

# Master in Accounting

Advanced Auditing

2.nd edition



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(CPA)

2021/2022



## Professor

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## Introduction

Late 20<sup>th</sup> century and early 21<sup>st</sup> century is being marked by events that brought Auditor profession to the spotlight: financial scandals, **Arthur Andersen** bankruptcy, pressure for **separation between of consulting and auditing activities**, auditor rotation, **Sarbanes-Oxley Act** of 2002, Directive 2006/43/CE, Regulation (EU) n.º 537/2014 and Directive 2014 /56/EU of European Parliament and Council, new Statutes of Order of Statutory Auditors – Ordem dos Revisores Oficiais de Contas (Law 140/2015, of 7/9), legal framework of audit supervision and its code of ethics, etc.

On the other hand, audit is a discipline that crosses with other areas of management, namely taxation, company law, ethics, accounting, statistics, finance. In short, facts that have contributed to a growing interest of the academic community in the investigation of audit-related issues.



## Introduction

### Case Study a)

Based on public information provide 3 recent examples of financial scandals.

Prepare a presentation to share with colleagues.



## Introduction

### ❖ Examples of committed fraud

#### Enron

1. Used *special-purpose entities* (SPE) to decrease their responsibilities and to count **artificial income** for either SPE either Enron.
2. Contracts lasting for several years were accounted for in the first year, reducing costs and oversizing income.

#### WorldCom

1. **Current expenditures** were accounted as **investments** (with this they transformed the losses they indeed had into profits).
2. **Very large amount of loans** to top executives were not paid by them.

#### Tyco

1. **Manipulated the accounts** to show high profits.
2. **Non-approved loans** to top executives (these executives used company's money to buy personal property and other assets).

## Introduction

### ❖ Studies regarding fraud

Other fraud examples were studied by **Agrawal, Jaffe, and Karpoff (1999)**.

They identified **103 companies** accused of **fraud** present at Wall Street Journal Index between 1981 and 1992. They have also established 103 control companies whose code of economic activity and net sales were similar to that of companies with fraud.

- The companies that were part of fraud's companies sample had significantly more fraud than the ones of the control group in the 2 years before and 2 years after regarding the year of the key event for the study.
- The differences in operating performance around the event of fraud were not statistically different between two groups.

Regarding management rotation they “**didn't find evidence that fraud revelation leads to a subsequent alteration in the leadership structure**” – in the cases which CEO and Chairman are the same person.

They also evaluated the rotation for the tree top positions and the alterations remain non-significant between companies in fraud situation and the ones in the control group..

## Introduction

### ❖ Studies regarding fraud

During the year of the fraud event, and in the 3 following years, the companies in fraud situation reduce slightly their executive board, reducing simultaneously their internal and external members; on the other hand, the companies in the control group increased slightly their executive board (but not significantly).

- **The authors conclude that the reduced impact from reported frauds in the study may reflect the favorable economic and financial characteristics for the period 1981-1992.**

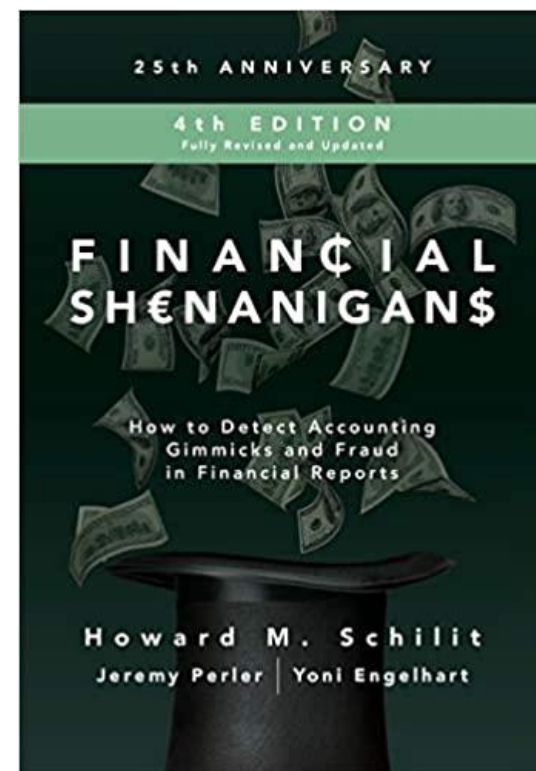
## Introduction

### ❖ Some books about corporate fraud

**Howard Schilit** published in 1993 the first edition of his book: “*Financial Shenanigans in 1993*”.

Created an analysis and research center (CFRA) to detect early warning signs in relation to operational problems or accounting “anomalies”. In the 2002 edition of his book, he mentions **30 techniques of financial “cheating”** defined as practices that intentionally distort the financial situation or performance reported by a company.

In 2002, a similar book with many other examples was published by Mulford and Comiskey.



**2018 edition**  
ISBN-13: 978-1260117264  
ISBN-10: 126011726Xpj v

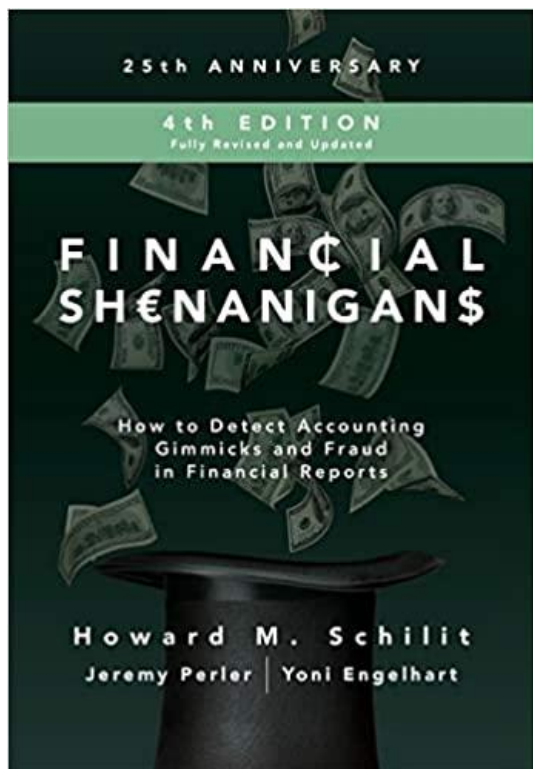
These disclosures have **caused outrage** and resulted in **Sarbanes-Oxley Act** (SOA) in July 30th, 2002.



## Introduction

### ❖ Some books about corporate fraud

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**2018 edition**

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## Introduction

### ❖ Sarbanes-Oxley Act



The **Sarbanes-Oxley Act** covers 11 main areas:

#### 1. PCAOB – Public Company Accounting Oversight Board

PCAOB is a private nonprofit entity subjected to the regulation and supervision of the SEC.

This organization is responsible for the **supervision of the audit** listed companies and the establishment of standards for audit reports. All audit firms must be registered in the PCAOB.

All companies must report to its audit committee is composed of at least one member who is financial expert under the SEC definition.

## Introduction

### ❖ Sarbanes-Oxley Act (cont.)



#### 2. Auditor independence:

- **Audit** firms are prohibited to providing non-audit services such as **consulting**.
- The Audit Partner should rotate at least **each 5 years**.
- **Audit reports** should be directed to the **audit committee** rather than to the management body.
- The auditing firm should not have employed an accounting or financial responsible of the audited company during the period of one year before the audit.

## Introduction

### ❖ Sarbanes-Oxley Act (cont.)



**3. Certification:** The CEO and CFO must be sure that the report is according the SEC requirements and properly presents the financial position of the company (making false statements gives rise to a **prison sentence between 10 and 20 years**);

**4. Disclosures:** Each annual and quarterly report prepared in accordance with those norms SEC has to disclose all material **off-balance-sheet transactions**.

**5. Insider trading:** *Insider trading* with the stocks of the company in which they work is considered an event subject to disclosure that must be reported in a *Form 4* *within a period of 2 days* (previously was until the 10th day of the month following the realization of the transaction).

**6. Conflict of interests:** Personal loans are prohibited by companies to administrators and directors;

## Introduction

### ❖ Sarbanes-Oxley Act (cont.)



**7. Professional responsibility:** New regulations establish minimum standards of professional conduct regarding **lawyers** who practice their activity in entities supervised by SEC.

**8. Studies and Reports:** Must be conducted several studies.

**9. Fraud accountability:** The elimination, alteration or falsification of registrations is a **crime**.

**10. Sanctions:** All audit or work papers must be kept for **5 years**. False certifications or reports forgery must result in fines until **5 million dollar** and/or **prison until 20 years**.

**11. Authority of SEC:** Everyone who had violated the antifraud norms may be prohibited of exercise administrative or management positions.

## Introduction

### Case Study b.1)

Search for **Audit proposals** from Audit firms as for example from the Big 4 firms.

(to be presented in next class)



## Introduction

### Case Study b.2)

Make an initial search of recent academic papers (2 or 3 papers) addressing the topic of **corporate financial fraud**.

Prepare a summary in 2 or 3 PPT pages of each study that you found.

(to be presented in next class)

## Introduction

The exercise of functions related to the area of Accounting / Finance requires an understanding of the **audit process**, namely a knowledge of the **methodology** and the ethical implications of the decisions made by the auditor.

The objective of the course is to provide its participants with fundamental skills for a correct application of the **audit methodology**, focusing on the **standards, principles** and **practical aspects** of daily life of auditors.





## Introduction

The topics covered are basic topics for a student who wants to start a career as an auditor. But also for any student of the 2nd cycle of Bologna who is interested in auditing companies from an internal or external perspective.

**Critical analysis** and **communication skills** will be developed through a **case-based discussion** forum and **exercises** that will allow addressing some of the themes exposed in the various sessions.



## Objectives

At the end of the course, participants should be able to:

- Understand the **concept of Audit** and the **role of the Auditor**;
- Know some professional **regulation** of the activity of the **Chartered Accountants / Statutory Auditors**;
- Understand how to develop and analyze the **audit evidence** necessary to support the auditor's opinion;
- Know the different **phases** that make up the **auditing process**;
- Recognize the scope of the **different types of opinion** established in the **auditing standards** and be able to prepare the appropriate **final report**.



## Program

N.º	Subject
1	Introduction
2	Report in Audit
3	Professional regulation
4	Audit pillars: materiality, risk and evidence
5	Audit path, client acceptance and audit planning
6	Business knowledge and assessment of the risks of material misstatements
7	Internal control
8	Auditing the sales cycle, receivables and receipts
9	Auditing the purchasing cycle, payables and payments

## References

- ✓ Arens A. A., Elder R. J., Beasley M. S. e Hogan, C. E. (2020), *Auditing and assurance services (Global Edition)*, 17<sup>th</sup> Ed., Prentice-Hall.
- ✓ Almeida, B. (2017), *Manual de Auditoria Financeira*, 2.<sup>a</sup> edição, Editora Escolar,
- ✓ Costa, Carlos B. (2017), *Auditoria financeira – teoria e prática*, 11.<sup>a</sup> edição, Rei dos Livros.
- ✓ Hayes, R., Gortemaker, H. e Wallage, P. (2014), *Principles of Auditing: An Introduction to International Standards on Auditing*, 3<sup>rd</sup> Ed., Prentice-Hall.
- ✓ Messier Jr. W. F., Glover S. M., Prawitt D. F. e Eilifsen, A. (2013), *Auditing & assurance services*, 3<sup>rd</sup> international edition, McGraw-Hill.
- ✓ Johnstone, K. M., Gramling, A., e Rittenberg, L. E., (2019), *Auditing: a risk based-approach*, 11<sup>th</sup> edition, Cengage Learning.

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# Auditing and Assurance Services (Subscription), 17th Edition

Alvin A Arens, Michigan State University


Randal J Elder, The University of North Carolina Greensboro

Mark S Beasley, North Carolina State University

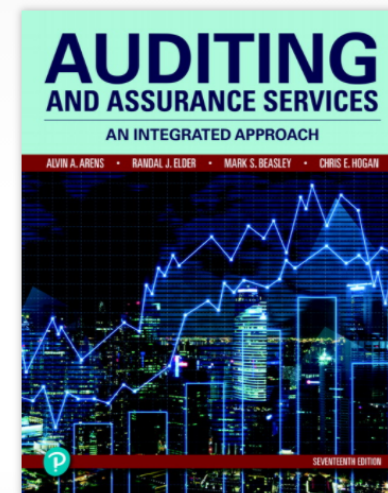
Chris E Hogan, Michigan State University

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## Assessment

The maximum final grade is 20 which is calculated as follows:

### Continuous evaluation

- ✓ Class participation – 5%
- ✓ Quizzes to take place in classes – 15%
- ✓ Group assignment (3 to 5 students) – 40%
- ✓ Individual written exam – 40%



The final grade will be obtained through the weighted average of the grades obtained in the three criteria listed above, and the grade obtained in the individual written test may not be less than 8 points out of 20. In case of failure, the component of the continuous assessment is considered at the time of appeal season (second possibility).

### Evaluation without the class component

- ✓ Individual written exam – 100%


In the individual written exam, it is allowed to consult elements of study.

## Assessment

### Group work

**Assignment - Part I:** Analysis of scientific articles that focus on issues that are related to course topics. Presentation should answer the following questions:

- What is the research problem / question being analyzed in the paper?
- What is the econometric model adopted on the paper?
- What are the dependent variable(s) and explanatory variables?
- What are the main conclusions of the study?
- Why is this paper important to auditors and what are the main implications of this study for the profession?
- Clues for future research.




**15 to 20  
minutes  
presentation in  
class**

## Assessment

- **Assignment Part II: Business Risk of an Entity**

**Some hints:**

- Identify 10 aspects related with “inherent risk” in a company.
- Inherent risk related with assertions and transactions
- Inherent risk related with the business
- Inherent risk related with financial reporting



**15 to 20  
minutes  
presentation in  
class**

Note: You may start by giving a more generic approach referent to inherent risk and then you can give an example for a specific company or organization for better clarification of the concepts. If the company is real, it would be better for explanation and presentation purposes.



## Important Dates

- ✓ Sessions: September 15<sup>th</sup> to December 17<sup>th</sup>, 2021
- ✓ Delivery and discussion of group assignments:
  - ✓ Part I
  - ✓ Part II
- ✓ Guest lecture
- ✓ Written exam of the regular assessment period: **January 3rd, 2022, at 09:00**
- ✓ Written exam of repeat assessment period: **January 31<sup>st</sup>, 2022, at 09:00**



[https://www.iseg.ulisboa.pt/aquila/unidade/SPG/masters/timetable-and-calendars/calendar-of-exams---1st-semester---2021-2022?\\_request\\_checksum\\_=2501611bf00e3d6aef4f9e192da5b741f68a1829](https://www.iseg.ulisboa.pt/aquila/unidade/SPG/masters/timetable-and-calendars/calendar-of-exams---1st-semester---2021-2022?_request_checksum_=2501611bf00e3d6aef4f9e192da5b741f68a1829)



## 1. Introduction

- ✓ Presentation of Group Work assignment **Part I: 20th** of October 2021
- ✓ Presentation of Group Work assignment **Part II: 24th** of November 2021

**Example of an evaluation table of Auditors 'proposals concerning  
audit services**

# 1. Introduction

## ✘ Importance of information

### ➡ Power of information

*It is widely accepted that knowledge has become the main force of production in recent decades. In the form of an informational commodity indispensable for a productive power, knowledge is already, and will continue to be, the main - perhaps the main - tool in the world competition for power.*

Jean François Lyotard (La Condition Postmoderne: Rapport sur le Savoir, 1979)

### ➡ Reliable information

*The truth is not simply what we think it is; it is also the circumstances in which it is said, and by whom, why and how it is said.*

Václav Havel (Disturbing the Peace - A Conversation with Karel Hvizdala, 1990)

## 1. Introduction

### ✘ Agency Theory (Jensen & Meckling, 1976)



Information asymmetry



Companies prepare information to provide to third parties

## 1. Introduction

### ✗ Duty of **accountability**

In order to reach all of our diverse audiences, the final report is now 17,000 pages.

You can pick it up here. hand-trucks are available at the back of the room.



**"I like the creative way you manipulate reality. You may be just the man we need to write our corporate annual reports."**

# 1. Introduction

## ✘ Duty of accountability

### Article 65.º CSC – Duty to report

- 1) The members of the board of directors shall prepare and submit to the competent bodies (General Assembly) of the company the management report, **including the non-financial statement or the separate report with this information (if applicable), the accounts for the financial year** and the other accounting documents provided for by law, for each annual financial year.
- 2) The preparation of the management report, **including the non-financial statement or the separate report (if applicable), the accounts for the financial year** and the other accounting documents **must** comply with the provisions of the law; the shareholders agreement may supplement, but not derogate from, those legal provisions.
- 5) The management report, **the separate report with the non-financial information (if applicable), the accounts for the financial year** and other accounting documents must be submitted to the competent body and assessed by it, except in special cases provided for by law, within **three months** of the closing date of each annual financial year, or within five months of the same date in the case of companies which must submit consolidated accounts or which apply the equity method.

## 1. Introduction

### ✘ Duty of accountability

#### Article 66.º-A CSC – Notes to the accounts

- 1) Information on the fees invoiced by the ROC
- 2) Information on operations with related parties

#### Article 66.º-B CSC – Non-financial statement (for large companies)

- 1) Information on environmental, social and worker-related issues, equality between women and men, non-discrimination, respect for human rights, combating corruption and money laundering.
- 4) The non-financial statement referred to in paragraph 1 shall also include, where appropriate, a reference to the amounts shown in the annual financial statements and additional explanations of those amounts.



## 1. Introduction

### ✘ Duty to accounts for issuers with listed securities

Yearly Accounts (art.º 245 & 245.º-A CVM)	Semester Accounts (art.º 246 CVM)
<p>Annual Report and Accounts – 4 months</p> <ul style="list-style-type: none"> <li>• Management report, annual accounts, legal certification of accounts and other accounting documents required by law or regulation;</li> <li>• Report prepared by the auditor;</li> <li>• Statement by the management body that the accounts comply with accounting standards and the management report accurately describes the business and <b>main risks</b>;</li> </ul> <p>Annual <b>Corporate Governance Report</b></p>	<p>After a maximum of 3 months from the end of the 1st semester:</p> <ul style="list-style-type: none"> <li>• Condensed financial statements;</li> <li>• Interim management report;</li> <li>• Statement by the management body that the accounts comply with the accounting standards and the management report faithfully describes the business and the main risks.</li> </ul>

### Audited information – art.º 8. CVM

- Annual Accounts
- Where the quarterly or half-yearly information has been subject to audit or limited review, the audit or review report shall be included or, if it has not been, this shall be stated.

## 1. Introduction

### ✘ Financial statements

Financial statements arise from a series of patrimonial facts that occurred in the life of an entity in each period, and which are reported through the following charts:

Microentities	Small companies	Other companies
<ul style="list-style-type: none"> <li>• Balance Sheet</li> <li>• Income Statement by Nature</li> <li>• Optional:               <ul style="list-style-type: none"> <li>- Apendix/notes,</li> <li>- Statement of changes in equity</li> <li>- Cash flow Statement</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Balance Sheet</li> <li>• Income Statement by Nature</li> <li>• Apendix/notes</li> <li>• Optional:               <ul style="list-style-type: none"> <li>- Statement of changes in equity</li> <li>- Cash flow Statement</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Balance Sheet</li> <li>• Income Statement by Nature</li> <li>• Statement of changes in equity</li> <li>• Cash Flow Statement</li> <li>• Apendix/notes</li> </ul>

## 1. Introduction

### ✘ Main accountability challenge



How users of financial information are assured that the information provided is **sufficient**, **appropriate**, **transparent** and **credible**?

## 1. Introduction

### ✘ Information risk

- There are countless stories of fraudulent financial reporting



**XEROX**  
CORPORATION



**ENRON**



**WORLD**COM

<https://www.youtube.com/watch?v=70Xnlrw07U4>

.....

Brennan, N. M., & McGrath, M. (2007). FINANCIAL STATEMENT FRAUD: SOME LESSONS FROM US AND EUROPEAN CASE STUDIES. *Australian Accounting Review*, 17(2), 49-61.

