

Audit of the Comprehensive Income Statement - Practical Application

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Course Outline

- Objectives of an auditor in an audit
- Developments in auditing profession and the impact on the actual audits.
- Analytical review of items of comprehensive income
- Risk assessment and detailed audit procedures
- Considerations for small and medium sized entities

Overall objectives of an auditor in any audit (ISA 200)

- (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to **express an opinion** on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
- (b) To report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings.

Developments in auditing profession and the impact on the audit objectives.

- The accounting literature has documented that the use of Internet searches prior to earnings announcements partially preempts the information content of the announcement (e.g., Drake, N. Myers, L. Myers, and Stuart 2014), **potentially indicating a declining importance of the audited financial statements as a primary source of information to investors and creditors, who have access to other sources of information.**
- Other literature has shown that some information in financial reports, including earnings, have declined in importance over time (Francis and Schipper 1999; Dontoh, Radhakrishnan, and Ronen 2004). Concerns include that audited financial statements **leave out important information such as knowledge (of particular import in valuing high technology firms or service providers), or fair value, or provide information in a format that has declined in value, and that investors have access to competing information that is timelier than the audited financial statements.**

Developments contd.....

- Experts agreed that although the auditing profession is beginning to evolve to incorporate new advances in technology and become more sensitive to changes in the global economy, it will further incorporate technology over the next decade to allow auditors to produce continuously audited financial statements, have more guidance in making important judgments, and shift their focus to evaluate risks rather than focusing on transactional data.

Developments contd.....

- The audit model has become increasingly **risk based** and **continuous**, a progression from the traditional, periodic historical audit. Auditors' tools used during fieldwork have also progressed. For example, paper and pencil checklists have been replaced by automated decision aids and interactive checklists, which are completed electronically.
- Other examples include software that customizes audit plans based on the characteristics of the individual client, analytical software programs, and the use of XBRL (eXtensible Business Reporting Language) as an enhancement to auditor fieldwork. Higher education is believed to have progressed to include more current issues in auditing. There has been an increased emphasis **on fraud concerns, the development of risk analyses**. There has also been an increasing emphasis on **technology and applying analytical procedures**.
- There was also consensus that the increasing use of technology will require additional training for veteran staff that may be less up to date with current technology than newer staff. As for the future of the audit profession, expert participants came to an overall consensus of forecasts related to the following topical areas: automation of judgment and audit procedures, **reliance on the internal audit function, frequency of external audit opinions and audited financial statement presentation, and the utilization of XBRL/GL (XBRL Global Ledger Taxonomy Framework)**.

Highlights and Recommendations Provided by Experts

- External auditors will rely more on internal audit work in the future
- Although use of automation will increase, judgement and decision making cannot be automated
- Audit will be recycled over the year, instead of only at year end
- There is a need for a more global perspective
- Client technology is leading audit procedures
- The use of technology depends upon proper safeguards for privacy
- Automation can be used for more tedious tasks so that auditors can use their expert judgment for more pressing issues

Developments contd.....

To continue a viable and relevant field, the auditing profession, as any profession, cannot resist advances that may further the efficiency or effectiveness of the process, or it will find itself no longer viable. Audited financial statements are widely accepted as a gold standard of reliable financial information.

However, the importance of annual financial statements is decreasing. A decade ago, if a person were told that bookstores would no longer be a viable model, then it would too have been an unlikely scenario. However, with the increasing use of tablets and smart devices, there is less and less in actual print, and major retail chains, such as Borders, have gone out of business, in part because they were not able to predict or make necessary modifications to keep up with the changing market. The auditing profession does not want to find itself in the same predicament. Now it is time to get ready for the future.

Common findings during AQRs)

- No section on income or expenses on file
- No work done
- Work done but is not documented
- Tick marks used but not explained
- No risk assessment done and therefore work done is not responding to any specific risk assessed
- The section not speaking for itself i.e. disorganised

Analytical Review of Items of Comprehensive Income

○ Components of SCI

- Revenue;
- Gains and losses arising from the de-recognition of financial assets measured at amortised cost
- finance costs
- share of the profit or loss of associates and joint ventures
- Tax expense
- If a financial asset is reclassified so that it is measured at fair value, any gain or loss arising from a difference between the previous carrying amount and its fair value at the reclassification date
- Profit or loss
- Each component of other comprehensive classified by nature

Assertions

Account	Primary Direction of Test	Assertions
Sales/Revenue	Understatement- Reciprocal or Independent Population	Recording(under) Cut off(early) Completeness Presentation valuation
Expenses	Overstatement <i>Selection from GL</i>	Validity Recording(over) Cutoff(late) Presentation Valuation

Corollary test

- when primary tests for overstatement of all assets, expenses and other debit account balances, combined with primary tests for understatement of all liabilities, revenues and other credit account balances result in all account balances being tested for overstatement and understatement either directly or indirectly.

