent to carry out specific course of action.

- The auditor's procedures ordinarily include inquiries of management, with appropriate corroboration of responses, for example, by:
  - Considering management's past history of carrying out its stated intentions with respect to assets or liabilities.
  - Reviewing written plans and other documentation, including, where applicable, budgets, minutes, etc.
  - Considering management's stated reasons for choosing a particular course of action.
  - Considering management's ability to carry out a particular course of action given the entity's economic circumstances, including the implications of its contractual commitments.
- The auditor also considers management's ability to pursue a specific course of action if ability is relevant to the use, or exemption from the use, of fair value measurement under the entity's applicable financial reporting framework.

3. Evaluate Appropriateness

- Where alternative methods for measuring fair value are available under the entity's applicable financial reporting framework, or where the method of measurement is not prescribed,
  - the auditor should evaluate whether the method of measurement is appropriate in the circumstances under the entity's applicable financial reporting framework. (ISA 545.24)
- The auditor should evaluate whether the entity's method for its fair value measurements is applied consistently. (ISA 545.27)

3. Evaluate Appropriateness

Example

- The audit procedures to evaluate whether a valuation method is appropriate.

  - Given a particular method, the auditor obtains an understanding of management's rationale for its selection by discussing with management its reasons for selecting the valuation method.
  - The auditor considers whether:
    a) Management has sufficiently evaluated and appropriately applied the criteria, if any, provided in the applicable financial reporting framework to support the selected method;
    b) The valuation method is appropriate in the circumstances given the nature of the asset or liability being valued and the entity's applicable financial reporting framework; and
    c) The valuation method is appropriate in relation to the business, industry and environment in which the entity operates.

4. Using the Work of an Expert

- The auditor should determine the need to use the work of an expert. (ISA 545.29)
- The auditor
  - may have the necessary skill and knowledge to plan and perform audit procedures related to fair values or
  - may decide to use the work of an expert.
- In making such a determination, the auditor considers the matters discussed ISA 620, "*Using the Work of an Expert*." (to be discussed)

5. Audit Procedures

- ISA 545 requires that: "The auditor should design and perform further audit procedures in response to assessed risks of material misstatement of assertions relating to the entity's fair value measurements and disclosures." (ISA 545.33)
- Audit procedures, for example, may involve:
  1. Testing management's significant assumptions, the valuation model, and the underlying data — Testing Assumption, Model and Data
  2. Developing independent fair value estimates to corroborate the appropriateness of the fair value measurement — Developing Independent Fair Value Estimates
  3. Considering the effect of subsequent events — Effect of Subsequent Events

5. Audit Procedures

- The existence of published price quotations in an active market ordinarily is the best audit evidence of fair value.
- Some fair value measurements, however, are inherently more complex than others.
- This complexity arises either
  - because of the nature of the item being measured at fair value or
  - because of the valuation method required by the applicable financial reporting framework or selected by management.
    - For example, the absence of quoted prices in an active market for a particular item

Testing Assumption, Model and Data

Developing Independent Fair Value Estimates

Effect of Subsequent Events

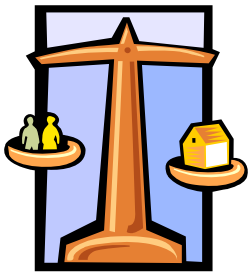
5. Audit Procedures

Testing Assumption, Model and Data

- The auditor's understanding of the reliability of the process used by management to determine fair value is an important element in support of the resulting amounts and therefore affects the nature, timing, and extent of further audit procedures.
- When obtaining audit evidence about the entity's fair value measurements and disclosures, the auditor evaluates whether:
  a. The **assumptions** used by management are reasonable;
  b. The fair value measurement was determined using an **appropriate model**, if applicable; and
  c. Management used **relevant information** that was reasonably available at the time.

5. Audit Procedures

Testing Assumption, Model and Data



- ISA 545 specifically states that:
  - Where the auditor determines there is a **significant risk** related to fair values, or where otherwise applicable,
    - the auditor should evaluate whether the significant assumptions used by management in measuring fair values, taken individually and as a whole, provide a reasonable basis for the fair value measurements and disclosures in the entity's financial statements. (ISA 545.39)

5. Audit Procedures

Testing Assumption, Model and Data

Example

- To be reasonable, the assumptions, individually and taken as a whole, of a valuation model need to be realistic and consistent with:
  1. The general economic environment and the entity's economic circumstances;
  2. The plans of the entity;
  3. Assumptions made in prior periods, if appropriate;
  4. Past experience of, or previous conditions experienced by, the entity to the extent currently applicable;
  5. Other matters relating to the financial statements, for example, assumptions used by management in accounting estimates for financial statement accounts other than those relating to fair value measurements and disclosures; and
  6. If applicable, the risk associated with cash flows, including the potential variability of the cash flows and the related effect on the discounted rate.