## 1. Introduction

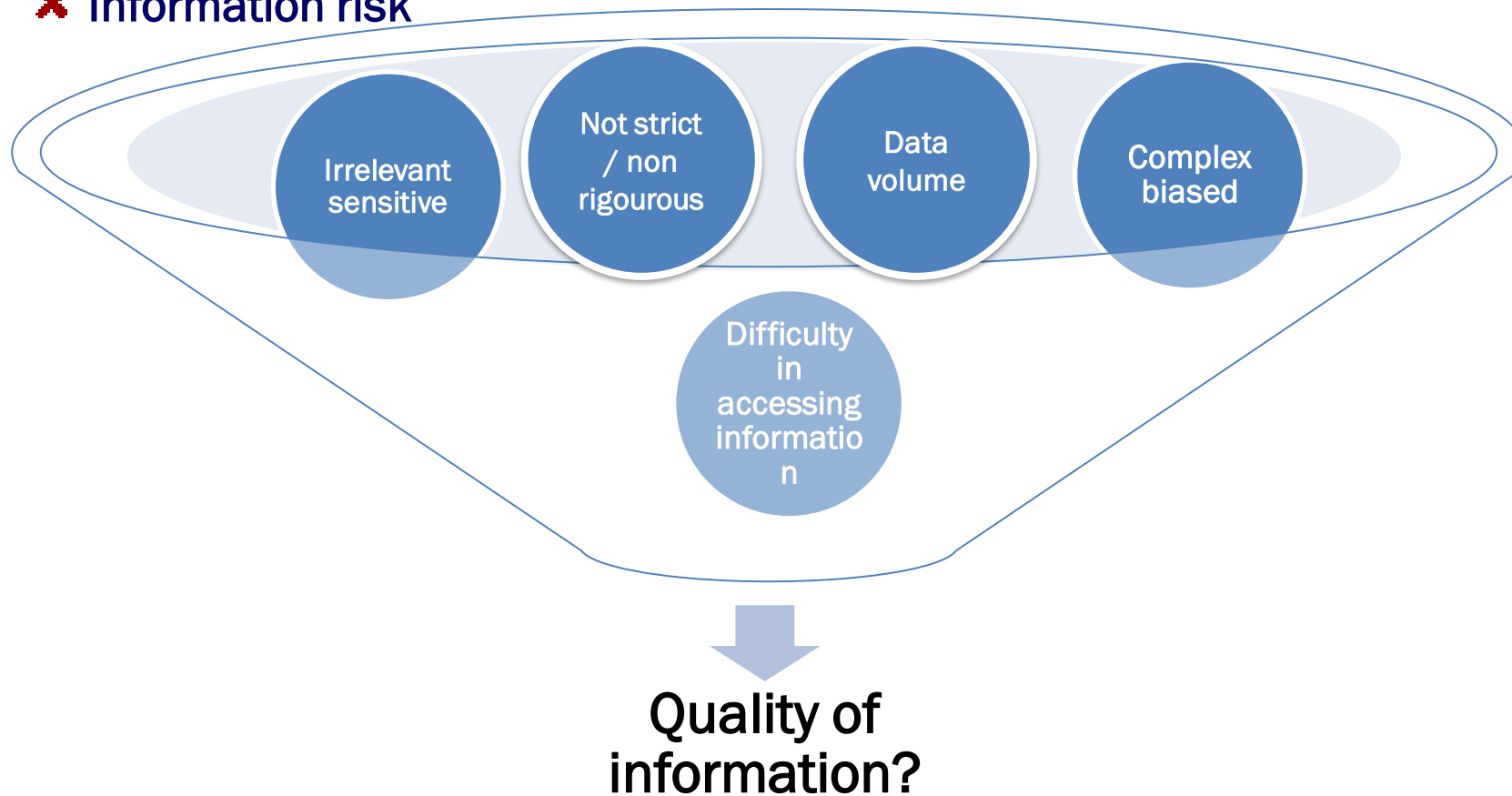
### ✘ Information risk

- Parliamentary Inquiry Committee into BES and GES Bank of Portugal
- ✓ *I speak from experience, if someone wants to cheat the **supervisor** cheats and hides* (Fernando Teixeira dos Santos, former Finance Minister)
- ✓ *When someone really wants to deceive someone, they deceive* (Machado Pereira, ROC of some companies of the Group)



## 1. Introduction

### ✘ Information risk



## 1. Introduction

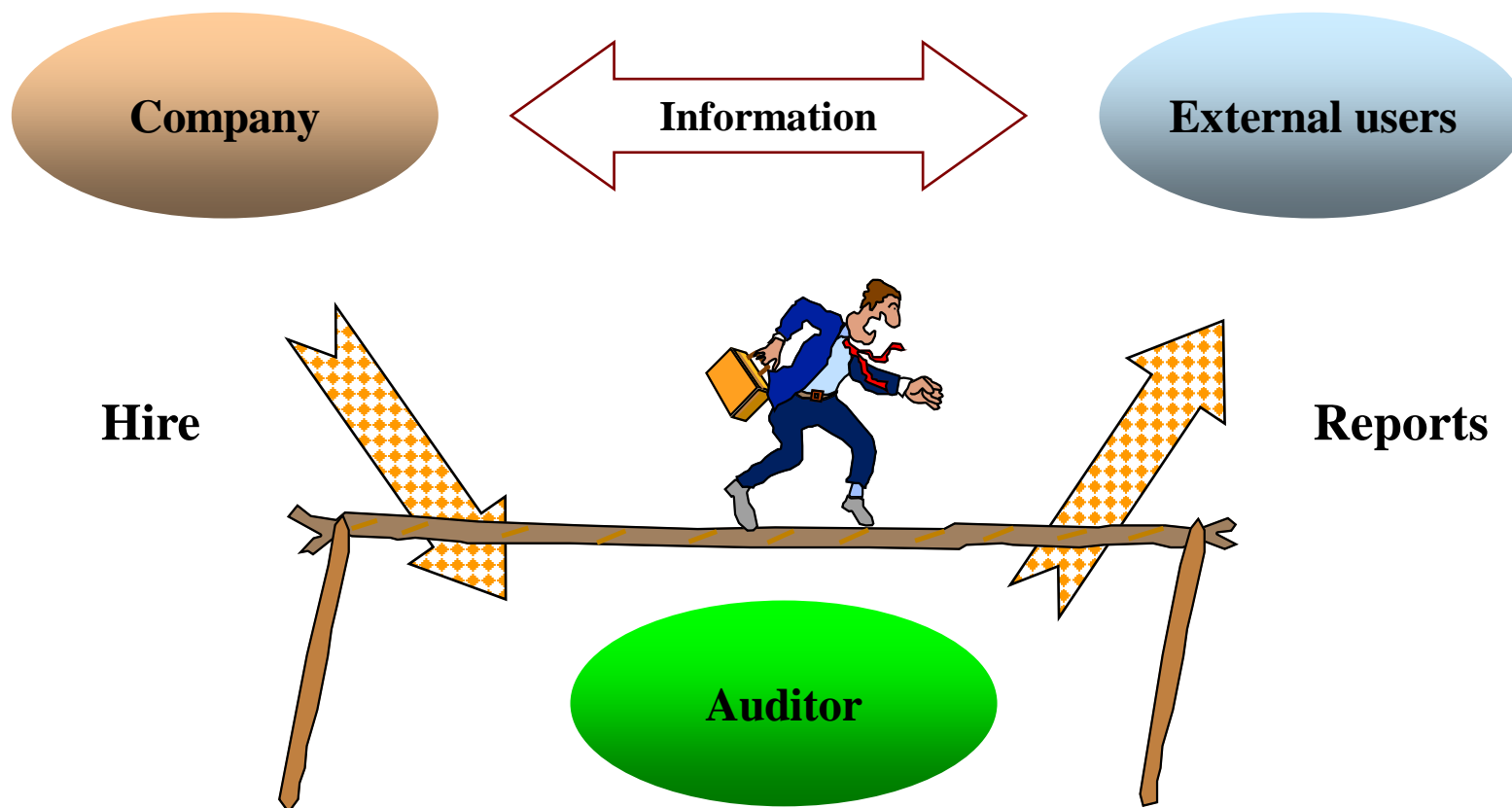
### ✘ Implications of information risk

In 1995, Robert Elliott (KPMG partner) indicates that the cost of capital of an American company is broken down into 3 tranches:



## 2. Financial Auditing

✘ Auditor's role: contributing to the Financial Statements **credibility**





## 2. Financial Auditing

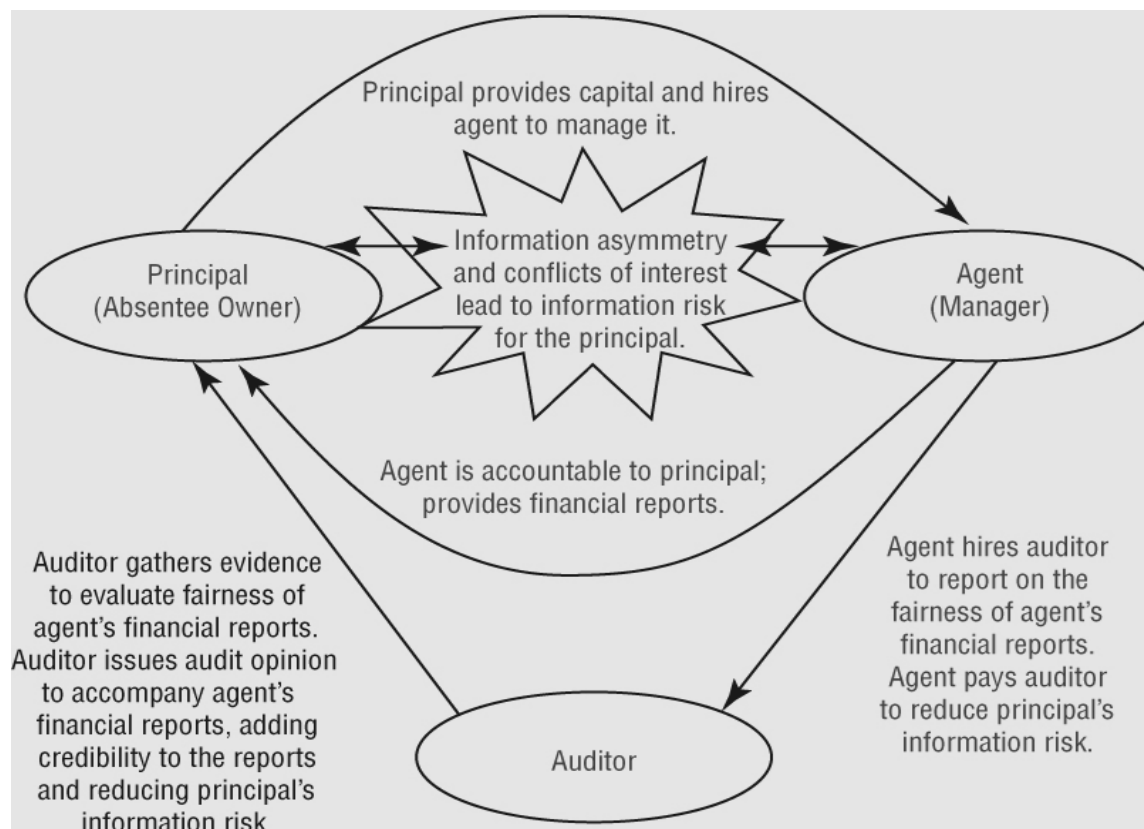
### ✘ Auditor's role - special function in the company

*By certifying the public reports that collectively depict a corporation's financial status, the **independent auditor** assumes a public responsibility transcending any employment relationship with the client. The independent public account performing this special function owes ultimate allegiance to the corporation's **creditors and stockholders**, as well as to the **investing public**. This public watchdog function demands .... complete **fidelity to the public trust**.*

Chief Justice Warren Burger (US Supreme Court)

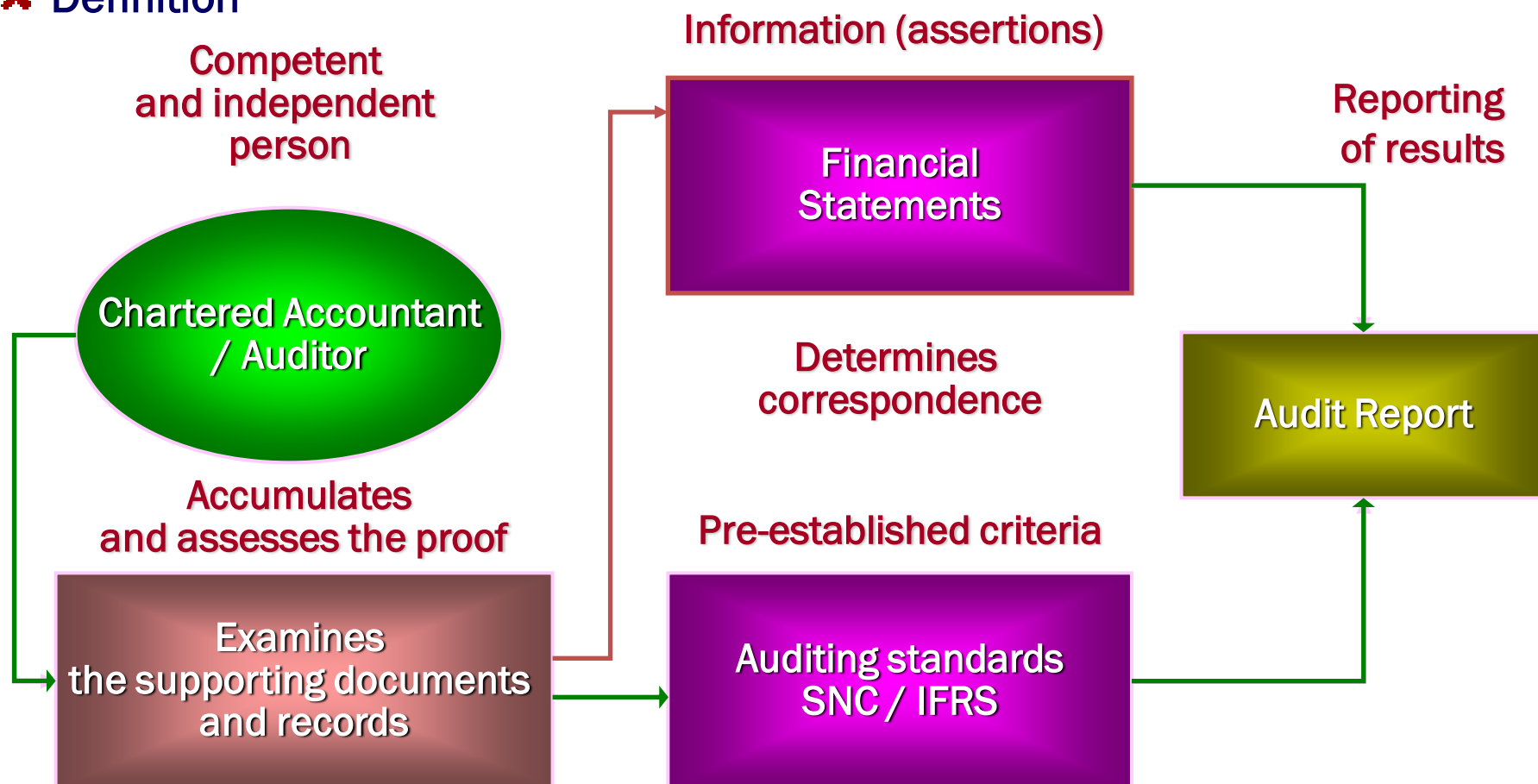
## 2. Financial Auditing

### ✘ What is the justification for the **existence of an audit?**



## 2. Financial Auditing

### ✘ Definition



## 2. Financial Auditing

### ✘ Overview



Fonte: <https://www.youtube.com/watch?v=aztSsS6GYw>

## 2. Financial Auditing

### ✘ Overview

*The public interest function of **statutory audit** means that a wide range of people and institutions rely on the quality of the work of statutory auditors or audit firms.*

*Good audit quality contributes to the orderly functioning of markets by improving the **integrity** and efficiency of financial statements.*

*Statutory auditors thus play a particularly important **social role**.*

Preamble of the Regulation (EU) N.º 537/2014 of the European Parliament and Council, from April 16<sup>th</sup>, 2014

## 2. Financial Auditing

### ✘ Auditor's responsibility

#### Auditor

- Responsible for the **audit report** and the **opinion issued**
- Duties to report to the **supervisory board** / **fiscal board** and competent authorities - Art. 63, 79 and 81 EOROC

#### Administration

- Is responsible for adopting adequate accounting policies and an **internal control system**, as well as for **presenting and preparing** the **financial statements**.

#### Consequences:

- **Chartered accountant** / Auditor (ROC) is jointly and **severally liable** to the company and stakeholders for any **damage** caused to them by their wrongful conduct - n.º 1 of art. 78 CSC
- Chartered accountant / Auditor (ROC) is liable to **creditors** for culpable failure to comply with legal or contractual provisions designed to protect them, and the assets become insufficient - n.º 2 of article 78 CSC
- For deficiencies in the report or opinion, the Chartered accountant / Auditor (ROC) is jointly and severally liable for damages caused to **issuers or third parties** - n.º 1 of article 10 CVM

## 2. Financial Auditing

### ✘ Auditor's general objectives – ISA 200 (§11 e 12) International Standards on Auditing\*

- ✓ When conducting an audit of financial statements, the **general objectives of the auditor** are:
  - Obtain **reasonable assurance** as to whether the FS **as a whole** are free of **material misstatement**, either due to **fraud or error**, thus enabling to express an opinion on whether the financial statements are prepared, in **all material respects**, according to an applicable **financial reporting framework**; and
  - **Reporting** on the **financial statements** according to its conclusions.

In all cases where **reasonable assurance of reliability cannot be obtained** and a qualified opinion is insufficient in the circumstances for reporting to users, ISAs require the auditor to give an **excuse of opinion** or to **resign** (or resign) from work, when such a resignation is possible under applicable law or regulation.

## 2. Financial Auditing

- **International Standards on Auditing (ISA)** are professional standards for the [auditing](#) of financial information. These standards are issued by the [International Federation of Accountants](#) (IFAC) through the [International Auditing and Assurance Standards Board](#) (IAASB).
- ISA guides the auditor to add value to the assignment hence building confidence of investors.

International Federation of Accountants  
529 Fifth Avenue,  
New York, NY 10017 USA



## 2. Financial Auditing

### ✘ Requirements to perform an audit– ISA 200

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Comply with relevant **ethical requirements**

---

Plan and execute an audit with **professional skepticism**

---

Exercise **professional judgment** when planning and executing an audit

---

Obtain sufficient and appropriate **audit evidence** to reduce **audit risk** to an acceptably low level

---

Conduct the audit in accordance with applicable **auditing standards**

## 2. Financial Auditing

### ✘ Requirements to perform an audit– ISA 200

#### ✓ Professional Judgement

Auditors add value to users by making **quality decisions** associated with their **assessment** of the client's financial statements. Quality decisions are **impartial**, meet users' expectations, comply with professional **auditing standards**, and are based on sufficient **factual information** to support the decision that is made.



**A well-structured decision process is fundamental**

## 2. Financial Auditing

### ✘ Requirements to perform an audit– ISA 200

#### ✓ Professional Skepticism (art. 70 EOROC)

- An attitude that includes an **interrogative mind**, characterized by **doubt** and a **critical spirit** that is alert to conditions that may indicate a possible misstatement due to **error or fraud**, and a critical appreciation of the **evidence**.
- The auditor should plan and perform an audit with professional skepticism recognizing that there may be **circumstances/situations** that cause the **financial statements to be materially misstated**.



**EXERCISE:** Indicate some possible cases of some of these circumstances

## 2. Financial Auditing

### EXERCISE

Please indicate some possible cases of some of these circumstances/situations, mentioned before, that may cause the financial statements to be materially misstated.

### EXERCISE

Analyse the last accounts report published by Enron

## 2. Financial Auditing

### ✘ Requirements to perform an audit– ISA 200

#### ✓ Effect of the absence of skepticism and appropriate professional judgment

KPMG LLP served as the external auditor for some of the largest subprime mortgage lenders in the United States leading up to and during the housing market crisis of the mid-2000s. The audits of two of their largest lending clients, New Century Financial Corporation and Countrywide, ultimately led the firm to settle litigation charges in 2010 for \$44.7 million and \$24 million, respectively. The business model of these two subprime mortgage lenders consisted of providing loans to borrowers with weak credit histories. The business model had begun to fail during a short period of time in 2007, when the economy weakened, borrowers began defaulting, and home prices declined drastically. New Century filed for bankruptcy and Countrywide was purchased by Bank of America, which subsequently suffered massive losses related to business failures at Countrywide.

Just before the housing crash of 2007 put the companies in severe financial crises, KPMG had given both companies unqualified audit

opinions. In both cases, KPMG was subsequently accused of violating professional standards, lacking independence, and being negligent. KPMG defended itself by arguing that its audits were not the cause of the financial woes at New Century and Countrywide. Rather, the firm contended that it was the failed business model of the two companies that led to investor losses. As you read through this chapter, consider the following questions:

- How does the business environment affect the litigation risk faced by audit firms? (LO 1)
- Should auditors be held liable when their client's business fails or its financial statements contain a fraud that the auditors did not detect? (LO 2)
- What defenses do auditors use in response to litigation? (LO 3)
- What actions can auditors take to minimize litigation exposure? (LO 3, 4, 5, 6)

Source: Johnstone, K. M., Gramling, A. e Rittenberg, L. E., (2014), Auditing: a business risk approach, 9th edition, Cengage.

## 2. Financial Auditing

### ✘ Services provided by auditors

#### Exclusive competence of the Chartered Accountant / Auditor (ROC) (Article 41 + 42 + 45.) - Functions of Public Interest

- Audit of accounts
  - Statutory audit - derives from the law or from the statutes (CLC)
  - Voluntary review - derives from contract (Audit Report)
  - Services related to the previous two - when they have a specific or limited purpose or scope.
- Other functions where the law requires the intervention of the Chartered Accountant / Auditor (ROC)

#### Other functions that may be performed by the Chartered Accountant / Auditor (ROC) (Article 48)

- Lecturing
- Members of audit committees and supervisory or oversight bodies of companies or other entities
- Consultancy and other services in the scope of matters inherent to their professional training and qualification
- Insolvency Administrator

## 2. Financial Auditing

### ✘ Services provided by auditors

#### Entities subject to audit/revision of accounts (Article 43)

- Resulting from legal, statutory or contractual provision
- Have organized accounts and meet the requirements set out in n.º 2 of Article 262 of the CSC (exceed 2 of the 3 limits in **2 consecutive years**):
  - Balance sheet: 1.500.000€
  - Sales and other revenues: 3.000.000€
  - Number of employees: 50

Research for other  
countries

### 3. Audit Report

#### ✘ Audit Report (ISA 700, 701, 705, 706, 720)

**Unchanged  
opinion (clean  
opinion)**

**Modified opinion**

**Limitation of scope:**

- Client's imposition or other circumstances
- Absence of financial statement

**Disagreement SNC/IFRS:**

- Recognition
- Measurement
- Disclosure

**Qualified opinion with  
reserve(s) – opinião  
qualificada com reserva(s)**

**Refuse of opinion  
(escusa opinião)**

**Qualified opinion  
with reserve(s)**

**Adverse opinion**

**Declaration of inability/impossibility to report**



### 3. Audit Report

#### ✘ Selection of the modified opinion (ISA 705)

Nature of the matter that gives rise to the modification	Auditor's judgment on the depth of the effects or possible effects on the Financial Statements	
	Material but not deep misstatements - Distorções materiais, mas não profundas	Material and deep misstatements – distorções materiais e profundas
FS are materially misstated	Opinion with reservations (by disagreement)	Adverse opinion
Inability to obtain appropriate and sufficient evidence	Opinion with reservations (by limitation of scope)	Refuse of opinion (escusa opinião)

## 3. Audit Report

### ✘ OROC Model - Technical Application Guide No. 1

Entities of public interest	Other entities
<p>Report on the audit of financial statements</p> <ul style="list-style-type: none"> <li>• Opinion or Opinion with reservations or Adverse opinion or Disclaimer of opinion</li> <li>• Basis for the opinion or BO with reservations or BO Adverse or Basis for the Disclaimer of Opinion</li> <li>• Material uncertainty related to going concern (if applicable)</li> <li>• Emphasis (if applicable)</li> <li>• Relevant auditing matters</li> <li>• Other matters (if applicable)</li> <li>• Other information (if applicable)</li> <li>• Responsibilities of the management and supervisory bodies for the financial statements</li> <li>• Responsibilities of the auditor for auditing the financial statements</li> </ul>	<p>Report on the audit of financial statements</p> <ul style="list-style-type: none"> <li>• Opinion or Opinion with reservations or Adverse opinion or Disclaimer of opinion</li> <li>• Basis for the opinion or BO with reservations or BO Adverse or Basis for the Disclaimer of Opinion</li> <li>• Material uncertainty related to going concern (if applicable)</li> <li>• Emphasis (if applicable)</li> <li>• Relevant auditing matters (if applicable)</li> <li>• Other matters (if applicable)</li> <li>• Other information (if applicable)</li> <li>• Responsibilities of the management and supervisory bodies for the financial statements</li> <li>• Responsibilities of the auditor for auditing the financial statements</li> </ul>
<p>Reporting on other legal and regulatory requirements</p> <ul style="list-style-type: none"> <li>• About the management report</li> <li>• About the corporate governance report</li> <li>• On the additional elements provided for in Article 10 of Regulation (EU) No 537/2014</li> </ul>	<p>Reporting on other legal and regulatory requirements</p> <ul style="list-style-type: none"> <li>• About the management report</li> </ul>

### 3. Audit Report

✘ *Unqualified opinion (ISA 700\*)* – **opinião limpa**

#### LEGAL CERTIFICATION OF ACCOUNTS / AUDIT REPORT

##### Report on the audit of financial statements

##### ✘ § Opinion

*We have audited the accompanying financial statements of XPTO, S.A., which comprise the balance sheet as at 31/12/2019 (showing a total of .... euros and total equity of .... euros, including a net profit of .... euros), the income statement by nature, the statement of changes in equity and the cash flow statement for the period then ended, and the notes to the financial statements that include a summary of significant accounting policies.*

**In our opinion**, the attached financial statements present in a **true and fair way**, in all material aspects, the financial position of XPTO, S.A. as of 12/31/2019 and its financial performance and cash flows for the period ending on that date in accordance with the **Accounting and Financial Reporting Standards** adopted in Portugal through the Accounting Standards System - Sistema de Normalização Contabilística (PT).