Audit of Revenue

To note;

(a) Work done during planning

- Understood and documented the sales/revenue process/system notes.
- Walkthrough the process to ensure that it is working as documented.
- Identified the controls in the process and tested them to ensure that they were operating effectively through out the period.

Audit of Revenue contd....

- ❑ From the risk assessment done, identified the assertions you want to test ;
- ✓ Revenue recognition-cut off procedures (completeness of revenue) (C)
- ✓ Incorrect computation of interest-measurement (M) or
- ✓ Double posting of invoices-Occurrence assertion.
- ✓ *(Under each assertion, document what could go wrong in order to invalidate the assertion)-if there is a problem with say income, corollary tests –receivables will have a problem-examples.)*

Audit of Revenue contd....

- Prepare a lead schedule as in the note in the financial statements(***see example in excel***) – ***Agree the lead schedule to the general ledger***
- Carry out revenue recognition procedures ;
- ✓ analytical procedures using disaggregated data (by month, by product line, by geographical area, by segment),
- ✓ inquiry of sales and marketing personnel for any unusual transactions or similar items,

Audit of Revenue contd....

- ✓ If TOCs were not done during planning, then carry out the tests (*See excel worksheet*)
- ✓ **review of the terms of sales agreements** – including sales incentives and client's policies for handling returns, to identify potential unusual transactions or events.

Audit of Revenue contd....

- perform procedures specifically designed to respond to areas of risk identified e.g. Cut-off test for completeness, re-computation of interest for measurement and vouching for occurrence.

Audit of Other Income

- Interest income-Obtain a detailed schedule, re-compute the interest or agree to supporting documents e.g. bank statements
- Gain on disposal of PPE-Recompute the gain or cross reference to PPE
- Any other income-obtain an understanding of their contents and vouch to the underlying documentation

(Examples of other income so that proposed tests can be brought forth)

Audit of Cost of Sales

- Much related to sales in terms of movements/analytics
- $\text{Cost of sales} = \text{OPS} + \text{Purchases} - \text{CLS}$
- Therefore our test will concentrate on the **purchases- test of controls/ more vouching**
- Alternatively, if the system computes the COS, then understand their costing method and test on a sample basis

Audit of Cost of sales(Cont'd)

Exercise for 15 minutes

- *Go into teams of five members*
- *Come up with system notes of purchases of a company in any industry of your choice*
- *Design a walk through test*
- *Identify controls*
- *Design test of controls on the purchases process*

Audit of Expenses

(a)Administrative(Cont'd)

- **Salaries & Wages** - Do payroll test
- ✓ Obtain month by month totals from the payroll; Agree the total to the TB and reconcile the difference
- ✓ Statutory deductions test-NSSF,NHIF & PAYE- ensure they were remitted on a timely basis
- ✓ Select a sample of employees and obtain their personal files-check that they are up to date and PAYE was correctly computed.

Audit of Expenses

(a)Administrative(Cont'd)

- **Director's remuneration-** these are mostly sitting allowance
- ✓ Obtain the BOD minutes for the period and do a reasonableness check i.e.
number of meetings * number of attendees * the allowance per director.
- Rent-Agree to the rent agreement

Audit of Expenses

(a)Administrative(Cont'd)

- **Professional fees**(Legal, secretarial & audit)-select a sample based on materiality levels and vouch; obtain a lawyer's confirmation;
- **Others**-Motor vehicle expenses, bank charges, computer expenses and bad debts-Select samples depending on the materiality level and vouch; compare with previous year and obtain detailed variance explanations.

Audit of Expenses

(b) Establishment

- **Insurance**-Obtain debit notes and do a reasonableness test if a few; select a sample and vouch ; cross reference to insurance prepayment schedule if it is maintained
- **Depreciation & Amortisation** -re-compute depreciation or cross reference to PPE
- **Repairs & Maintenance**-check for items which are capital in nature; select a sample and vouch

Audit of Expenses

(b) Establishment(Cont'd)

- **Electricity & water, security, Licenses and subscriptions**-Select samples depending on the materiality level and vouch; compare with previous year and obtain detailed variance explanations.

Audit of Expenses

(c) Finance cost

- **Bank loan interest** - obtain and review the loan agreement; re-compute the interest
- **Bank overdraft interest**-agree to the bank statement; re-compute the interest

Notes & Disclosures

- The lead schedule should actually be the note in the financial statements
- The total in the lead should tie to the financial statement amount
- All disclosures as per IAS 1 should be disclosed

To remember.....

NO DOCUMENTATION,NO WORK DONE

DISCUSSION

Considerations for Small and Medium Sized entities
(Discuss)

Questions & Answers