5. Audit Procedures

Testing Assumption, Model and Data

- If management relies on historical financial information in the development of assumptions,
  - the auditor considers the extent to which such reliance is justified.
- For items valued by the entity using a **valuation model**,
  - the auditor is not expected to substitute his or her judgment for that of the entity's management.
  - Rather, the auditor reviews the model, and evaluates whether the model is appropriate and the assumptions used are reasonable.
- For example, discounted cash flow method may not be used in valuing an equity investment in a start-up entity without cash revenue initially.

5. Audit Procedures

Testing Assumption, Model and Data

- ISA 545 also requires:
  - The auditor should
    - perform audit procedures on the **data** used to develop the fair value measurements and disclosures and
    - evaluate whether the fair value measurements have been properly determined from such data and management's assumptions. (ISA 545.50)

5. Audit Procedures

Developing Independent Fair Value Estimates

- The auditor may make an independent estimate of fair value (e.g., by using an auditor-developed model) to corroborate the entity's fair value measurement.
  - When developing an independent estimate using management's assumptions, the auditor evaluates those assumptions as discussed before.

Using management's assumptions

- Instead of using management's assumptions,
  - the auditor may develop separate assumptions to make a comparison with management's fair value measurements.

Using separate set of assumptions

- In that situation, the auditor nevertheless understands management's assumptions.
- The auditor uses that understanding
  - to determine that the auditor's model considers the significant variables and
  - to evaluate any significant difference from management's estimate.

Follows the requirements in ISA 520 "*Analytical Procedures*"

5. Audit Procedures

Effect of Subsequent Events

- The auditor should consider the effect of subsequent events on the fair value measurements and disclosures in the financial statements. (ISA 545.53)
- Transactions and events that occur after period-end but prior to completion of the audit, may provide appropriate audit evidence regarding the fair value measurements made by management.

For example, a sale of investment property shortly after the period-end may provide audit evidence relating to the fair value measurement.

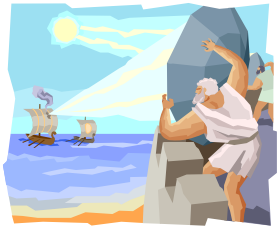
- In the period after a financial statement period-end, however, circumstances may change from those existing at the period-end.
  - Fair value information after the period-end may reflect events occurring after the period-end and not the circumstances existing at the balance sheet date.

For example, the prices of actively traded marketable securities that change after the period-end ordinarily

6. Disclosures about Fair Value

- The auditor should evaluate whether the disclosures about fair values made by the entity are in accordance with its financial reporting framework. (ISA 545.56)

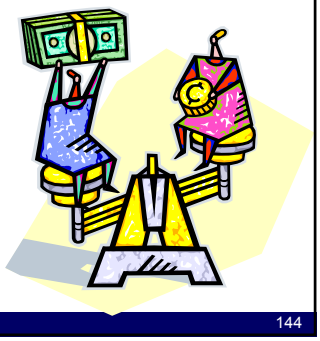
Same for Measurement and Disclosure



- When auditing fair value measurements and related disclosures included in the notes to the financial statements, (whether required by the applicable financial reporting framework or disclosed voluntarily),
  - the auditor ordinarily performs essentially the **same** types of audit procedures as those employed in auditing a fair value measurement recognized in the financial statements.

7. Evaluate Results of Procedures

- In making a final assessment of whether the fair value measurements and disclosures in the financial statements are in accordance with the entity's applicable financial reporting framework, the auditor should evaluate
  - the sufficiency and appropriateness of the audit evidence obtained
  - as well as the consistency of that evidence with other audit evidence obtained and evaluated during the audit. (ISA 545.61)



7. Evaluate Results of Procedures

Example

- When assessing whether the fair value measurements and disclosures in the financial statements are in accordance with the entity's applicable financial reporting framework, the auditor evaluates the consistency of
  - the information and audit evidence obtained during the audit of fair value measurements with
  - other audit evidence obtained during the audit,

  in the context of the financial statements taken as a whole.
- For example, the auditor considers whether there is or should be a relationship or correlation between
  - the interest rates used to discount estimated future cash flows in determining the fair value of an investment property and
  - interest rates on borrowings currently being incurred by the entity to acquire investment property.

8. Management Representations

- The auditor should obtain written representations from management regarding
  - the reasonableness of significant assumptions, including
    - whether they appropriately reflect management's intent and ability to carry out specific courses of action on behalf of the entity where relevant to the fair value measurements or disclosures. (ISA 545.63)
- ISA 580, "*Management Representations*" discusses the use of management representations as audit evidence.

8. Management Representations

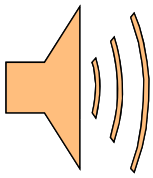
Example

- For fair value measurement and disclosure, suggest the points to be included in the management representations.