**\* (ISA) 700 (REVISED), FORMING AN OPINION AND REPORTING ON FINANCIAL STATEMENTS**

### 3. Audit Report

#### ✘ *Unqualified opinion (ISA 700)*

#### ✘ § Basis for the opinion

*Our audit was conducted in accordance with the International Auditing Standards (ISA) and other technical and ethical standards and guidelines of the Statutory Auditors Body (OROC). Our responsibilities under these standards are described in the section "Auditor's Responsibilities for Auditing Financial Statements" below. We are independent from the Entity under the terms of the law and comply with all other ethical requirements under the Code of Ethics of the Order of Statutory Auditors.*

*We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.*

### 3. Audit Report

#### ✘ *Unqualified opinion (ISA 700)*

#### ✘ § Responsibilities of the management body and the supervisory body (*conselho fiscal*) by the financial statements (if applicable)

The **management body** is responsible for:

- ✓ the preparation of financial statements that present a true and fair view of the entity's financial position, financial performance and cash flows in accordance with the Accounting and Financial Reporting Standards adopted in Portugal through the Accounting Standards System;
- ✓ the preparation of the **management report** in accordance with applicable laws and regulations;
- ✓ the creation and maintenance of an appropriate **internal control system** to enable the preparation of financial statements free from material misstatement due to fraud or error;
- ✓ the adoption of appropriate accounting policies and criteria in the circumstances; and
- ✓ the assessment of the Entity's ability to maintain itself in **going concern**, disclosing, when applicable, the **matters that may raise significant doubts about the continuity of activities.**

*The supervisory body is responsible for supervising the preparation and disclosure process of the Entity's financial information. (if applicable)*

## 3. Audit Report

### ✘ *Unqualified opinion (ISA 700)*

#### ✘ § Responsibilities of the auditor for auditing the financial statements

Our responsibility is to obtain **reasonable assurance** that the financial statements as a whole are free from material misstatement due to fraud or error, and to issue a report stating our opinion. **Reasonable assurance** is a **high level of security** but is not a guarantee that an audit performed in accordance with ISA will always detect a material misstatement when it exists. Misstatements may arise from fraud or error and are considered material if, **alone or jointly**, they can reasonably be expected to influence economic decisions of users taken based on those financial.

As part of an audit according to ISA, we make **professional judgments** and maintain **professional skepticism** during the audit and also:

- ✓ We identify and assess the risks of material misstatement of financial statements due to fraud or error, design and execution of audit procedures that respond to these risks and obtain **audit evidence** that is sufficient and appropriate to provide a basis for our **opinion**. The **risk of not detecting material misstatement due to fraud is higher** than the risk of not detecting material misstatement due to error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations or overlap with internal control;

## 3. Audit Report

### ✘ *Unqualified opinion (ISA 700)*

#### ✘ § Responsibilities of the auditor for auditing the financial statements

- ✓ we gain an understanding of **internal control** relevant to the audit with the objective of designing audit procedures that are appropriate in the circumstances, but not to express an opinion on the **effectiveness of the Entity's internal control**;
- ✓ we assessed the adequacy of the accounting policies used and the reasonableness of the **accounting estimates** and related disclosures made by the management body;
- ✓ we concluded on the appropriation of the use, by the management body, of the assumption of going concern and, based on the audit evidence obtained, if there is any material uncertainty related to events or conditions that may raise significant doubts about the Entity's capacity to continue its activities. If we conclude that there is material uncertainty, we should draw attention in our report to the related disclosures included in the financial statements or, if these disclosures are not appropriate, **modify our opinion**. Our conclusions are based on the **audit evidence** obtained to date of our report. However, future events or conditions may lead the Entity to **discontinue its activities**;
- ✓ we assessed the overall presentation, structure and content of the financial statements, including the disclosures, and whether these financial statements represent the underlying transactions and events so as to achieve a fair presentation;

### 3. Audit Report

#### ✘ *Unqualified opinion (ISA 700)*

#### ✘ § Responsibilities of the auditor for auditing the financial statements

- ✓ we communicate with those in charge of governance, *including the supervisory board*, among other matters, the scope and planned timing of the audit, and significant audit findings including any significant internal control weaknesses identified during the audit;
- ✓ of the matters that we communicate to the governance officers, including the supervisory body, we determine those that were the most important in the audit of the current year's financial statements and that are the relevant audit matters. We describe these matters in our report, except when the law or regulation prohibits their public disclosure;
- ✓ we declare to the supervisory board that we complied with the relevant ethical requirements regarding independence and communicate all relationships and other matters that may be perceived as threats to our independence and, where applicable, the respective safeguards.

Our responsibility also includes verifying that the information in the management report is consistent with the financial statements.





## 3. Audit Report

### ✘ *Unqualified opinion (ISA 700)*

#### Reporting on other legal and regulatory requirements

#### ✘ § About the management report

In compliance with article 451, no. 3, paragraph e) of the Commercial Companies Code (CSC), we are of the opinion that the management report was prepared in **accordance with the applicable legal and regulatory requirements** in force, the information contained therein is consistent with the audited financial statements and, taking into account knowledge and appreciation of the Entity, **we have not identified any material inaccuracies**.

#### § On the additional elements provided for in Article 10 of Regulation (EU) No 537/2014

In compliance with Article 10 of Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014, and in addition to the relevant audit matters indicated above, we also report the following:

- ✓ *We were appointed/elected auditors of the Entity for the first time at the General Shareholders' Meeting held on ... for a term of office between 201X and 201X. We were appointed/elected at the shareholders' meeting held on ... for a second term of office between 201X and 201X.*
- ✓ ...

Date, signature (name of firm and partner responsible for the audit) and professional address



### 3. Audit Report

#### ✘ *Unqualified opinion (ISA 700)*

EXERCISE – FIND EXAMPLES OF UNQUALIFIED OPINIONS FROM  
CHARTERED ACCOUNTANTS / AUDITORS

### 3. Audit Report

#### ✘ *Modified / qualified opinion (ISA 705)*

##### ✘ § Opinion with reservations

**Limitation of scope:** *In our opinion, except for the possible effects of the matter referred to in the section "Basis for the opinion with reservations", the attached financial statements present ... .*

**Disagreement:** *In our opinion, except for the effects of the matter referred to in the section "Basis for Opinions with Reservations", the attached financial statements present ...*

##### ✘ § Basis for qualified opinion

(description of reservations)

- Includes a **description** and **quantification** of the reasons for the reserve for disagreement
- Explain the reasons for reservations for limitation to the scope of work

*Our audit was conducted in accordance with..."*

*We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our **audit opinion with reservations**.*

### 3. Audit Report

#### ✘ *Modified / Qualified opinion (ISA 705)*

##### ✘ Example of reservations by disagreement - misstatement at disclosure level

As stated in Note yy, the Company's financing agreements have expired, and the amounts payable are due on March 19, 2021. The Company has not been able to complete renegotiate the financing or obtain alternative financing. This situation indicates that there is a material uncertainty that could raise significant doubts about the Company's ability to continue. The financial statements do not adequately disclose this matter.

##### ✘ Example of reservations by disagreement - misstatement at measurement level

As mentioned in Note X to the financial statements, no depreciation has been reflected in the financial statements, which constitutes a derogation to the SNC. This is the result of a decision taken by management at the beginning of the previous financial year and which led us to issue a qualified opinion in the audit report on the financial statements for that year. Based on the straight-line depreciation method and annual rates of 5% for the building and 20% for the equipment, the loss for the year should be increased by xxx in 2021 and xxx in 2020, tangible fixed assets should be reduced by the accumulated depreciation of xxx in 2021 and xxx in 2020 and accumulated losses should be increased by xxx in 2021 and xxx in 2020.

### 3. Audit Report

#### ✘ *Modified / Qualified opinion (ISA 705)*

##### ✘ Example of reservations by limitation of scope

*Because we were appointed auditors of the Company during 2019, we were unable to observe the physical counting of inventories at the beginning of that period or to confirm through alternative procedures those quantities in inventory. Since opening inventories affect the determination of results of operations, we were unable to determine whether adjustments to the results of operations and the results carried forward from opening 2019 would be necessary. Our audit opinion on the financial statements for the period ended December 31, 2019 has been modified accordingly. Our opinion on the financial statements for the current period as of 12/31/2020 is also modified due to the possible effects of this matter on the comparability of the amounts of the current period with the amounts of the corresponding figures.*

##### ✘ Example of reservation by limitation of scope

*At 31/12/2020, it was not possible to test the interest recognized in results for the year from the portfolio of credit granted to clients, due to an impossibility of extracting information from the operating system. For this reason, it was not possible for us to analyze the information of sufficient and appropriate support to validate the accounting balance of Interest Obtained in the amount of \_\_\_\_ euros.*

### 3. Audit Report

#### ✘ *Modified opinion with Disclaimer - disclaimer of opinion (ISA 705)*

##### ✘ § Disclaimer of opinion (title is changed)

*We have been hired to audit the financial statements ....*

*We **do not issue an opinion** on the attached financial statements. Due to the relevance of the matters referred to in the section "Basis for the disclaimer of opinion", we have **not obtained sufficient and appropriate audit evidence** to provide us with a basis for issuing an opinion on the attached financial statements.*

##### ✘ **Bases for the disclaimer of opinion**

(description of reservations)

Delete the 2 paragraphs that appear in the model of the unmodified opinion.

### 3. Audit Report

#### ✘ *Modified opinion with Disclaimer - disclaimer of opinion (ISA 705)*

#### ✘ § Responsibilities of the auditor for auditing the financial statements

*Our responsibility is to perform an audit on the financial statements in accordance with the International Auditing Standards (ISA) and other technical and ethical standards and guidelines of the Statutory Auditors Institute. However, due to the matter(s) described in the section Bases for the Disclaimer of Opinion, we have not obtained sufficient and appropriate evidence to provide a basis for an audit opinion on these financial statements.*

*We are independent from the Entity under the terms of the law and comply with all other ethical requirements under the Code of Ethics of the Portuguese Institute of Chartered Accountants (OROC).*

### 3. Audit Report

#### ✘ *Adverse opinion (ISA 705)*

#### ✘ § **Adverse opinion** (title is changed)

*In our opinion, due to the relevance of the matters referred to in the section "Basis for Adverse Opinion", the attached financial statements do not present ...*

#### ✘ § **Basis for adverse opinion**

(description of reservations).

*Our audit was conducted in accordance with...*

*We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our adverse opinion.*



### 3. Audit Report

#### ✘ **Special sections (if applicable)**

#### ✘ § **Material Uncertainty Regarding Going Concern (optional)**

If there is a qualification by incorrect application of the **going concern** assumption, then this section ceases to exist.

*As mentioned in the notes to the financial statements, the Entity prepares the financial statements on a **going concern basis**. The going concern assumption implies that the Entity has **adequate resources to maintain the activities** and that the management board has **no intention of ceasing the activities** in the short term.*

**=> there is material uncertainty, and it is duly disclosed in the FS (ISA 570)**

*As set out in Note X to the financial statements, which indicates that Banco Menos, S.A. recorded a loss of xxxxx during the year ending 31/12/2020 and that date, the **financial autonomy ratio is 7%**. As referred to in Note 6, these events or conditions, as well as other matters referred to in that Note, indicate that there is a **material uncertainty** which may pose **significant doubts** as to the **entity's ability to continue**. **Our opinion is not modified with respect to this matter.***

## 3. Audit Report

### ✘ Audit Report - Relevant Audit Matters (ISA 701)

#### ✘ § Relevant Audit Matters

- Relevant matters are those that required special attention in the execution of the audit and that were previously communicated to the management body.
- Indicators of relevant subjects
  - ✓ Areas assessed for high risk of material misstatement or significant risks
  - ✓ Areas involving significant judgments produced by the management body including estimates involving high estimation uncertainty
  - ✓ Transactions with significant impact on accounts
- Relevant matters should be included in the audit report, if:
  - ✓ Audited entity has listed securities
  - ✓ Required by law or regulation
  - ✓ Auditor decides to report on the matter, and this is not against the law.

## 3. Audit Report

### ✘ Audit Report - Relevant Audit Matters (ISA 701)

#### ✘ § Relevant Audit Matters

=> Auditor decides to describe them in audit report

The relevant auditing matters are the ones that, in our **professional judgment**, had the greatest importance in the auditing of the financial statements of the current period. These matters should be considered in the context of the audit of the financial statements as a whole, and in the **formation of the opinion**, and **we do not issue a separate opinion** in this respect.

*In addition to the material(s) described in the section "Basis for Opinion with Reservations" and in the section "Material Uncertainty Regarding Going Concern", we have decided that the following are relevant audit material to be communicated in this report. => (if there are reservations and/or material uncertainty)*

*(Describe below the following subjects to support the audit opinion:*

- a description of the **most significant risks** of material misstatement identified, including the risks of material misstatement due to fraud, referring, where relevant, to the respective disclosures included in the financial statements;
- a summary of the auditor's response to the material **misstatement risks assessed**;
- if relevant, any **key observations** that may have arisen in relation to those risks.)

## 3. Audit Report

### ✘ Audit Report - Relevant Audit Matters (ISA 701)

#### ✘ § Relevant Audit Matters

=> Auditor considers that there are no relevant matters other than reservations or material uncertainty

*The relevant auditing matters are the ones that, in our professional judgment, had the greatest importance in the auditing of the financial statements of the current period. These matters should be considered in the context of the audit of the financial statements as a whole, and in the formation of the opinion, and we do not issue a separate opinion in this respect.*

*Except for the material described in the Bases for Opinions with Reservations (Adverse) or Material Uncertainty Regarding Going Concern, we inform you that there are no other relevant auditing matters to report in our report.*

=> Auditor considers that there are no relevant matters

*The relevant auditing matters are the ones that, in our professional judgment, had the greatest importance in the auditing of the financial statements of the current period. These matters should be considered in the context of the audit of the financial statements as a whole, and in the formation of the opinion, and we do not issue a separate opinion in this respect.*

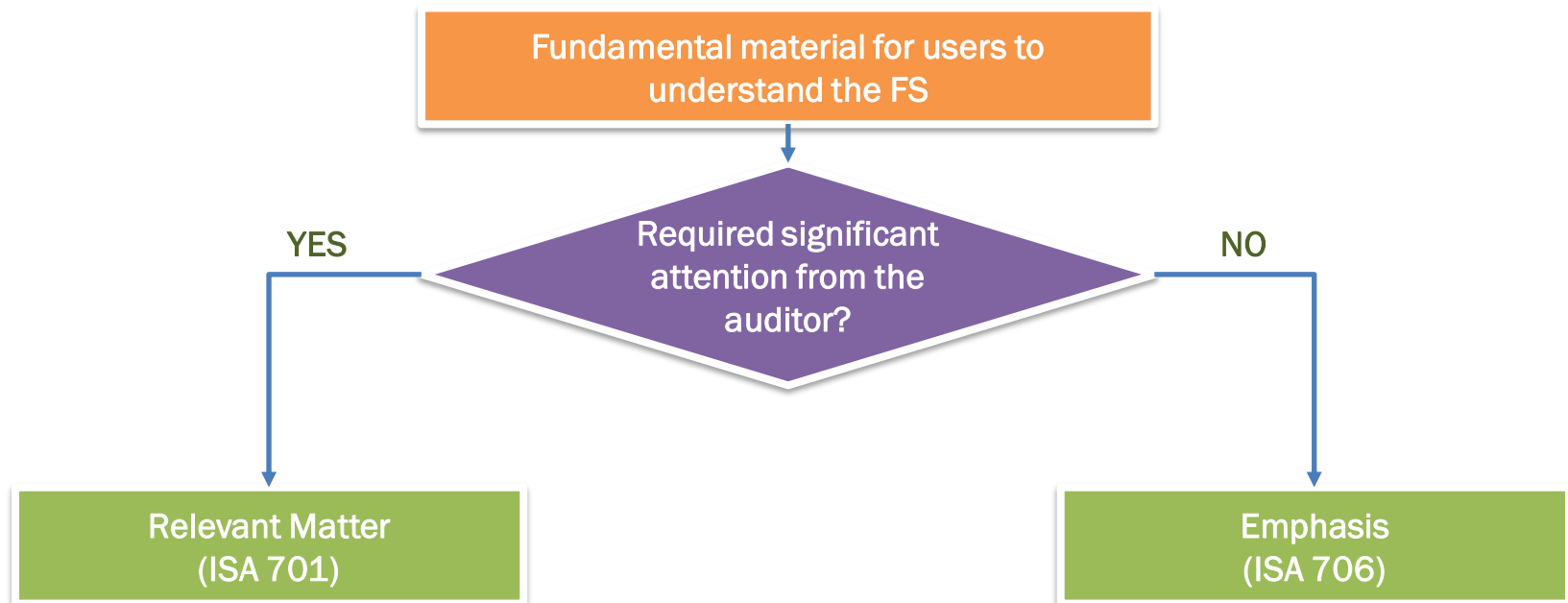
*We inform you that there are no relevant audit matters to communicate in our report.*

### 3. Audit Report

#### ✘ Audit report - opinion with emphasis and/or other matters (ISA 706)

#### ✘ § Emphasis

Matter appropriately presented or disclosed in the financial statements which, in the auditor's judgment, is of such importance that it is fundamental for the users' understanding of the financial statements. These matters **do not include** the **reservations** and/or **relevant audit matters**.



## 3. Audit Report

### ✘ *Audit report - opinion with emphasis and/or other matters (ISA 706)*

#### ✘ § Emphasis

Examples of subjects to be reported as emphasis:

- An uncertainty related to the **future outcome of litigation** or exceptional **regulatory actions**
- Significant **subsequent event** occurring between the date of the FS and the date of the auditor's report
- The early **application** of a **new accounting standard** that has a **material effect** on the FS
- **Disaster** with material impact on the financial position of the entity
- Changes in **accounting policies**
- **Correction** of a **qualified misstatement** in the previous year

### 3. Audit Report

#### ✘ *Audit report - opinion with emphasis and/or other matters (ISA 706)*

#### ✘ § Other subjects

These are matters that are not related to the matters presented or disclosed in the FS, but which in the **auditor's opinion are relevant to users' understanding** of the audit, the auditor's responsibilities or his report. Disclosure of such matters is not prohibited by law and does not encompass relevant auditing matters.

Examples:

- Explain why **Auditor did not resign** if you issued a **Disclaimer Opinion**
- Indicate that you have issued an opinion on the FS prepared by the company based on **another accounting standard** (e.g. on the reporting of the subsidiary information)
- In the special purpose report indicate that it is intended exclusively for its intended users and should not be distributed or used by others
- Accounts audited by another auditor
- Disclosure of the substantive reasons for the current auditor's **difference of opinion** on the financial statements of the **previous period** compared to the opinion that the auditor **previously expressed**

### 3. Audit Report

#### ✘ Audit report - opinion with emphasis and/or other matters (ISA 706)

##### ✘ § Emphasis Example

- Refer to the site where you can find the disclosures related to the subject matter
- Indicate that Opinion is not changed

*We draw your attention to Note X to the financial statements, which describes the uncertainty regarding the outcome of the lawsuit filed against the Company by XYZ Company. Our opinion is not changed in this matter.*

##### ✘ § Example of Other Subjects

*The financial statements of Banco Menos, S.A. for the year ended December 31, 2017 were audited by another auditor who expressed an unreserved opinion on these financial statements as of March 31, 2018.*



## 3. Audit Report

### ✘ *Audit report - other information (ISA 720)*

#### ✘ § Other information - auditor's responsibility

- ✓ The annual report includes financial and non-financial information that is beyond the Financial Statements. Normally, the other information includes: Management Report (part of the obligations); message from the President.
- ✓ Auditor should request the **Management Report** and other documents before issuing the **Audit Report**.
- ✓ If the auditor finds any inconsistencies between the financial statements and the other information or considers that the other information is materially misstated, the auditor should request its correction and ultimately **inform the shareholders** (in this case, if the auditor had already issued the report)
- ✓ If the other information is not corrected, the auditor should describe in his report the misstatement in the “Other Information”.

### 3. Audit Report

#### ✘ *Audit report - other information (ISA 720)*

#### ✘ § Other information (in the scenario where the Other Information is obtained before the date Audit Report)

*The Board of Directors is responsible for the other information. The other information includes the Management Report and (including other maps that are part of the Annual Report). Our opinion on the financial statements does not cover the other information and therefore we do not express any opinion on the same.*

*In connection with our audit of the financial statements, our responsibility is to read the other information and, in that context, to consider whether the other information is materially inconsistent with the financial statements or whether our knowledge acquired in the audit or otherwise indicates that the other information is materially misstated. If, based on the work performed, we conclude that the other information is **materially misstated**, we are required to **report such fact**.*

**The following text depends on whether or not the other information is materially misstated.**

### 3. Audit Report

#### ✘ Audit report - other information (ISA 720)

#### ✘ § Other information

Other information contains material misstatements	Other information contains no material misstatements
<p><i>As described below, we conclude that the other information is materially misstated.</i></p> <p><i>(describe the inconsistencies/misstatements)</i></p>	<ul style="list-style-type: none"> <li>✓ Report with unmodified opinion <i>We have nothing to report regarding the other information.</i></li> <li>✓ Report with <b>modified opinion</b> <i>Additionally and as described in the above section of the Basis of Opinion with <b>Reservations</b>, we have not obtained adequate and sufficient evidence of the existence of certain equipment which totaled a net book value of __ EURO. Consequently, we cannot conclude whether the other information is materially misstated with respect to this matter.</i></li> </ul>

## 4. Professional regulation

### ✘ Introduction

Auditors are professionals  
Professionals are people  
People make mistakes  
That's why auditors make mistakes



## EXERCISE – Going concern

Understanding the going concern is a major issue for the Auditor's work.

Assume that you are auditing the accounts of a bank in Portugal, and you want to better understand the market in which it operates, major opportunities and threats and what are the main trends that may impact the bank's activity.

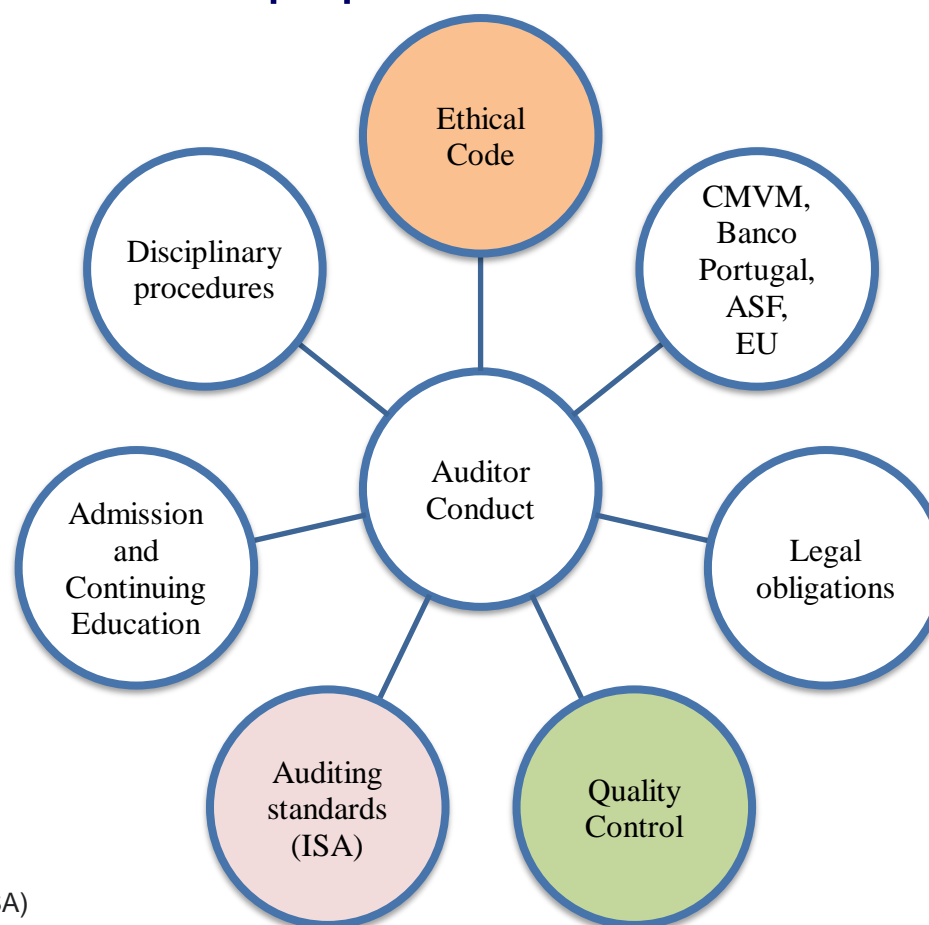
For this you want to understand what are the products/services that competitive banks are offering to clients and what are the conditions (price, timing, commissions, etc) they propose.

This benchmark should allow you to understand the banking industry market in Portugal and in other countries in particular the offer to clients.

With this market understanding you should be able to build your opinion concerning the going concern of the Bank that you are auditing.

## 4. Professional regulation

### ✘ Facts that contribute to the proper conduct of the auditor



International Standards on Auditing (ISA)

## 4. Professional regulation

### ✘ Auditing standards

#### ✓ No. 6 art. 45.º EOROC:

Audits are conducted in accordance with **international auditing standards** adopted by the European Commission unless otherwise stated:

- *The review is for matters that are not regulated by international auditing standards;*
- *The imposition of additional audit procedures or requirements arises from specific legal requirements or to the extent necessary to enhance the credibility and quality of the accounts.*

#### ✓ No. 8 art. 45.º EOROC:

While adopted by the European Commission, the international auditing standards are directly applicable.

## 4. Professional regulation

### IAASB

## ✘ Auditing standards IAASB – International Auditing and Assurance Standards Board

It is an independent body that seeks to develop high quality standards of public interest for:

- Auditing -> International Auditing Standards (ISA's) and International Recommendations of Auditing Practices (IAPS)
- Simplified examinations or review work -> International Standards of Review Work (ISRE)
- Reliability assurance work -> international standards on assurance work (ISAE)
- Related Services -> International Standards for Related Services (ISRS)
- Quality control -> international quality control standards (ISCQ)





## 4. Professional regulation

### ✘ Auditing standards and audit services

#### The Importance of Adhering to Professional Auditing Standards as Illustrated in the Audits of Thornton Precision Components, Limited performed by Ernst & Young, LLP UK

Auditors who adhere to the professional auditing standards are viewed as conducting a quality audit. A lack of adherence to the professional auditing standards heightens the risk that the auditor will provide an unqualified audit opinion on financial statements that are materially misstated. This lesson is highlighted in the 2004-2006 audits of Thornton Precision Components, Limited (TPC) performed by Ernst & Young, LLP UK (E&Y UK).

TPC became a wholly owned UK subsidiary of Symmetry Medical, Inc. in 2003. Symmetry became a public company in 2004 and was listed on a United States stock exchange. Its consolidated financial statements included TPC's financial data. Beginning in 2003, Ernst & Young, LLP (E&Y US) became Symmetry's audit firm. In connection with the 2004-2006 audits of Symmetry, E&Y US engaged E&Y UK to perform audits of TPC, using Public Company Accounting Oversight Board (PCAOB) auditing standards. During the 2004-2006 audits, E&Y US relied on E&Y UK's audits to issue unqualified audit opinions for Symmetry.

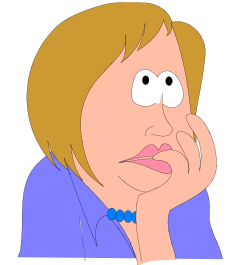
From 1999 through September 2007, TPC's management participated in multiple schemes to increase TPC's revenues, net income, and other

performance indicators. These schemes included booking fictitious revenues, understating costs of goods sold, creating fictitious inventories, and improperly capitalizing certain expenses. The fraud at TPC was not discovered by the auditors, but only came to light in 2007 when a TPC employee alerted Symmetry's CEO to the fraud. In 2008, Symmetry restated its financial statements, which included among other items, significant reductions in Symmetry's net income.

In 2012, the Securities and Exchange Commission (SEC) concluded that E&Y UK (a firm registered with the PCAOB) had conducted its audits in such a way that the audits did not adhere to the relevant professional auditing standards. Deficiencies in E&Y UK's 2004-2006 audits of TPC included a failure to perform appropriate procedures to audit the accounts receivable balances, adequately review top-side journal entries, properly audit inventory, and a failure to plan, staff, and supervise the audits. During the audit, the audit partner and manager did not appropriately question management's representations, did not fully document the results of testing, did not appropriately consider the risks of misstatements due to fraud, and did not exercise due professional care and professional skepticism.

## 4. Professional regulation

### ✘ Ethics and professional deontology



#### ✓ Ethical dilemma

- It is a situation where the person has to decide on the appropriate behavior.
- Methodology of analysis:
  - Getting the relevant facts
  - Identify ethical issues from the facts
  - Determine who is affected by the outcome of the dilemma and how each individual/group is affected
  - Identify the available alternatives that the person has in hand to solve the dilemma
  - Identify the expected consequences in each alternative
  - Decide what action to take

## 4. Professional regulation

### ✘ Ethics and professional deontology

#### independence

#### Why Is Owning Stock in an Audit Client Unacceptable?

In 2005, Susan Birkert was an audit senior working for KPMG on the audit engagement of Comtech Corporation. One of Susan's friends asked her whether she thought that Comtech stock was a good investment. She responded that, indeed, it was a good investment. At that point, her friend asked if she would like him to purchase Comtech stock on her behalf. She agreed, and gave her friend \$5,000 to make the purchase under his name rather than hers. She did so because she was aware that owning stock in one's audit client is not allowed because of independence concerns. If auditors own stock in their audit clients, they are not independent of their clients because they are part owners. Therefore, rather than acting in an unbiased manner during the conduct of the audit, they might make judgments that favor the

client company rather than external users of the financial statements. Even if the auditor does not actually behave in a biased manner and is independent in fact, external users may perceive an independence conflict—the auditor would not be independent in appearance.

Susan continued working on the Comtech engagement well into 2006, and she lied when she responded to KPMG's yearly written requirements to comply with the firm's independence policies. Prompted by an anonymous tip later in 2006, KPMG launched an internal investigation into the matter and terminated her employment. The PCAOB barred her from serving as an external auditor for a period of at least one year. For further details on this case, see PCAOB Release No. 105-2007-003.

Source: Johnstone, K. M., Gramling, A. e Rittenberg, L. E., (2014), Auditing: a business risk approach, 9th edition, Cengage.

## 4. Professional regulation

### ✘ Ethical principles



## 4. Professional regulation

### ✘ Auditor independence

#### ✓ Art. 71 EOROC:

- The chartered accountant (ROC) or any singular person in a position to directly or indirectly influence the outcome of the statutory or voluntary audit shall be **independent** of the audited entity and **shall not participate in the decision-making** of that entity.
- People involved in the work, as well as closely related persons, **may not hold or have any material and direct economic interest** in or participate in the transaction of any financial instruments issued, guaranteed or otherwise supported by any audited entity that falls within the scope of its statutory audit activities.
- People involved in the work **may not accept offers** or favors from the audited entity, except if they are **insignificant**.



## 4. Professional regulation

### ✘ Auditor independence

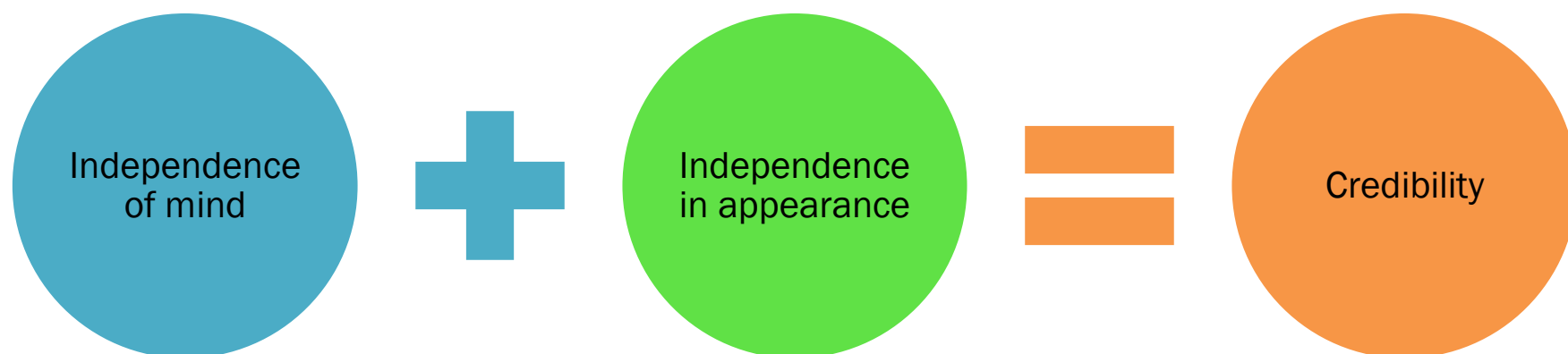
✓ Art. 77 EOROC: conditions for carrying out statutory audits to public interest entities

- 📄 Non audit fees / total fees < 30% - when non audit services are provided for a period of 3 or more consecutive years to the entity, its parent company or its subsidiaries.
- 📄 If total fees received in each of the last three years exceed 15% of the SROC's turnover:
  - Inform the supervisory board of the audited entity and the safeguard measures taken
  - The supervisory board must assess whether there are conditions to continue the provision of services for a period not exceeding 2 years
  - Communicate the situations before to CMVM
  - CMVM may determine that in the calculation enters the fees of companies in the SROC network
- 📄 If the Statutory Audit is performed, the SROC or another firm in its network is barred from rendering services to the EPI, parent company or other company controlled by it:
  - Tax advisory services (e.g. payroll taxes)
  - Preparation and entry of accounting records and accounts
  - ...
- 📄 Any consulting service must be previously approved by the EPI's supervisory board.

EPI – entity of public interest

## 4. Professional regulation

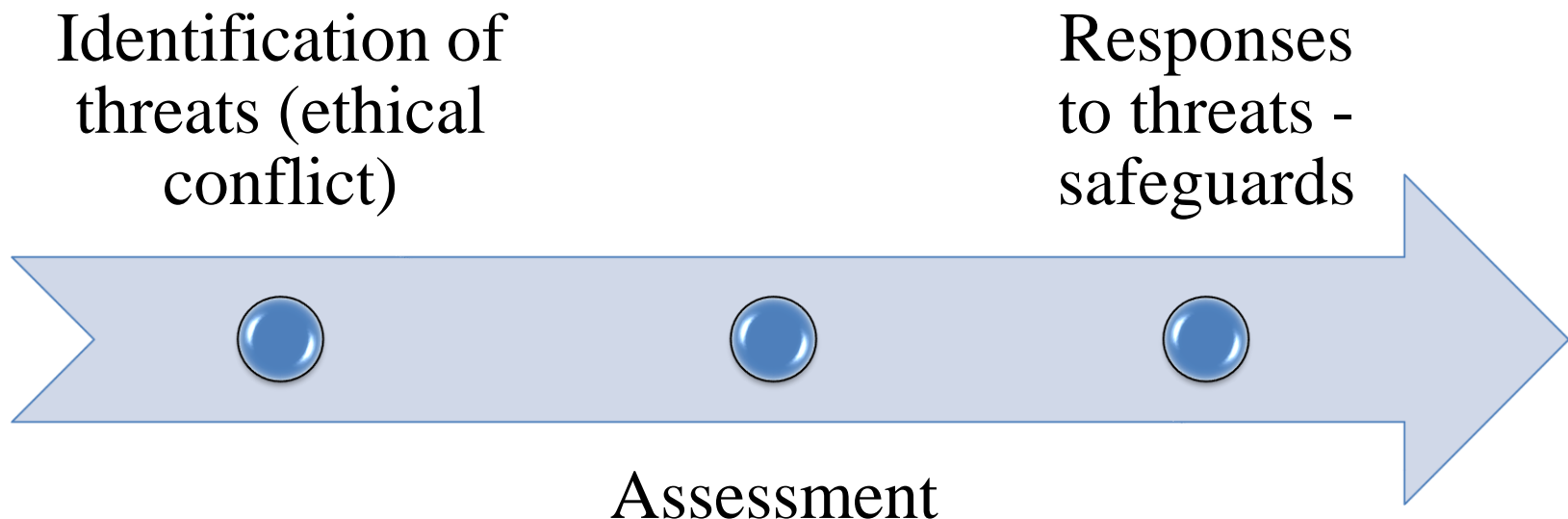
### ✘ Auditor independence



Auditing as ethical  
judgment process

## 4. Professional regulation

### ✘ Ethical principles - threat resolution process



Threat of personal interest, threat of self-review, threat of representation, threat of familiarity, threat of intimidation.

Threats to independence => Chartered accountant (ROC) must not carry out the work (no. 3 art. 71 EOROC)



## 4. Professional regulation

### ✘ Quality control

Methods that seek to ensure that SROC is meeting the normative requirements of the profession, contributing to its defense and professional reputation.

#### By SROC

- ISCQ 1
- Art. 74 EOROC: duty to have an internal control system
- Art. 80 EOROC: Internal quality control of the work in EPI

#### By OROC (peer review) under CMVM supervision to auditors who do not audit public interest entities

- No. 1 do art. 69.º EOROC
- At least one check every 6 years (RCQOROC)

#### By the CMVM to the auditors of public interest entities (No.4 of Article 4 of the Legal Framework for Audit Supervision)

- At least one check every 3 years (art. 26 of Reg. 537/2014)

## 4. Professional regulation

### ✘ International Standard on Quality Control 1

See ISA 220

Auditors have an obligation to establish and maintain a **quality control system** that provides **reasonable assurance of reliability**:

- ✓ The firm and its staff comply with professional standards and applicable legal and regulatory requirements; and
- ✓ Reports issued by the firm or the partners responsible for the work are appropriate under the circumstances.

### The IAASB's Quality Management Proposals

February  
2019:  
Three  
exposure  
drafts  
released  
for public  
comment

- Proposed ISQM 1 (Previously ISQC 1), *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*
- Proposed ISQM 2, *Engagement Quality Reviews*
- Proposed ISA 220 (Revised), *Quality Management for an Audit of Financial Statements*
- Also released: a covering explanatory memorandum – addresses:
  - The relationships between the standards
  - Overall matters
  - Possible effective dates, including a question to seek views about the time needed to implement the standards

## 4. Professional regulation

### ✘ International Standard on Quality Control 1

Element	Overview	Example
Quality related leadership responsibilities within the firm	The firm must <b>promote a culture</b> in which <b>quality is essential</b> to be observed in the execution of services and policies and procedures must be established to support this culture	The firm's <b>training programs</b> emphasize the importance of quality work and this is reinforced in individual performance assessment and incentive system decisions.
Relevant ethical requirements	The firm shall define policies and procedures that provide reasonable assurance that the firm, employees and other individuals subject to the <b>requirement of independence</b> will effectively maintain independence when required by a relevant ethical standard	Each partner and employee must answer an <b>annual independence questionnaire</b> , namely in matters of financial threats, familiarity.
Acceptance and continuation of client relationships and specific jobs	Policies and procedures should be established to decide when the firm should accept or continue a relationship with a client. These policies and procedures should <b>minimize the risk of being associated with a client whose management body shows a lack of integrity</b> . The firm should only accept work that it can carry out with high levels of professional competence.	<b>Client assessment form (KYC)</b> , dealing with matters such as previous auditor's comments, management body integrity assessment.

## 4. Professional regulation

### ✘ International Standard Quality Control 1

Element	Overview	Example
Human resources	<p>Policies and procedures should be established to provide the firm with reasonable assurance that it has <b>sufficient staff with the necessary competence</b>, skills and commitment to ethical principles:</p> <ul style="list-style-type: none"> <li>⇒ Carry out work in accordance with <b>professional standards</b> and other legal requirements</li> <li>⇒ Allow the firm to issue a report that is appropriate to the circumstances</li> </ul>	Each employee must be evaluated in any job using the firm's Role Assess Matrix.
Work execution	The firm shall define policies and procedures that provide reasonable assurance that work is performed in accordance with <b>professional standards</b> and other applicable legal requirements, and that the firm issues the report appropriate to the circumstances	The firm has a partner responsible for providing <b>internal clarifications</b> in <b>accounting</b> and <b>auditing matters</b>
Monitoring	The firm should establish a monitoring process designed to provide reasonable assurance that <b>policies and procedures</b> related to the <b>internal quality control system</b> are <b>relevant and adequate</b> , and that they are working effectively.	The firm has a <b>partner responsible for quality control</b> who must test that the quality control procedures are being put in place.

## 4. Professional regulation

### ✗ OROC Horizontal Control

- Assess the degree of **adequacy of the means** used in relation to the nature and size of the work and the entities subject to legal review or auditing.
- Determine whether the Review/Audit Standards issued by OROC, and the applicable regulations and legislation, are complied with in the exercise of professional activity.

Controlo Horizontal	Total				SROC				ROC			
	2018		2017		2018		2017		2018		2017	
	nº	%	nº	%	nº	%	nº	%	nº	%	nº	%
Sem observações dignas de registo	34	55%	34	52%	11	52%	12	50%	23	56%	22	52%
Com observações de menor relevância	12	19%	16	24%	2	10%	6	25%	10	24%	10	24%
Com observações de relevância	12	19%	16	24%	7	33%	6	25%	5	12%	10	24%
Com resultados insatisfatórios	4	6%	-	0%	1	5%	-	0%	3	7%	-	0%
Subtotal	62	100%	66	100%	21	100%	24	100%	41	100%	42	100%
Anulados	1		6		-		2		1		4	
Total	63		72		21		26		42		46	

## 4. Professional regulation

### ✘ OROC Vertical Control

- Verify that the checks made and the conclusions drawn from the working files are consistent with the content of the reports included in the reporting documents.
- Determine whether audit standards are met.