- Depending on the nature, materiality and complexity of fair values, management representations about fair value measurements and disclosures contained in the financial statements also may include representations about the following:
  1. The appropriateness of the measurement methods, including related assumptions, used by management in determining fair values within the applicable financial reporting framework, and the consistency in application of the methods.
  2. The basis used by management to overcome the presumption relating to the use of fair value set forth under the entity's applicable financial reporting framework.
  3. The completeness and appropriateness of disclosures related to fair values under the entity's applicable financial reporting framework.
  4. Whether subsequent events require adjustment to the fair value measurements and disclosures included in the financial statements.

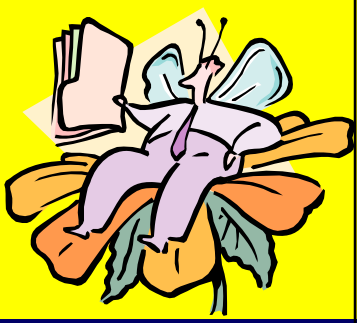
9. With Those Charged with Governance

- ISA 260, "*Communication of Audit Matters with Those Charged with Governance*" requires auditors to communicate audit matters of governance interest with those charged with governance.
- Because of the uncertainties often involved with some fair value measurements, the potential effect on the financial statements of any significant risks may be of governance interest.
- For example, the auditor considers communicating
  - the nature of significant assumptions used in fair value measurements,
  - the degree of subjectivity involved in the development of the assumptions, and
  - the relative materiality of the items being measured at fair value to the financial statements as a whole.
- The auditor considers the guidance contained in ISA 260 when determining the nature and form of communication.



Today's Agenda

Using the Work of an Expert (ISA 620)



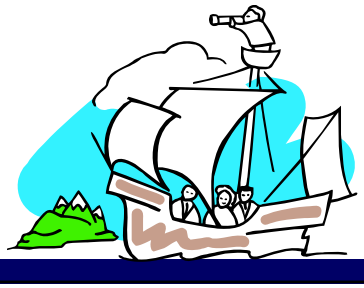
The Requirements of ISA 620

- **Expert** means a person or firm possessing special skill, knowledge and experience in a particular field other than accounting and auditing.
- ISA 620 requires that:
  - When using the work performed by an expert, the auditor should obtain sufficient appropriate audit evidence that such work is adequate for the purposes of the audit. (ISA 620.2)

The Requirements of ISA 620

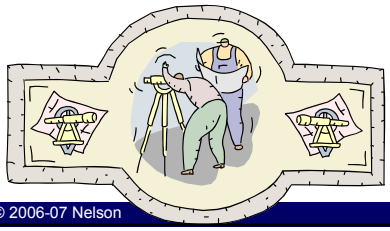
Points for Discussion

1. Expert employed by the audit firm
2. Determining the need to use the work of an expert
3. Competence and objectivity of the expert
4. Scope of the expert's work
5. Evaluating the work of the expert
6. Reference to an expert in the auditor's report



1. Expert Employed by Audit Firm

- An expert may be contracted or employed by the entity or the auditor.
- When the auditor uses the work of <u>an expert employed by the audit firm</u>,
  - the auditor will be able to rely on the firm's systems for recruitment and training that determine that expert's capabilities and competence, as explained in ISA 220, "*Quality Control for Audits of Historical Financial Information*" instead of needing to evaluate them for each audit engagement.



2. Determining the Need of An Expert

- In obtaining an understanding of the entity and performing further procedures in response to assessed risks,
  - the auditor may need to obtain, in conjunction with the entity or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert.
- When determining the need to use the work of an expert, the auditor would consider:
  a) The engagement team's knowledge and previous experience of the matter being considered;
  b) The risk of material misstatement based on the nature, complexity, and materiality of the matter being considered; and
  c) The quantity and quality of other audit evidence expected to be obtained.

2. Determining the Need of An Expert

Example

- Examples in which an expert is needed:
  - Valuations of certain types of assets
    - For example, land and buildings, plant and machinery, works of art, and precious stones.
  - Determination of quantities or physical condition of assets
    - For example, minerals stored in stockpiles, underground mineral and petroleum reserves, and the remaining useful life of plant and machinery.
  - Determination of amounts using specialized techniques or methods
    - For example, an actuarial valuation and valuation of share .
  - The measurement of work completed and to be completed on contracts in progress.
  - Legal opinions concerning interpretations of agreements, statutes and regulations.

3. Competence and Objectivity

To use the work of an expert, the auditor should evaluate the following of the expert:

Professional Competence

This will involve considering the expert's:

a) Professional certification or licensing by, or membership in, an appropriate professional body; and

b) Experience and reputation in the field in which the auditor is seeking audit evidence.