Controlo Vertical	Total				SROC				ROC			
	2018		2017		2018		2017		2018		2017	
	nº	%	nº	%	nº	%	nº	%	nº	%	nº	%
Sem observações dignas de registo	29	32%	36	34%	20	39%	28	44%	9	22%	8	19%
Com observações de menor relevância	25	27%	36	34%	13	25%	21	33%	12	29%	15	36%
Com observações de relevância	30	33%	25	24%	14	27%	10	16%	16	39%	15	36%
Com resultados insatisfatórios	8	9%	9	8%	4	8%	5	8%	4	10%	4	10%
Subtotal	92	100%	106	100%	51	100%	64	100%	41	100%	42	100%
Anulados	1		4		-		-		-		4	
Total	93		110		51		64		41		46	

## 4. Professional regulation

### ✘ Causes of deficiencies detected in OROC control

- Vertical control

	Relevância	Menor Relevância	Total	2018 %	Total	2017 %
Nº processos	23	16	39	62%	42	58%
Nº dossiês	30	25	55	60%	61	58%
<b>Nº Observações</b>						
Planeamento	24	4	28	16%	87	48%
Execução	42	8	50	28%		
Relato	29	16	45	25%		
Divulgações	17	12	29	16%		
DOG	8	11	19	11%	3	2%
Honorários	1	2	3	2%	4	2%
Outras	2	2	4	2%		
	<b>123</b>	<b>55</b>	<b>178</b>	<b>100%</b>	<b>182</b>	<b>100%</b>

## 4. Professional regulation

### ✘ Causes of deficiencies detected in OROC control

- Horizontal control

Controlo horizontal	Relevância	Menor Relevância	Total	2018 %	Total	2017 %
Nº processos	16	12	28	44%	32	44%
<b>Nº Observações</b>						
SICQ	28	7	35	60%	29	50%
PBCFT	4	3	7	12%	6	10%
Independência	3	3	6	10%	6	10%
Recursos Humanos	4	-	4	7%	14	24%
Formação	4	1	5	9%	2	3%
Honorários	-	1	1	2%	1	2%
	<b>43</b>	<b>15</b>	<b>58</b>	<b>100%</b>	<b>58</b>	<b>100%</b>

Legenda:

SICQ – Sistema Interno de controlo de qualidade

PBCFT – Prevenção do branqueamento de capitais e financiamento do terrorismo



## 4. Professional regulation

### ✗ Other relevant subjects

#### ✓ Mandates (art. 54.º EOROC)

- Term of office is from 1 to 4 years
- Boundaries in EIP – Entidades Interesse Público (public interest entities):
  - Partner responsible for the audit: **maximum of 7 years from the first appointment** and can then be appointed after 3 years.
  - Minimum term of 2 years and maximum limit 8 years (4-year terms) and 9 years (3-year terms) -> may be extended up to 10 years as long as there is a substantiated proposal from the **supervisory board**.
  - After a forced replacement (10 years have passed) a new designation only after 4 years.
  - The above-mentioned periods are counted from the moment the entity is considered of public interest
  - Gradual **rotation of senior management** involved in statutory audit

<http://www.cmvm.pt/pt/AreadoInvestidor/Faq/Pages/FAQs-Auditoria.aspx>

## 4. Professional regulation

### ✘ Other relevant subjects

#### ✓ Auditor's "labor" mobility (art. 72.º & 91.º)

- Impediment to hire the ROC for management and inspection positions in the audited entity: up to 1 year (general); up to 2 years (EPI)
- Impediment to hire personnel and other SROC partners involved in the work for management and inspection positions in the audited entity: up to 1 year
- Responsible for the work that has been done in Auditors Report (CLC) functions in the last 3 years cannot be designated administrator/board member (including in group companies)
- EPI: employment contracts for Chartered Accountants ROC and SROC partners only after 3 years

## 4. Professional regulation

### ✘ Audit Quality

#### ✓ Competence

Audit should be performed in accordance with applicable **auditing standards**

- Provide acceptable assurance that the financial statements are prepared in **all material aspects** in accordance with the **accounting principles**
- Provide **acceptable assurance** that the financial statements are **not materially misstated**, whether **due to errors or fraud**.

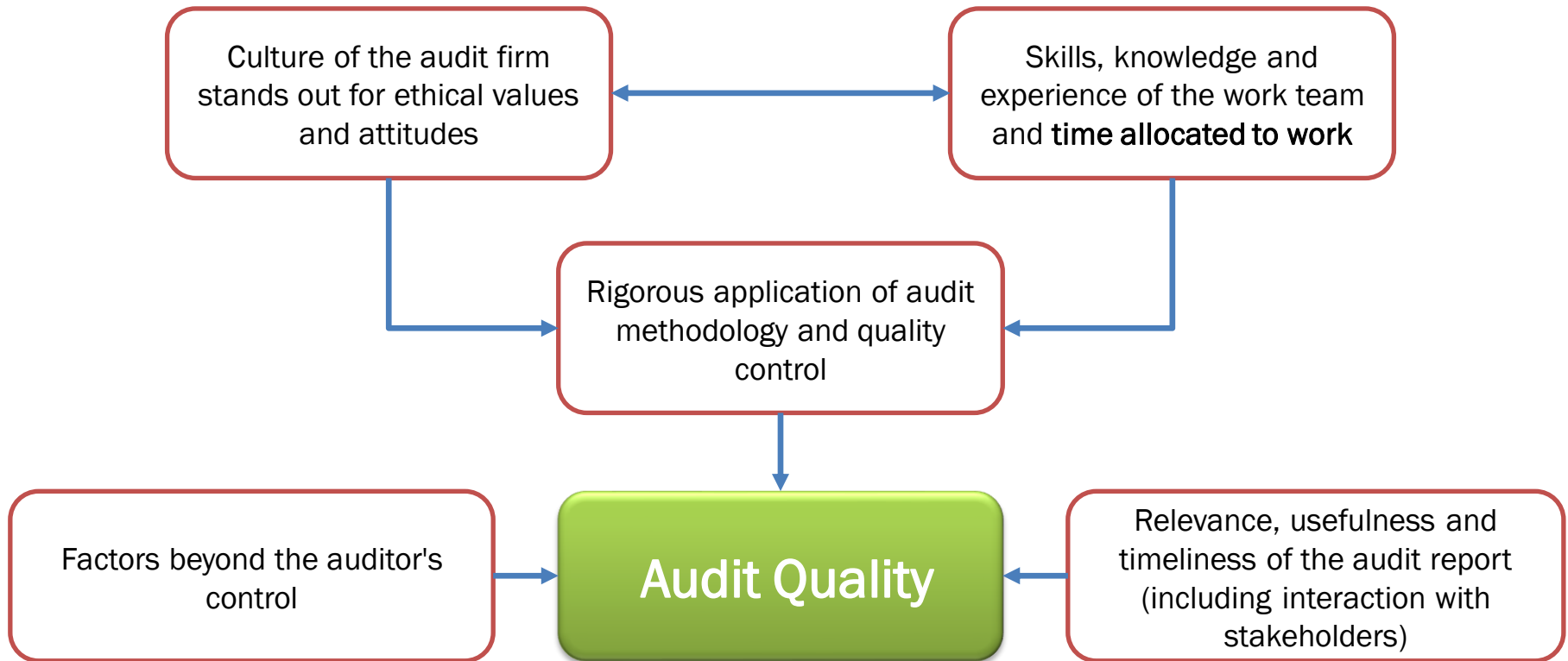
#### ✓ Independence

Auditor must report material **misstatements detected** and **not corrected**.

## 4. Professional regulation

### ✘ Audit Quality

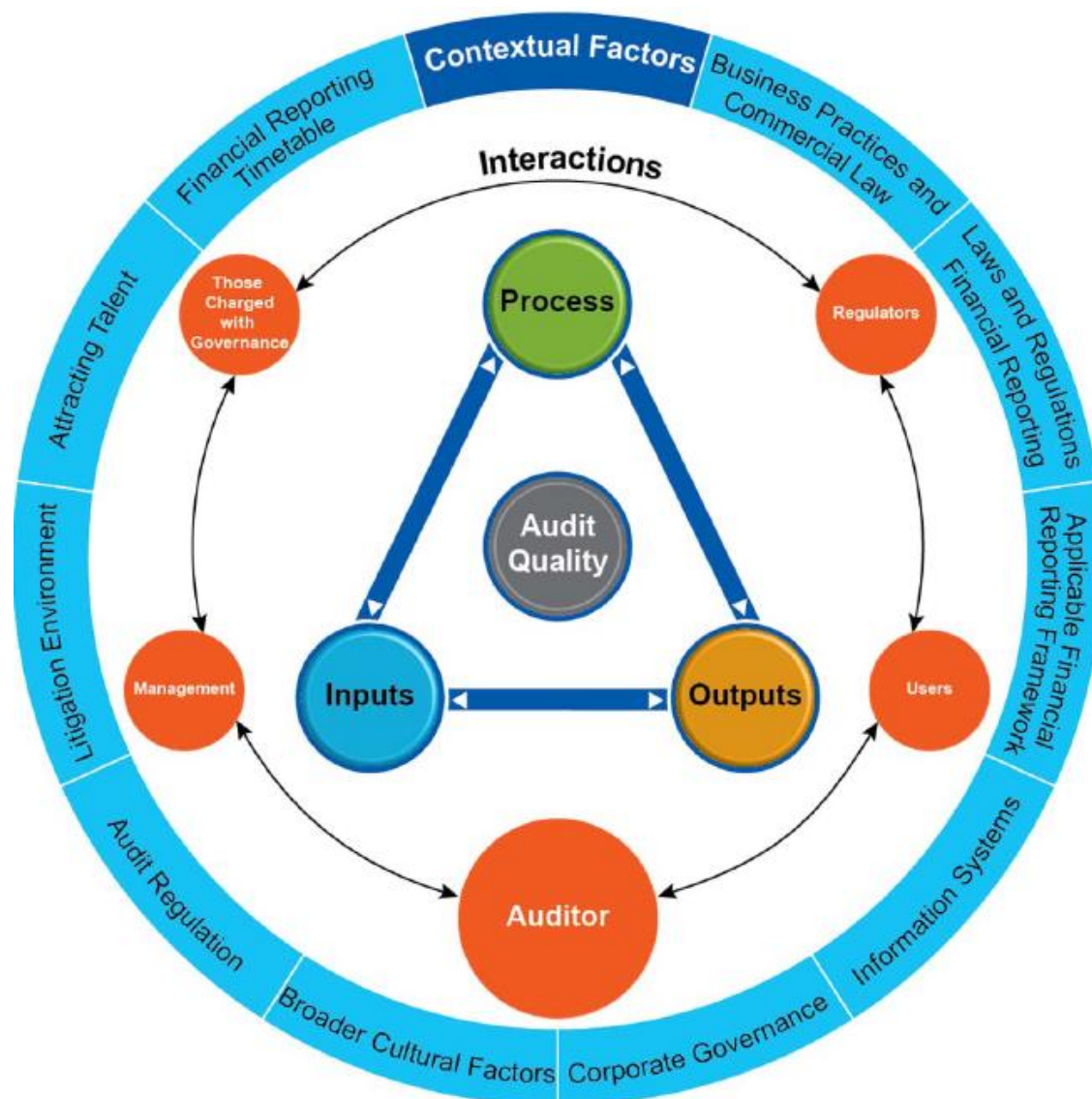
#### ✓ Audit quality drivers (Financial Reporting Council, UK, 2008)



## 4. Professional regulation

### ✘ Audit Quality

Key elements of audit quality (IAASB Framework, 2016)



## 4. Professional regulation

### ✘ Importance of conducting a quality audit

On December 20, 2011, the Public Company Accounting Oversight Board (PCAOB) revoked the ability of Bentleys Brisbane Partnership (an external audit firm) to audit public company audits, and the Board imposed a monetary penalty of \$10,000 on Robert Forbes, the audit partner in charge of the audit of Alloy Steel International. These penalties were imposed because the PCAOB concluded that Bentleys and Forbes failed to exercise **due professional care** (a standard of care expected to be demonstrated by a competent auditing professional), failed to exercise **professional skepticism** (an attitude that includes a questioning mind and critical assessment of audit evidence), and failed to obtain sufficient evidence necessary to issue an audit opinion on the financial statements of Alloy Steel's 2006 fiscal year end financial statements. The PCAOB also concluded that Bentleys violated PCAOB quality control standards because the firm did not develop policies to ensure that the work performed by its personnel met PCAOB auditing standards and the Board said that the firm did not undertake audits that the firm could reasonably expect to be completed with professional competence.

Alloy Steel International is an American company headquartered in Malaga, Australia. Alloy's stock was traded on the Over the Counter (OTC) Bulletin Board and as such was subject to Securities and Exchange Commission (SEC) rules and requirements. Its auditors were subject to PCAOB rules and requirements. On the

audit of Alloy, Bentleys and Forbes made a number of critical quality control mistakes. Bentleys and Forbes used an unregistered audit firm in Australia to actually perform the audit work, rather than performing the audit work themselves. Bentleys' and Forbes' involvement on the engagement was limited to reviewing the unregistered audit firm's workpapers. The unregistered audit firm's personnel had no training or experience in conducting audits that complied with PCAOB standards. Despite these factors, Bentleys and Forbes issued and signed an unqualified audit report on Alloy's 2006 financial statements. For further information about this scenario, see PCAOB disciplinary proceedings in Release No. 105-2011-007.

As you read through this chapter, consider the following questions:

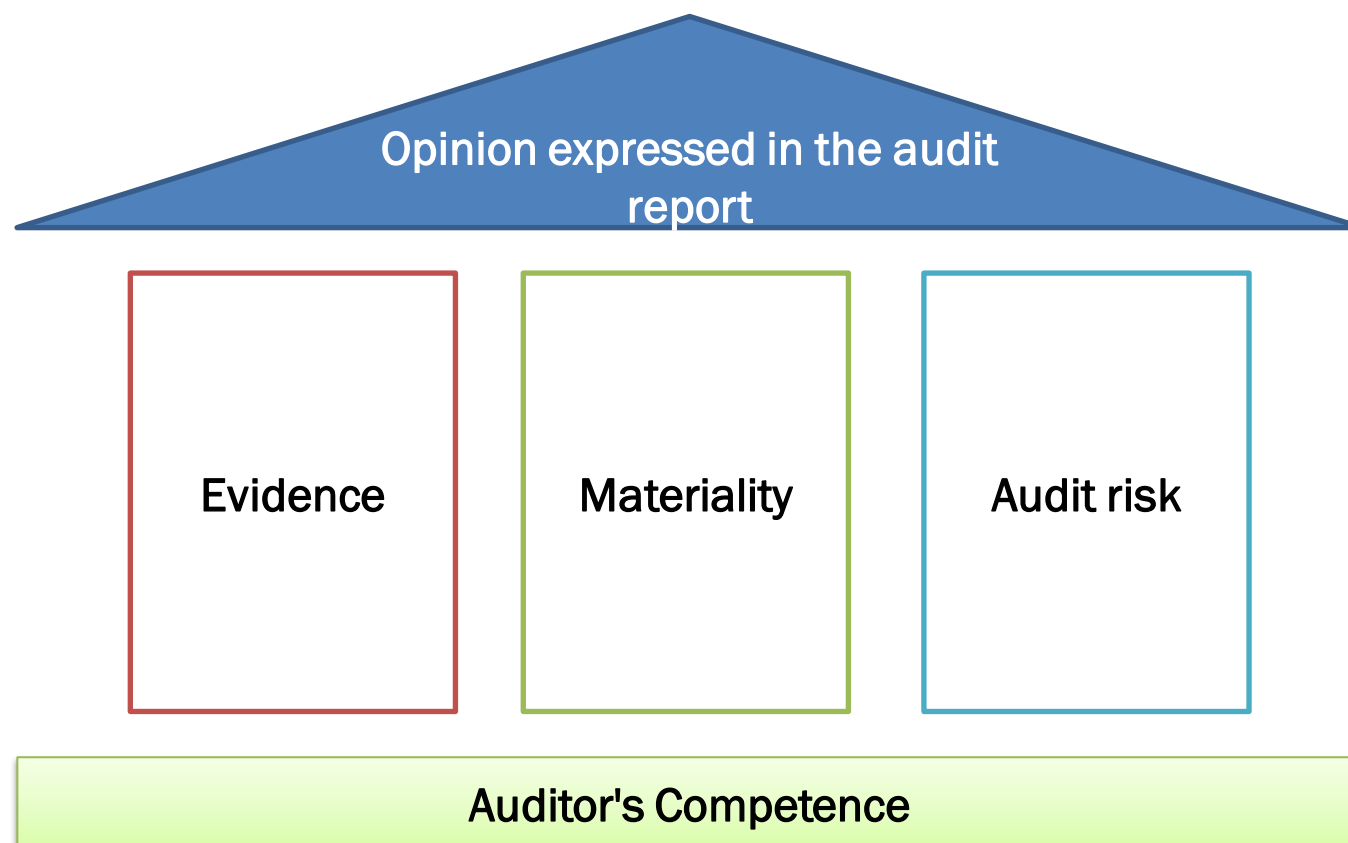
- What is the objective of auditing, and what process should auditors follow to accomplish this objective? (LO 1)
- Why do companies obtain audited financial statements? (LO 1)
- Who are the users of audited financial statements? (LO 1)
- What skills and knowledge are needed to be a competent audit professional? (LO 3)
- Why is it vital to perform an audit in a quality manner? (LO 5)
- Why are low quality audits, like those performed in this case, harmful? (LO 5)

**The Public Company Accounting Oversight Board (PCAOB) revoked the ability to an audit firm to audit public company**

Source: Johnstone, K. M., Gramling, A. e Rittenberg, L. E., (2014), Auditing: a business risk approach, 9th edition, Cengage.

## 5. Audit Pillars

### ✘ Essential elements in an audit



## 5. Audit Pillars

### ✘ Audit Evidence

“The Auditor shall design and implement audit procedures in such a way as to obtain **sufficient and appropriate audit evidence** to enable him/her to draw reasonable conclusions on the basis of which he/she **forms his/her opinion**”. – ISA 500

- ✓ The auditor's opinion results from the proof/evidence obtained in the different procedures developed by the auditor on each of the **management assertions** contained in the Financial Statements. Therefore, the **audit evidence** is fundamental for:
  - ☑ Express whether FS are truly and appropriately presented;
  - ☑ Decide on the type of report to issue: modified or not modified report.
  
- ✓ The more appropriate and sufficient **audit evidence** obtained the **lower the audit risk**.



## 5. Audit Pillars

### ✘ Audit Evidence

#### Concept (ISA 200.13)

- ✓ Any information used by the auditor to determine whether the information being audited - **assertions** - is in accordance with previously defined criteria. Therefore, **audit evidence** translates the information used by the auditor to arrive at the conclusions on which he/she bases his opinion.
  
- ✓ **Assertions:** statements made by management, explicitly or otherwise, which are included in the financial statements through the way the **classes of transactions and events, account balances and disclosures** are recognized, measured and presented.

The assertions are used by the auditor to consider the different types of material misstatements that can occur.



## 5. Audit Pillars

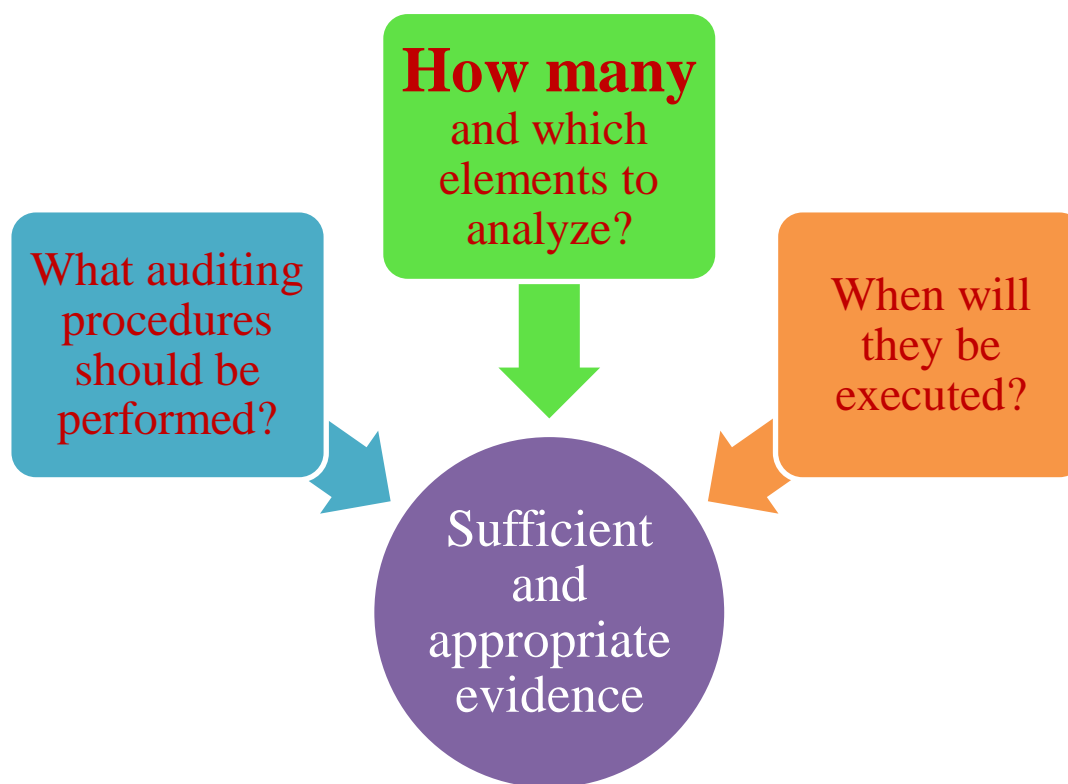
### ✘ Evidence concerning the assertions

Class of transactions and events, and related disclosures for the audited period	Account balances and related disclosures, at the end of the audited period
Occurrence	Rights and obligations
Completeness	Existence
Cutoff	Completeness
Classification	Accuracy, valuation and imputation
Accuracy	Classification
Presentation	Presentation

Assertions concerning other disclosures not directly related to the classes of transactions, events or account balances recorded (examples: Note on financial risk management - credit, liquidity, interest rate, exchange rate): should be used the above assertions.

## 5. Audit Pillars

### ✘ Key questions about the evidence



✘ The Auditor must be thorough (**precise**) and impartial in assessing the evidence.

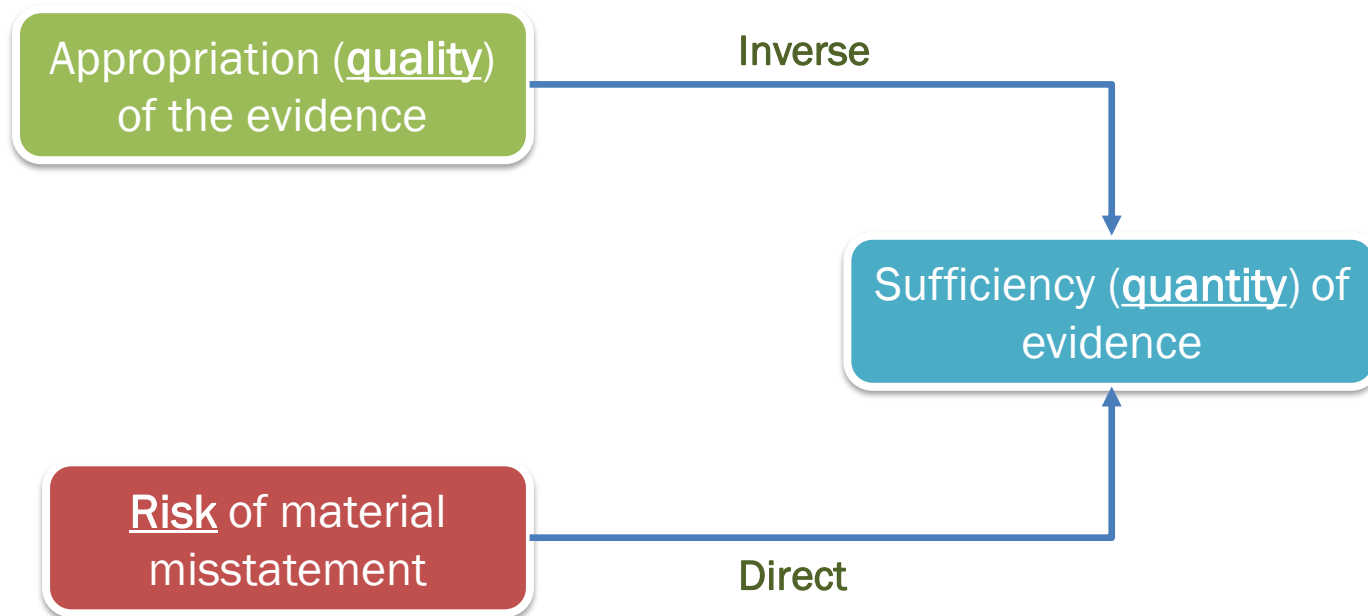
## 5. Audit Pillars

### ✘ Persuasive audit evidence

Decisions about the evidence	Characteristics that affect persuasion
<p><b>Nature</b> of audit procedures and timeliness</p>	<p>Appropriate</p> <ul style="list-style-type: none"> <li>• Relevant</li> <li>• Trust               <ul style="list-style-type: none"> <li>✓ Supplier independence</li> <li>✓ Effectiveness of internal control</li> <li>✓ Direct knowledge of the auditor</li> <li>✓ Supplier Qualifications</li> <li>✓ Objectivity of the evidence</li> <li>✓ Opportunity: when they are executed, and the period covered by the analysis</li> </ul> </li> </ul>
<p><b>Sample size</b> and elements to select</p>	<p>Sufficient</p> <ul style="list-style-type: none"> <li>• Sample size must be adequate</li> <li>• Select the correct elements</li> </ul>

## 5. Audit Pillars

### ✘ Audit Evidence



Getting more evidence may, however, not compensate its lack of quality

## 5. Audit Pillars

### ✘ Persuasive audit evidence

#### The Parmalat Confirmation Fraud

The Parmalat fraud involved a large family-held Italian company that produced dairy products around the world. The company's management perpetrated a fraud that involved taking cash from the business for family purposes, but not recording the transactions in the books, thereby resulting in an overstatement of cash on the company's books. It also shifted monetary assets in and out of banks located in the Bahamas Islands. The audit firm decided it should independently confirm the existence of Parmalat's \$3.2 billion account with the Bank of America in New York. Unfortunately, the audit senior was careless, and after preparing the

#### AUDITING IN PRACTICE

confirmation, he put it in the client's mail room where it was intercepted by management. Management was able to scan the signature of a Bank of America employee from another document and put it on a copy of the confirmation form. A Parmalat employee then flew to New York from Italy just to mail that confirmation to the auditors with the appropriate postmark. The auditors received the fraudulent confirmation and concluded that the cash balance existed. There is an important point here: **There are no trivial tasks in an audit.** Each procedure must be completed in a professional manner and with **due care.**



Source: Johnstone, K. M., Gramling, A. e Rittenberg, L. E., (2014), Auditing: a business risk approach, 9th edition, Cengage.

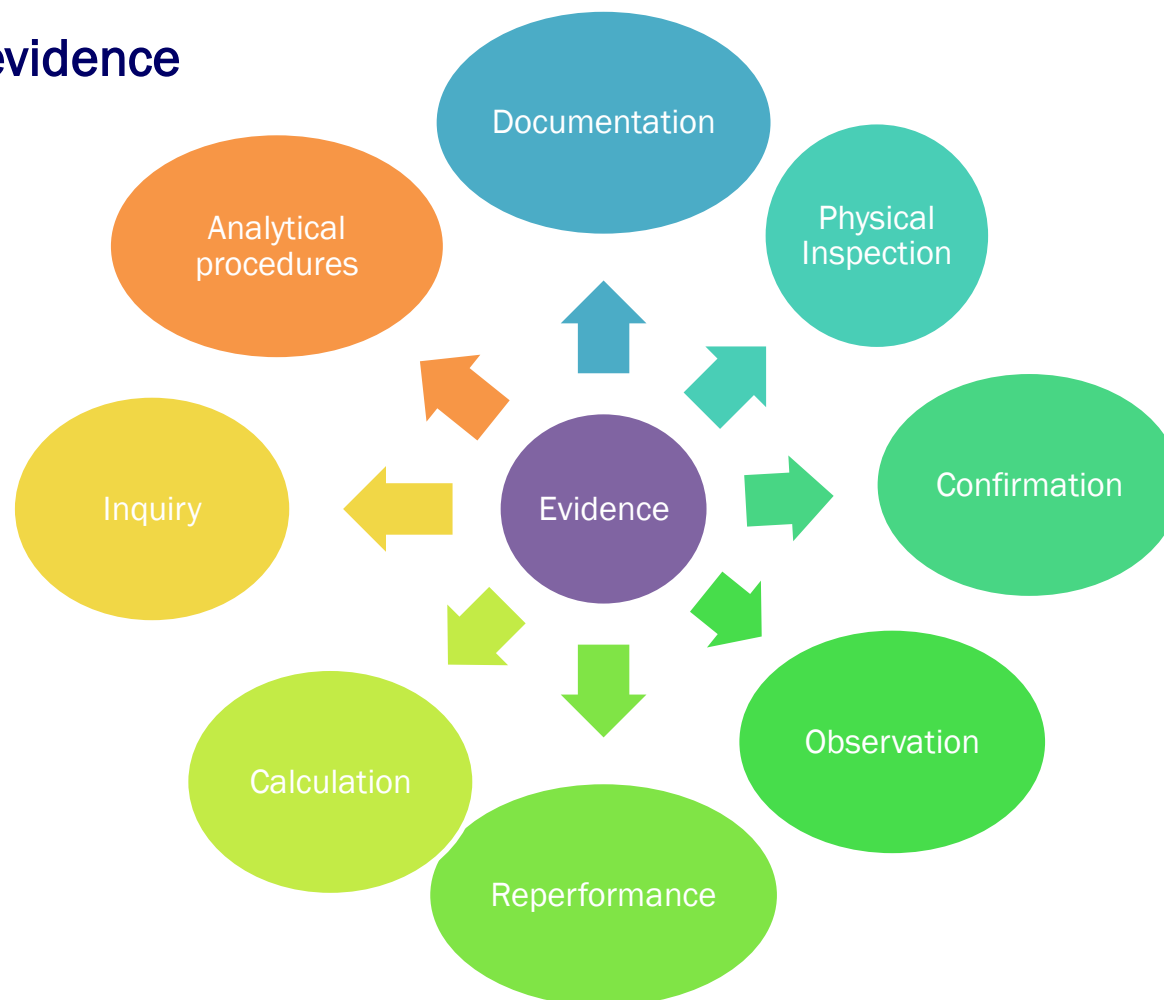
## 5. Audit Pillars

**Exercise:**

To prevent a situation as the one described before what could the auditor have done?

## 5. Audit Pillars

### ✘ Types of evidence





## 5. Audit Pillars

### ✘ Audit procedures

Audit procedures should take into account the **objectives** to be achieved by the auditor

Preliminary risk assessment procedures

Control tests

Substantive procedures

Understanding the Entity and its Environment

Understanding ICS

Fraud

ICS – internal control system

## 5. Audit Pillars

### ✘ Implications of the **absence of evidence** => ISA 705

Depending on the circumstances, if the auditor is **unable** to obtain **appropriate and sufficient audit evidence**, this will have the following consequences:

#### ✓ **OPINION WITH RESERVATION (BY LIMITATION OF SCOPE)**

*In our opinion, except for the possible effects of the matter referred to in the section "Basis for Opinions with Reservations", the attached financial statements present .....*

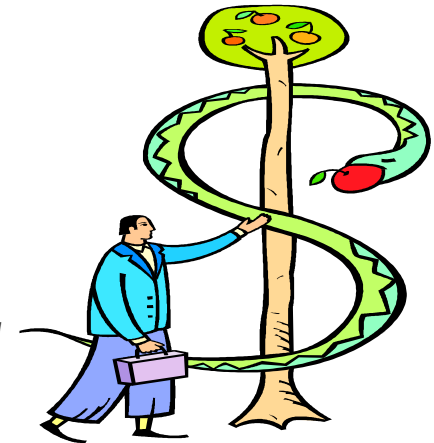
#### ✓ **EXCUSE OF OPINION**

*We do not issue an opinion on the attached financial statements. Due to the relevance of the matter(s) referred to in the section "Basis for the avoidance of doubt", **we have not obtained sufficient and appropriate audit evidence** to provide a basis for our opinion on the accompanying financial statements.*

## 5. Audit Pillars

### ✘ Starting point: the auditor's responsibility is to issue an opinion

*In our opinion, the attached financial statements present in a true and fair way, in all material aspects, the financial position of XPTO, S.A. as of 12/31/2020 and its financial performance and cash flows for the period ending on that date in accordance with the Accounting and Financial Reporting Standards adopted in Portugal through the Accounting Standards System.*



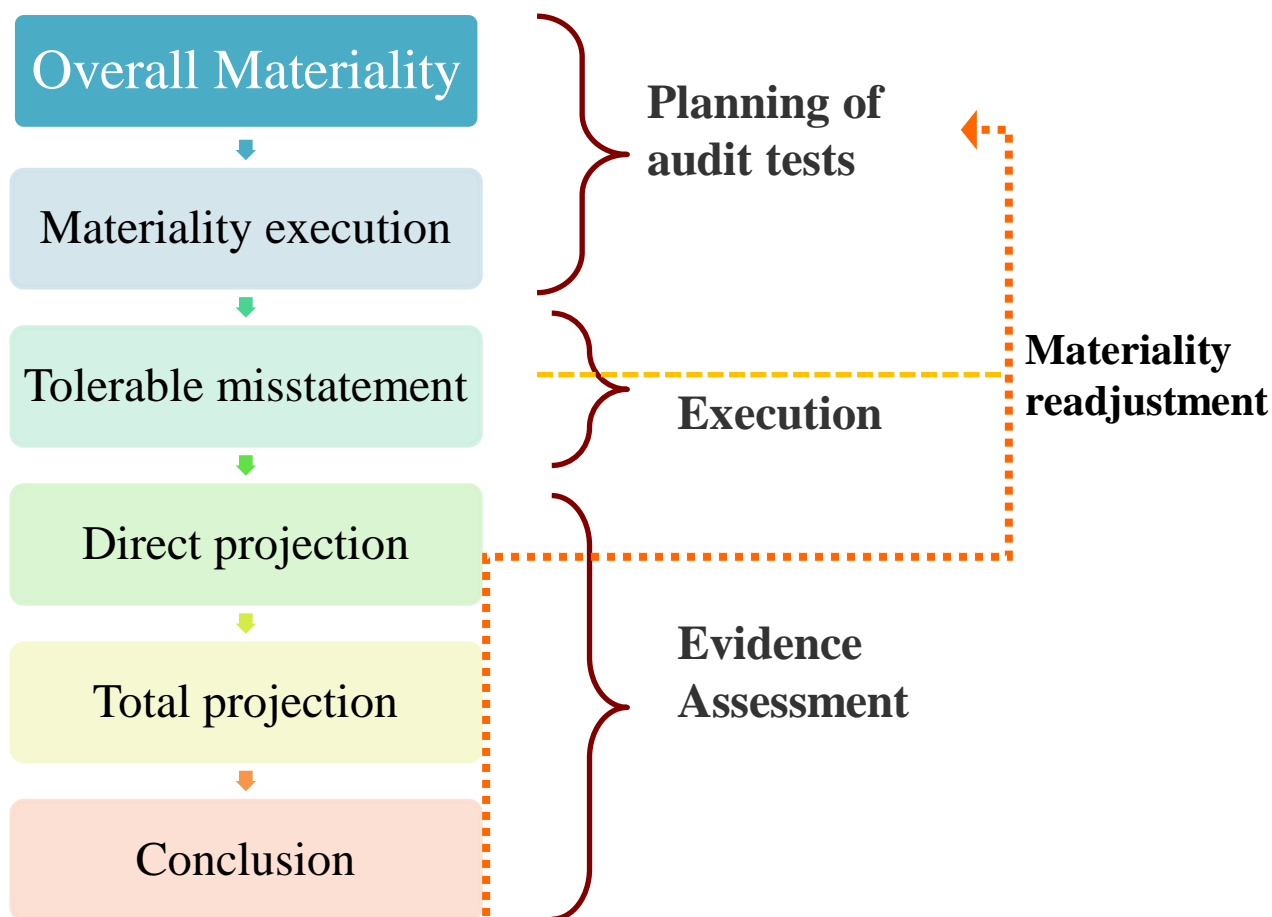
## 5. Audit Pillars

### ✘ Materiality concept – ISA 320

- **Overall materiality**: misstatements, including omissions, are considered material if they are expected, individually or jointly, **to influence the economic decisions** made by users on the basis of the financial statements. Judgements about overall materiality are determined by:
  - Circumstances at hand (e.g. studying the possibility of **merging**)
  - Perception of common financial information needs by users of the FS
  - **Size or nature** of a misstatement or by the **combination of both**.
- **Execution Materiality**: amount or amounts lower than the overall materiality that aims to reduce to an appropriately low level the probability that uncorrected and undetected aggregate misstatements exceed the overall materiality. Execution materiality is used in assessing the **risk of material misstatement** and determining additional auditing procedures.

## 5. Audit Pillars

### ✘ Materiality (ISA 320 + ISA 450 + ISA 530)



## 5. Audit Pillars

### ✘ Global Materiality: quantitative aspect

#### ✿ GM formula = indicator x %

Choosing the **appropriate reference indicator** depends:

- ✓ Elements of the FS: assets, liabilities, equity, income or expenses
- ✓ **Items** that attract users' **attention**: profit, revenue, net assets, ...
- ✓ Nature of the entity, **life cycle**, sector of activity and economic environment it operates
- ✓ **Structure of ownership** of the entity and the way it is financed
- ✓ Volatility of the reference indicator

#### ✿ Thresholds suggested by IFAC – International Federation of Accountants

- ✓ 3% to 7% of pre-tax profits
- ✓ 1% to 3% of revenues
- ✓ 1% to 3% of assets
- ✓ 3% to 5% of equity



## 5. Audit Pillars

### Assignment

For a company that in terms of Life cycle is considered a **Startup** what would be the impact of this in terms of the definition of the Thresholds suggested by IFAC concerning Global Materiality?



## 5. Audit Pillars

### ✘ Global Materiality: qualitative aspect

Financing Clauses (covenants)

Trends for changes

Managers' incentives system

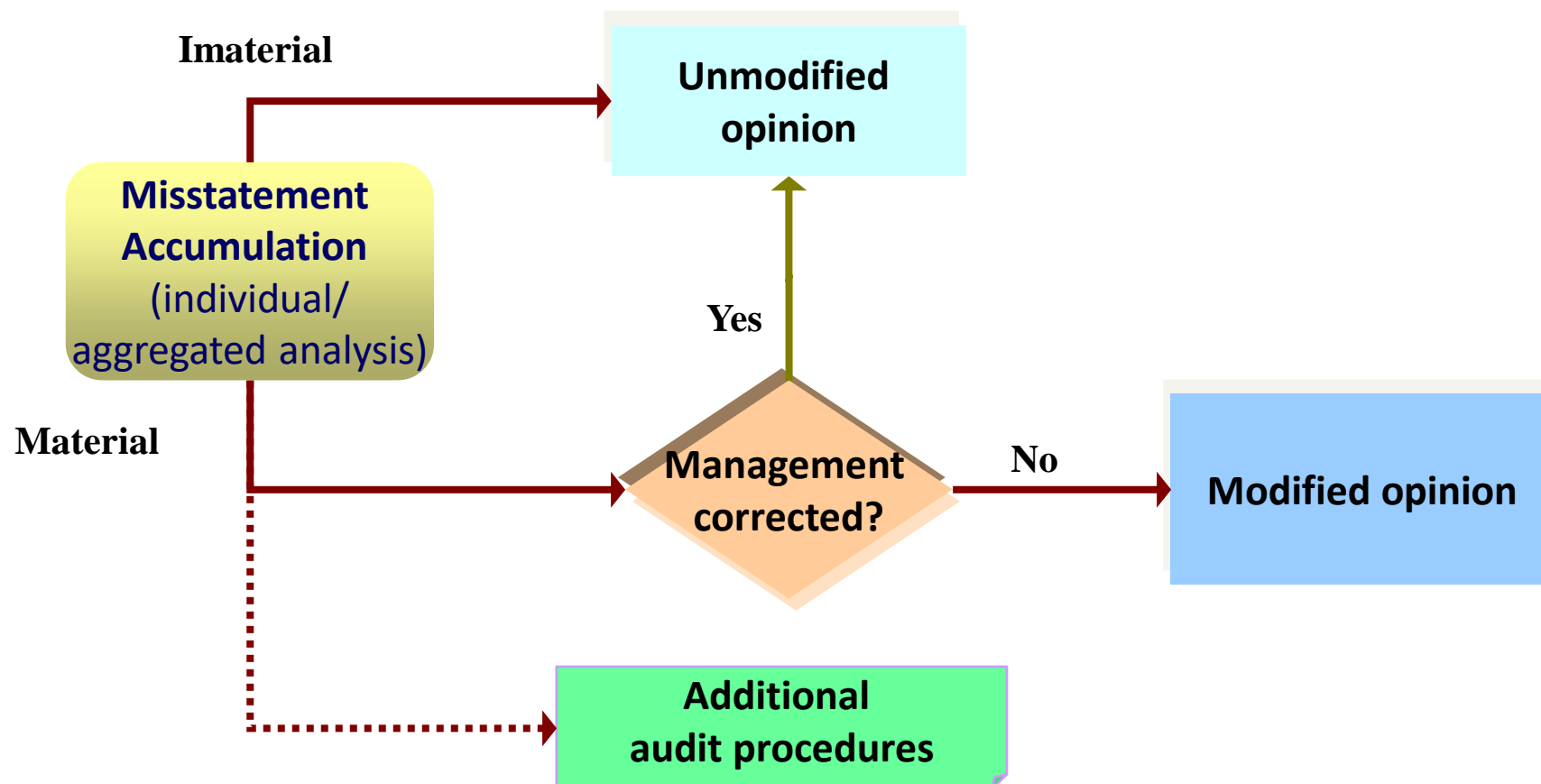
Users of financial statements

Propensity to hide illegal acts



## 5. Audit Pillars

### ✘ Relationship between materiality and type of auditor opinion



## 5. Audit Pillars

### ✘ Audit risk

**Concept:** it is the auditor's susceptibility to express an inappropriate opinion when the financial statements are materially misstated (ISA200.13)

- ▶ In the report, the auditor expresses an opinion with an acceptable level of assurance that the financial statements are free from material misstatement.
- ▶ Acceptable security does not mean absolute security, so the financial statements may be misstated, and the auditor has not detected such misstatements - it is intended to minimize the occurrence of such a situation.



**Audit Risk** is determined by the auditor and managed by the auditor.

## 5. Audit Pillars

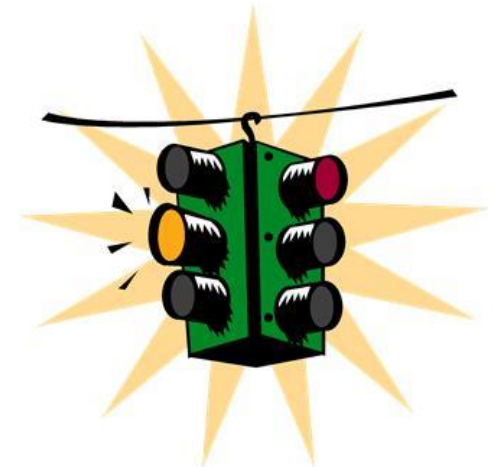
### ✘ Acceptable Audit Risk

#### Concept:

It is the measure of how much the auditor is available to accept that the financial statements may be materially misstated after having performed the audit and having issued an unqualified opinion.