Objectivity

The risk that an expert's objectivity will be impaired increases when the expert is:

a) Employed by the entity; or

b) Related in some other manner to the entity, for example, by being financially dependent upon or having an investment in the entity.

3. Competence and Objectivity

To use the work of an expert, the auditor should evaluate the following of the expert:

Professional Competence

Objectivity

- The auditor, if he is concerned regarding the competence or objectivity of the expert,
  - needs to discuss any reservations with management
  - considers whether sufficient appropriate audit evidence can be obtained concerning the work of an expert
  - may need to undertake additional audit procedures or seek audit evidence from another expert

4. Scope of the Expert's Work

- The auditor should obtain sufficient appropriate audit evidence that the scope of the expert's work is adequate for the purposes of the audit. (ISA 620.11)
- Audit evidence may be obtained through a review of the terms of reference which are often set out in written instructions from the entity to the expert.

4. Scope of the Expert's Work

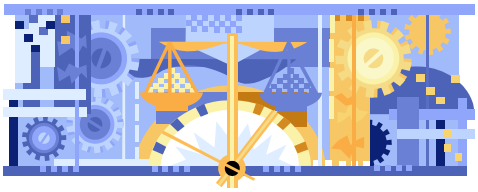
Example

- Suggest some matters to be included in the instructions to the expert.

- Instructions to the expert may cover matters such as the following:
  - The objectives and scope of the expert's work.
  - A general outline as to the specific matters the auditor expects the expert's report to cover.
  - The intended use by the auditor of the expert's work, including the possible communication to third parties of the expert's identity and extent of involvement.
  - The extent of the expert's access to appropriate records and files.
  - Clarification of the expert's relationship with the entity, if any.
  - Confidentiality of the entity's information.
  - Information regarding the assumptions and methods intended to be used by the expert and their consistency with those used in prior periods.

4. Scope of the Expert's Work

- In the event that the scope of the expert's work are not clearly set out in written instructions to the expert
  - ➢ the auditor may need to communicate with the expert directly to obtain audit evidence in this regard.
- In obtaining an understanding of the entity,
  - – the auditor also considers whether to include the expert during the engagement team's discussion of the susceptibility of the entity's financial statements to material misstatement.



5. Evaluating the Expert's Work

- The auditor should evaluate the appropriateness of the expert's work as audit evidence regarding the assertion being considered.
- This will involve evaluation of whether the substance of the expert's findings
  - – is properly reflected in the financial statements or
  - – supports the assertions, and
  - – consideration of:
    - **source data used**;
    - **assumptions and methods used** and their **consistency** with prior periods; and
    - **results of the expert's work** in the light of the auditor's overall knowledge of the business and of the results of other audit procedures.

5. Evaluating the Expert's Work

- When considering whether the expert has used **source data** which is appropriate in the circumstances, the auditor would consider the following procedures:
  a) Making inquiries regarding any procedures undertaken by the expert to establish whether the source data is relevant and reliable.
  b) Reviewing or testing the data used by the expert.

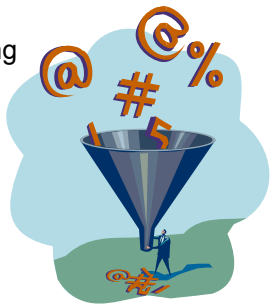
5. Evaluating the Expert's Work

- The appropriateness and reasonableness of **assumptions and methods used** and their application are the responsibility of the expert.
- The auditor does not have the same expertise and, therefore, cannot always challenge the expert's assumptions and methods.
- However, the auditor will need
  – to obtain an understanding of the assumptions and methods used and
  – to consider whether they are appropriate and reasonable,

  based on the auditor's knowledge of the business and the results of other audit procedures.

5. Evaluating the Expert's Work

- The auditor should resolve the following matters
  - if **the results of the expert's work** do not provide sufficient appropriate audit evidence or
  - if the results are not consistent with other audit evidence. (ISA 620.15)
- This may involve
  - discussions with the entity and the expert,
  - applying additional audit procedures, including possibly engaging another expert, or
  - modifying the auditor's report.



6. Reference in Auditor's Report

- When issuing an unmodified auditor's report, the auditor should not refer to the work of an expert. (ISA 620.16)
  - Such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility, neither of which is intended.

6. Reference in Auditor's Report

- If, as a result of the work of an expert, the auditor decides to issue a modified auditor's report,
  - in some circumstances it may be appropriate, in explaining the nature of the modification, to refer to or describe the work of the expert (including the identity of the expert and the extent of the expert's involvement).
- In these circumstances, the auditor would obtain the permission of the expert before making such a reference.
  - If permission is refused and the auditor believes a reference is necessary, the auditor may need to seek legal advice.

CPA专业方向师资培训 —— Day 7

End of Afternoon Session

21 August 2007

Full version of the slides can be found in
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