#### Factors to consider in their definition:

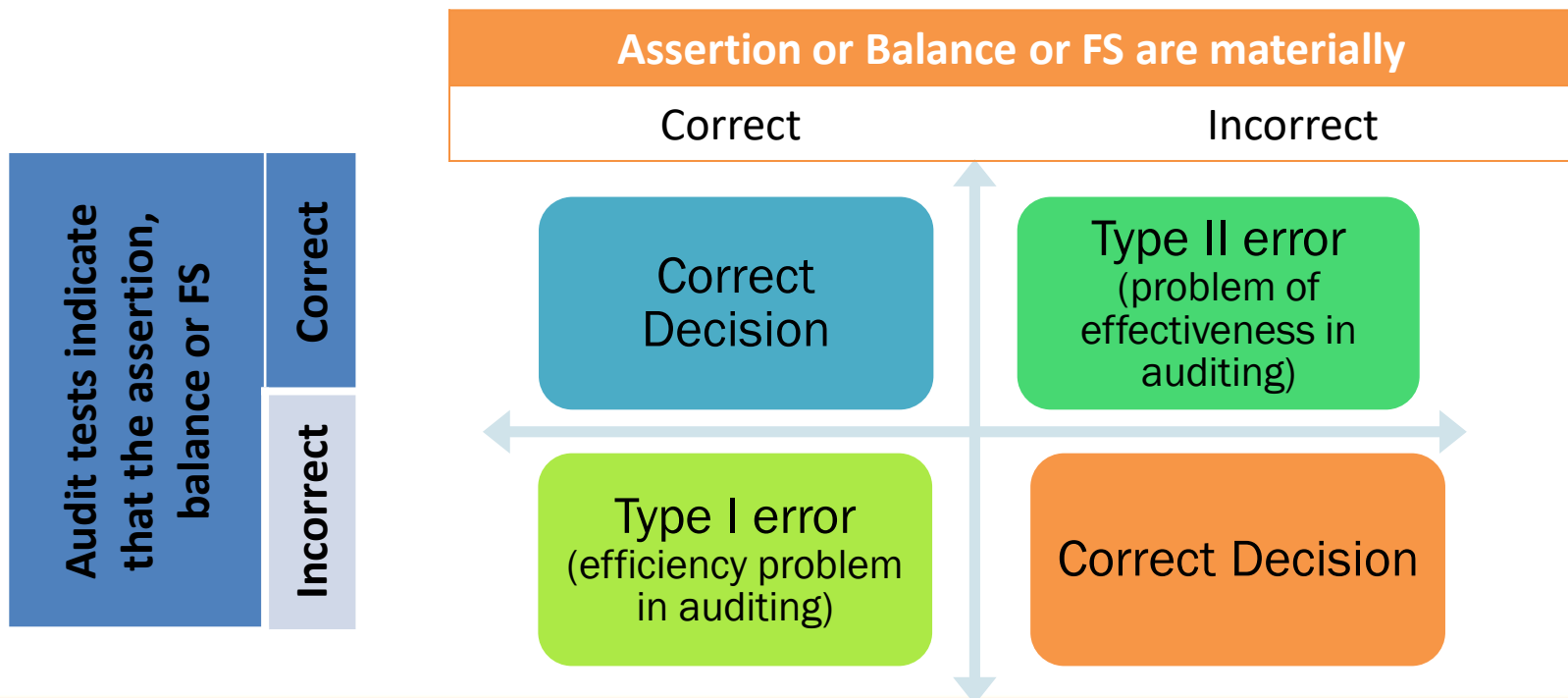
- User confidence in FS
- Probability financial difficulties
- Management Integrity



## 5. Audit Pillars

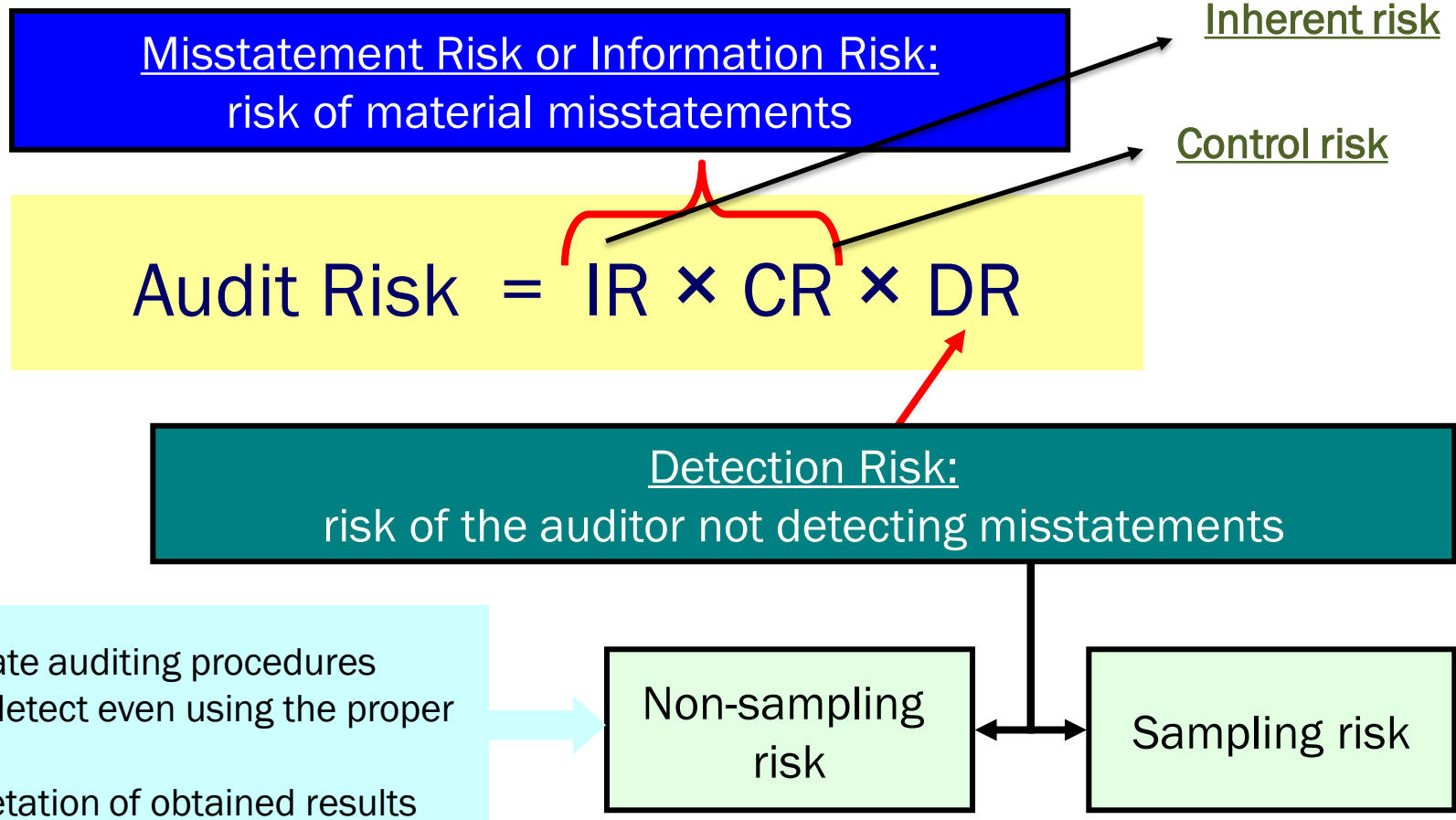
### ✘ Audit Risk

The greater the auditor's need to have security in the opinion he is expressing, the lower the audit risk will have to be. For a **99% security level** the auditor is willing to incur an **audit risk of 1%**.



## 5. Audit Pillars

### ✘ Audit risk components



## 5. Audit Pillars

### ✘ Audit risk components

$$\text{Audit Risk} = \text{IR} \times \text{CR} \times \text{DR}$$

**Inherent risk:** Measures the auditor's assessment of the susceptibility of an assertion to be material misstatement.

**Control risk:** measures the auditor's assessment of the risk that a material misstatement could occur in an assertion and not be prevented or detected on a timely basis by the client's **internal control**.

Detection Risk: Risk of the auditor not detecting misstatements

## 5. Audit Pillars

### ✘ Audit risk components

#### Inherent Risk

Is the risk of a **material misstatement** in the financial statements **arising due to error or omission** as a result of factors other than the failure of controls (factors that may cause a misstatement due to absence or lapse of controls are considered separately in the assessment of control risk).

Inherent risk is generally considered to be **higher** where a **high degree of judgment and estimation is involved** or where **transactions** of the entity are **highly complex**.

For example, the **inherent risk** in the audit of a newly formed financial institution (ex. a Fintech) which has a significant trade and exposure in **complex derivative instruments** may be considered to be significantly **higher** as compared to the audit of a well-established manufacturing concern operating in a relatively stable competitive environment.

## 5. Audit Pillars

### ✘ Audit risk components

#### Control Risk

Is the risk of a material misstatement in the financial statements arising due to **absence or failure** in the operation of **relevant controls** of the entity.

Organizations must have **adequate internal controls** in place to prevent and detect instances of fraud and error. **Control risk** is considered to be **high** where **the audited entity does not have adequate internal controls** to prevent and detect instances of fraud and error in the financial statements.

Assessment of control risk may be higher for example in case of a **small sized entity** in which **segregation of duties is not well defined** and the financial statements are prepared by individuals who do not have the necessary technical knowledge of accounting and finance.



## 5. Audit Pillars

### ✘ Audit risk components

#### Detection Risk

Is the risk that the auditors **fail to detect a material misstatement** in the financial statements.

An auditor must apply audit procedures to detect material misstatements in the financial statements whether due to fraud or error. Misapplication or omission of critical audit procedures may result in a material misstatement remaining undetected by the auditor.

Some **detection risk is always present** due to the inherent limitations of the audit such as the use of sampling for the selection of transactions.

**Detection risk** can be **reduced** by auditors by **increasing the number of sampled transactions** for detailed testing.

## 5. Audit Pillars

### ✘ Audit risk components

**Audit risk model** is used by the auditors to manage the overall risk of an audit engagement.

Auditors proceed by examining the **inherent** and **control risks** pertaining to an audit engagement while gaining an understanding of the entity and its environment.

**Detection risk** forms the **residual risk** after taking into consideration the **inherent and control risks** pertaining to the audit engagement and the overall **audit risk** that the **auditor is willing to accept**.

Where the auditor's assessment of **inherent and control risk is high**, the **detection risk** is set at a **lower level** to keep the **audit risk** at an **acceptable level**.

**Lower detection risk** may be achieved by increasing the **sample size** for audit testing.

Conversely, where the auditor believes the **inherent and control risks** of an engagement to be **low**, **detection risk** is allowed to be set at a **relatively higher level**.

## 5. Audit Pillars

### Example

ABC is an audit and assurance firm which has recently accepted the audit of XYZ. During the planning of the audit, engagement manager has noted the following information regarding XYZ for consideration in the risk assessment of the assignment:

XYZ is a listed company operating in the financial services sector

- XYZ has a large network of subsidiaries, associates and foreign branches
- The company does not have an internal audit department and its audit committee does not include any members with a background in finance as suggested in the corporate governance guidelines
- It is the firm's policy to keep the overall audit risk below 10%

Inherent risk in the audit of XYZ's financial statements is particularly high because the entity is operating in a highly regulated sector and has a complex network of related entities which could be misrepresented in the financial statements in the absence of relevant financial controls. The first audit assignment is also inherently risky as the firm has relatively less understanding of the entity and its environment at this stage. The inherent risk for the audit may therefore be considered as high.

Control risk involved in the audit also appears to be high since the company does not have proper oversight by a competent audit committee of financial aspects of the organization. The company also lacks an internal audit department which is a key control especially in a highly regulated environment. The control risk for the audit may therefore be considered as high.

Source: <https://accounting-simplified.com/audit/risk-assessment/audit-risk/>

## 5. Audit Pillars

### Example

If inherent risk and control risk are assumed to be 60% each, detection risk has to be set at 27.8% in order to prevent the overall audit risk from exceeding 10%.

### Working

Audit Risk = Inherent Risk x Control Risk x Detection Risk

0.10 = 0.60 x 0.60 x Detection Risk

0.10 = 0.36 x Detection Risk

Detection Risk = 0.278 = 27.8%

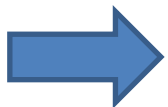
## 5. Audit Pillars

### How does audit risk affect audit strategy?

The extent and nature of audit procedures is determined by the level of detection risk required to bring audit risk to an acceptable level.

Auditors cannot control the inherent risk or control risk. They can however balance these risks by determining a **suitable detection risk** to keep the overall audit risk in check.

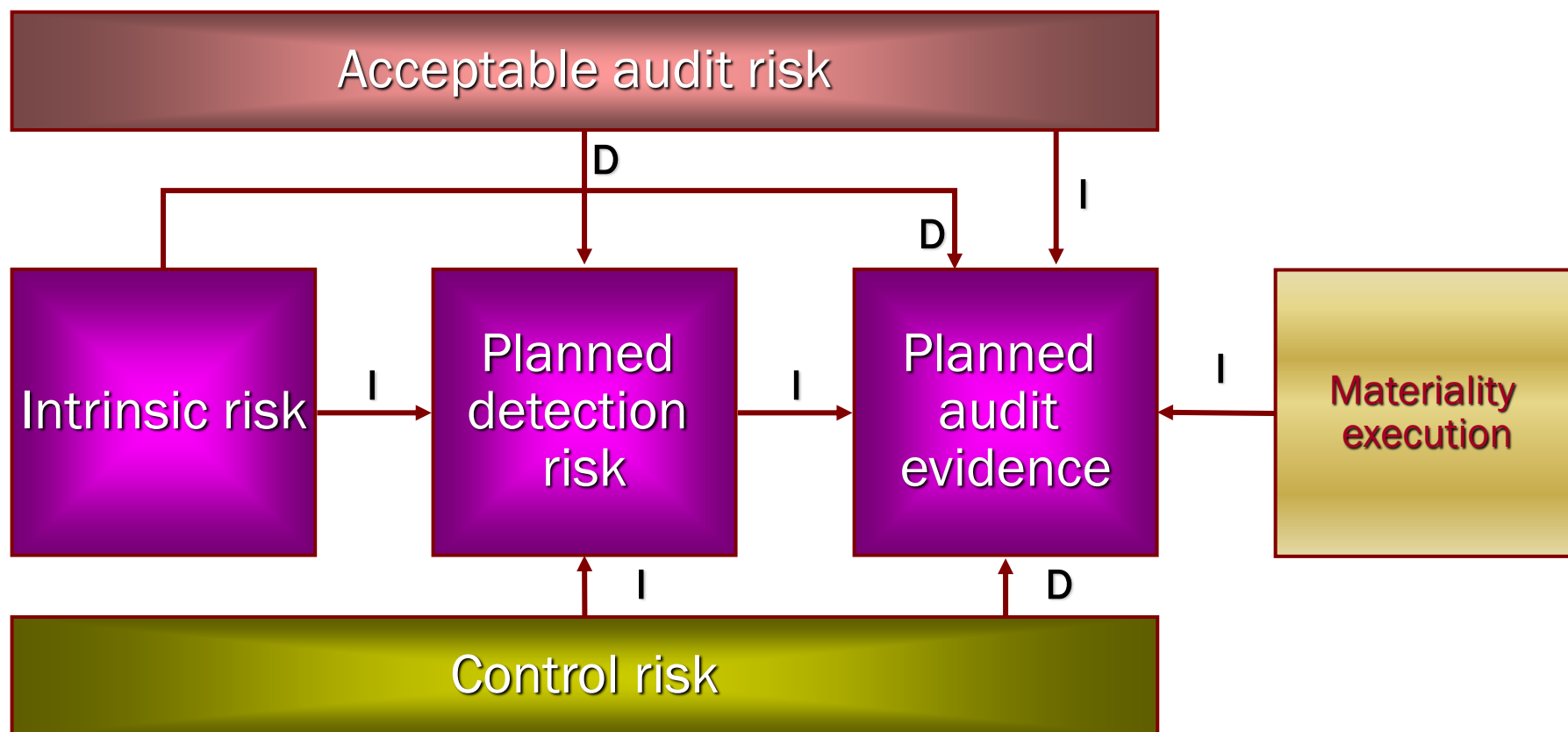
Detection risk directly influences audit strategy.



For example, if an audit requires a low detection risk to counter a high control risk, auditors may rely less on **control testing** and conduct extensive **substantive procedures** to form a valid audit opinion.

## 5. Audit Pillars

### ✘ Relationship between the 3 pillars



D = direct relation; I = inverse relation

## 5. Audit Pillars

### ✘ Auditing is highly influenced by the professional judgment of the Chartered Accountant (§23 of ISA 200)

- ✓ The materiality and audit risk.
- ✓ The nature, timeliness and extent of audit procedures used to satisfy ISA requirements and collect audit evidence.
- ✓ The verification that sufficient and appropriate audit evidence has been obtained and the need to do more to achieve the objectives of the ISAs and thus the general objectives of the auditor.
- ✓ The assessment of the judgements made by management in the application by the entity of the applicable financial reporting framework.
- ✓ The elaboration of conclusions based on the audit evidence obtained, such as, for example, the assessment of the reasonableness of the estimates made by the management in the preparation of the financial statements.



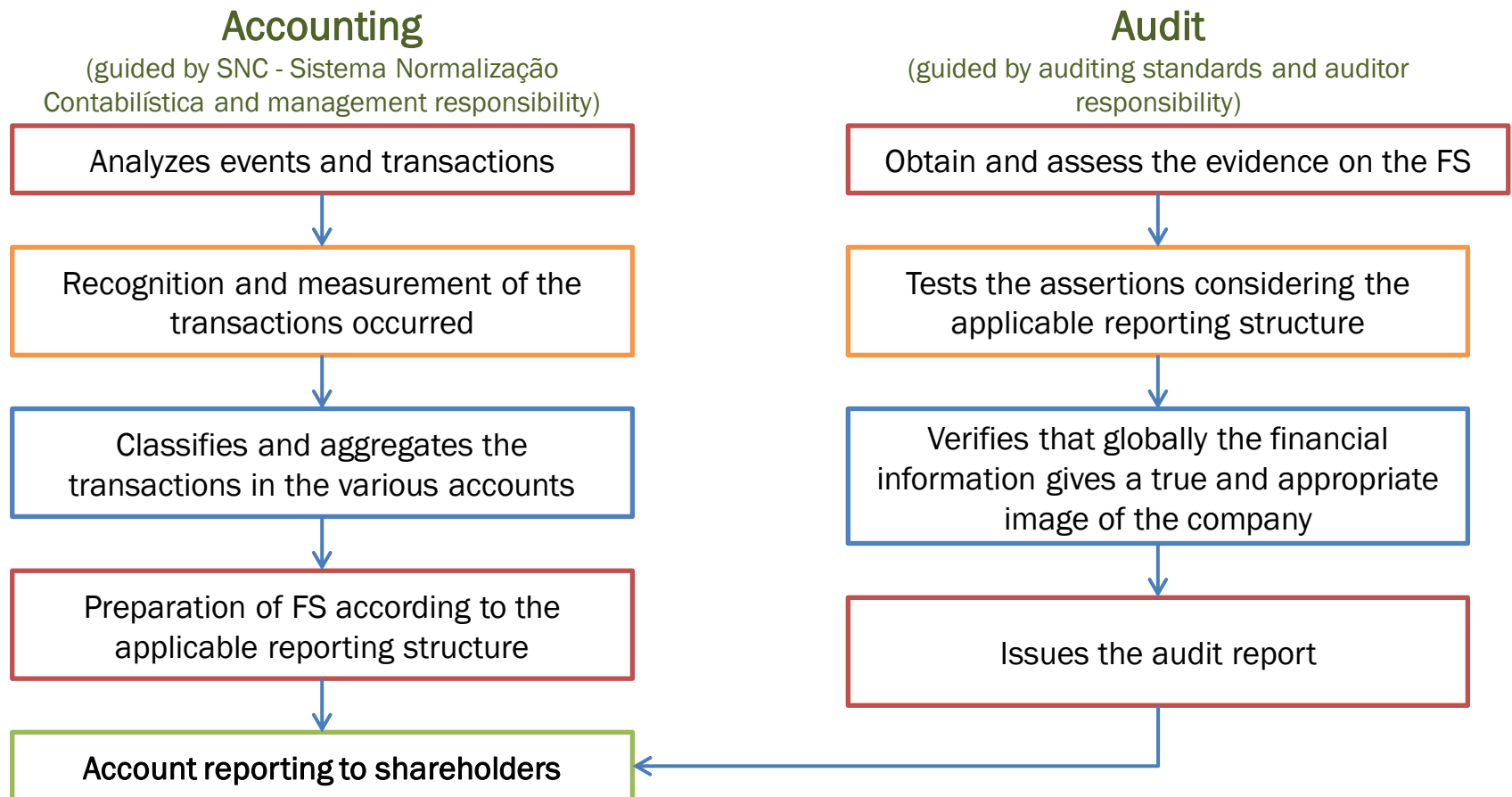
## Quiz I

1. Explain why auditor´s reports are important to users of financial statements and why it is desirable to have standard wording? **(4,0 points)**
2. What are the different reports auditors can issue in the scope of their work? **(6,0 points)**
3. Provide a definition of professional judgement when referring to the Auditor **(5.0 points)**
4. Define independence of the auditor and why this is a critical aspect? **(5,0 points)**



## 6. Audit path

### ✘ Accounting process and auditing



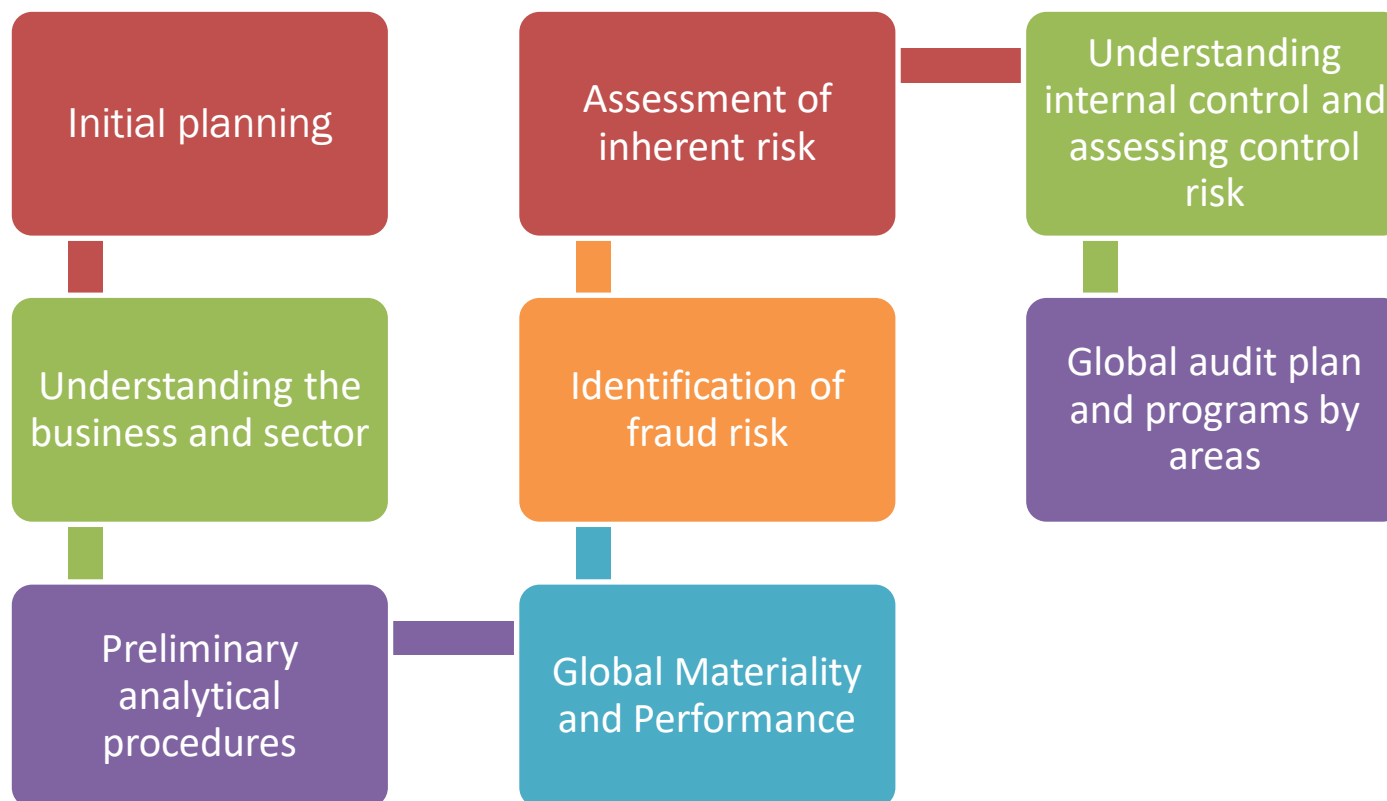
## 6. Audit path

### ✘ Stages of the audit



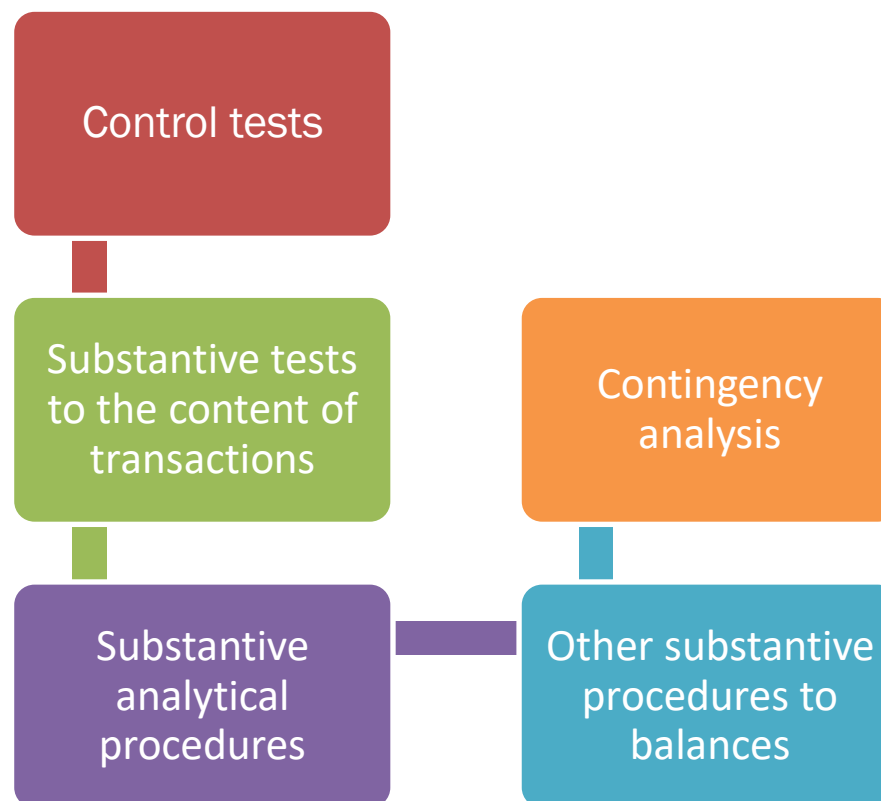
## 6. Audit path

### ✘ Audit planning



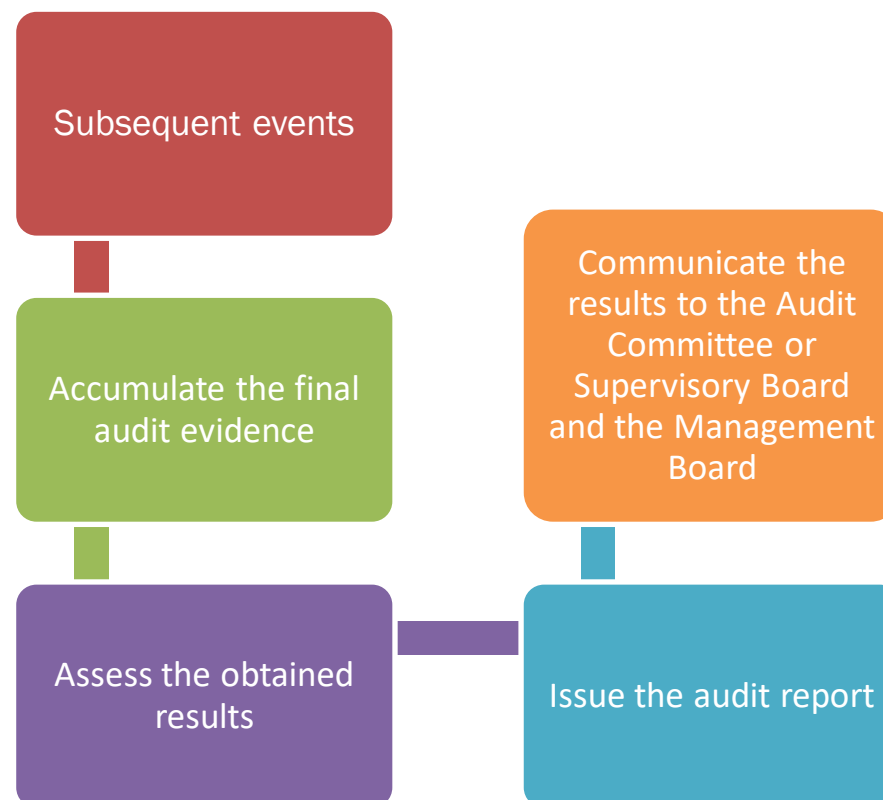
## 6. Audit path

### ✘ Response plan to misstatement risks



## 6. Audit path

### ✘ Conclusion, assessment and audit report



## 7. Acceptance of the commitment

### ✘ Overview

✓ **Objective:** to determine if the conditions for the commitment are met and later convince the client to hire the auditor

✓ Is it easy to get clients?

**Services nature**

**Comunication**



**Market structure**

### MANAGING ENGAGEMENT RISK

AIG was a large insurance company that posted a \$3.9 billion restatement of earnings in May 2005. AIG purposely hid many of the transactions related to the restatement from its audit firm, PwC. Following the

restatement, PwC was sued for damages, and ultimately paid a settlement of \$97.5 million. In short, management's lack of integrity ultimately cost the CPA firm many millions of dollars.

## 7. Acceptance of the commitment

### ✘ Example BES vs PWC

✓ BES was a client that had a significant level of risk

✓ PwC wanted to stop being an auditor of BES because Salgado had too much strength

[http://www.jornaldenegocios.pt/empresas/detalhe/pwc\\_quis\\_deixar\\_de\\_ser\\_auditora\\_do\\_bes\\_porque\\_salgado\\_tinha\\_demasiada\\_forca.html](http://www.jornaldenegocios.pt/empresas/detalhe/pwc_quis_deixar_de_ser_auditora_do_bes_porque_salgado_tinha_demasiada_forca.html)

*“O facto do Dr. Ricardo Salgado desempenhar em conjunto três papéis relevantes, a saber, CEO, responsável financeiro e responsável pela contabilidade, deixava-nos crescentemente desconfortáveis, pelo que entendemos que existiam riscos adicionais relacionados com esta realidade”, disse José Alves, presidente da PwC, na comissão parlamentar de inquérito à gestão do BES e do GES.”*

✓ PwC says there were "difficulties in obtaining information" at BES

[http://economico.sapo.pt/noticias/pwc-diz-que-havia-dificuldades-de-obtencao-de-informacao-no-bes\\_210272.html](http://economico.sapo.pt/noticias/pwc-diz-que-havia-dificuldades-de-obtencao-de-informacao-no-bes_210272.html)

## 7. Acceptance of the commitment

### Exercise

Indicate how you would conduct a client risk assessment including AML – anti money laundering for your audit firm?



## 7. Acceptance of the commitment

### ✘ Stages (art. 73 and 78 EOROC, Section 2 of Chapter 3 CEDP, ISA 210, ISA 220)

1

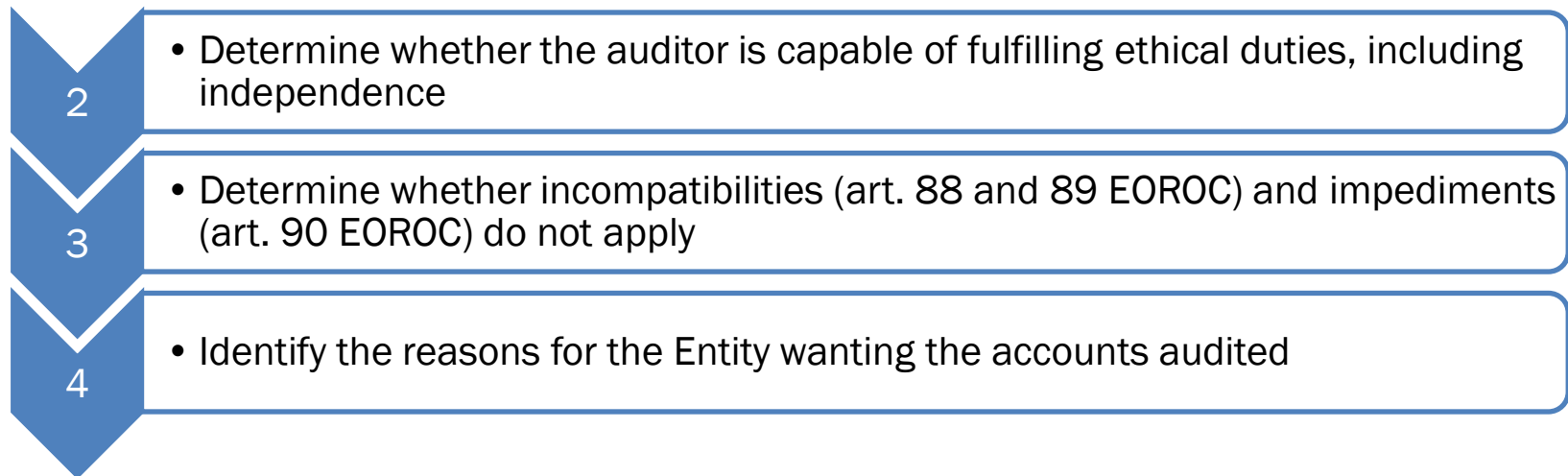
- Assess Management integrity, competence and independence of the Supervisory Board, quality of the internal risk management process

- ✿ Integrity of the Management Board and Supervisory Board – art. 78 EOROC
- ✿ Changes in management, organizational structure
- ✿ Communicate with the previous auditor
- ✿ Inquire other entities
- ✿ Analysis of publications about the company
- ✿ Hindsight\* analysis of the relationship with the client (§14 – 18 ISA 220)
  - ✿ Conflicts about the audit scope, opinion type, fees, etc.
  - ✿ Unilateral termination of contract
  - ✿ Rules of compulsory rotation in EPI – art. 54 e 78 EOROC

\* Retrospectiva

## 7. Acceptance of the commitment

### ✘ Stages



- ✿ Legal or voluntary
- ✿ Media exposure of the entity
- ✿ Who are the main users of FS (attention to **regulators!!**)
- ✿ Stakeholder participation (e.g. banking loans with covenants)

## 7. Acceptance of the commitment

### ✘ Stages

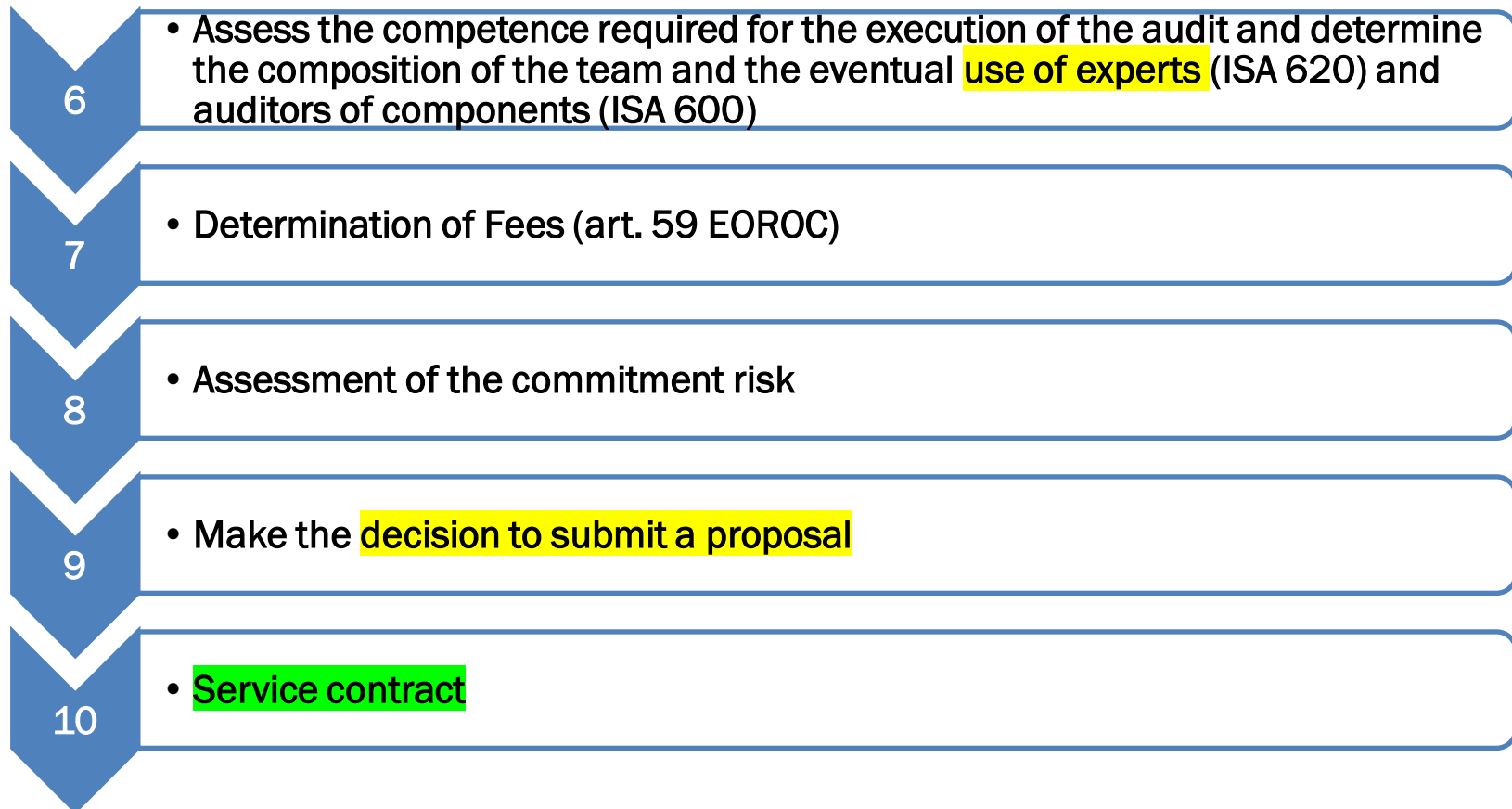
5

#### • Identify special circumstances or unusual risks

- ✿ Changes in company activities
- ✿ Legislation affecting the sector where the entity is inserted
- ✿ Developments in the environment affecting the business (PEST analysis)
- ✿ Susceptibility of FS being misstated - **is there a past of reserves?**
- ✿ New investments and/or restructuring programs
- ✿ **Existence of related parts**
- ✿ Prospective assessment of financial stability and client compliance with legal aspects
- ✿ **Identify possible limitations of scope**
- ✿ Assess the financial reporting system and its impact on the feasibility of an audit
- ✿ Management recognizes its responsibility in the preparation of the FS and Internal Control Systems

## 7. Acceptance of the commitment

### ✘ Stages



## 7. Acceptance of the commitment

### ✘ Stages

#### ✓ Commitment Letter

- ✿ The auditor should agree on the terms of audit work with the management or the governance representatives
- ✿ Agreed terms of audit work must be recorded in an **engagement letter**
- ✿ Audit objective and scope
  - Audit objective and scope
  - Responsibilities of the auditor and management
  - Applicable financial reporting referencial
  - **Timetables for planning and executing the audit**
  - Composition of the audit team
  - The expectation that management will provide written statements
  - **Fees and basis of invoicing**
  - Form and content of reports to be issued

GAT 4

GAT - Guia aplicação técnica

## 8. Audit Planning

### ✘ Ubiquitous requirement at the planning stage

✓ Objective: to identify and assess the risks of material misstatement, either due to fraud or error - §25 & 26 of ISA 315

#### 1) Identify misstatement risks

- Level of the FS
- Level of assertions for classes of transactions, account balances and disclosures (**inherent risk** and **control risk**)

#### 2) Assess (magnitude and probability) the risks of misstatement

- Level of the FS
- Level of assertions

## 8. Audit Planning

### ✘ Planning

- ✓ Objective: planning an audit aims at its effective execution - §4 ISA 300 **reducing the audit risk** to an acceptably low level
- ✓ It consists of two main activities:



Overall **audit strategy**

Detailed **audit plan**

## 8. Audit Planning

### ✘ Planning

#### Overall strategy

- Characteristics of the assignment
- Reporting objectives and reports to produce
- Critical factors to consider when performing the work
- Nature, timeliness and extent of required resources

See appendix  
ISA 300

#### Audit plan

- Nature, timeliness and depth of risk assessment
- Nature, timeliness and depth of additional audit procedures at assertion level
- Other auditing procedures required by some standard



## 8. Audit Planning

### ✘ Business knowledge

#### ✓ ISA 315. 3

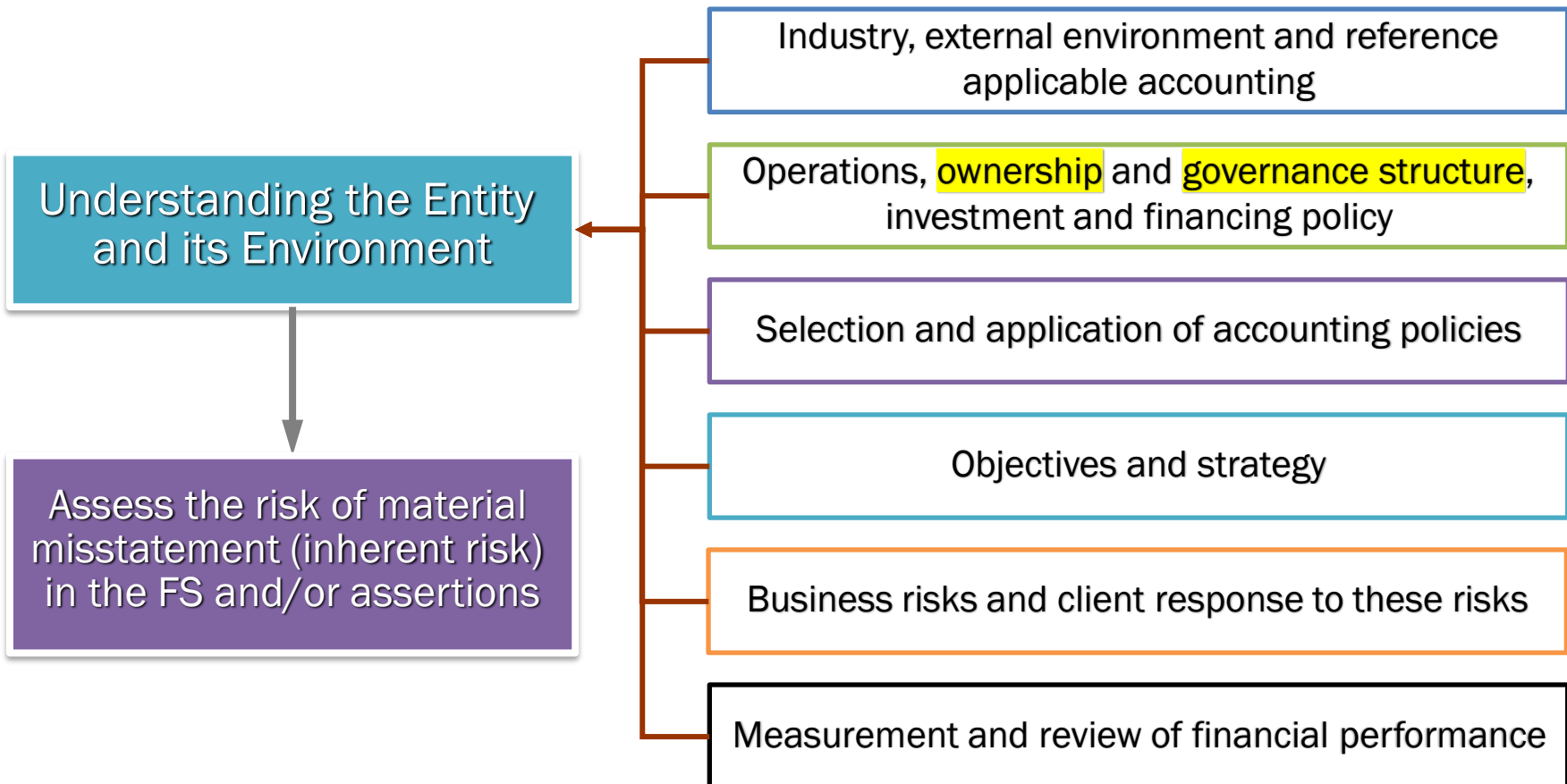
The objective of the auditor is to identify and assess the risks of material misstatement, due to fraud or error, at the level of the financial statements and the level of assertion, through the knowledge of the entity and its environment, including its internal control, thus providing a basis for designing and implementing responses to the assessed material misstatement risks.



**MMR** is the risk of the **FS** being **materially misstated** **before** the audit


## 8. Audit Planning

### ✘ Business knowledge - elements foreseen in ISA 315



## 8. Audit Planning

### ✘ Business knowledge - business risk vs MMR

 **Business Risk:** risk resulting from significant conditions, events, circumstances, actions or inactions that may adversely affect the entity's ability to achieve its objectives and execute its strategies, or to set inappropriate objectives and strategies - §4 ISA 315.



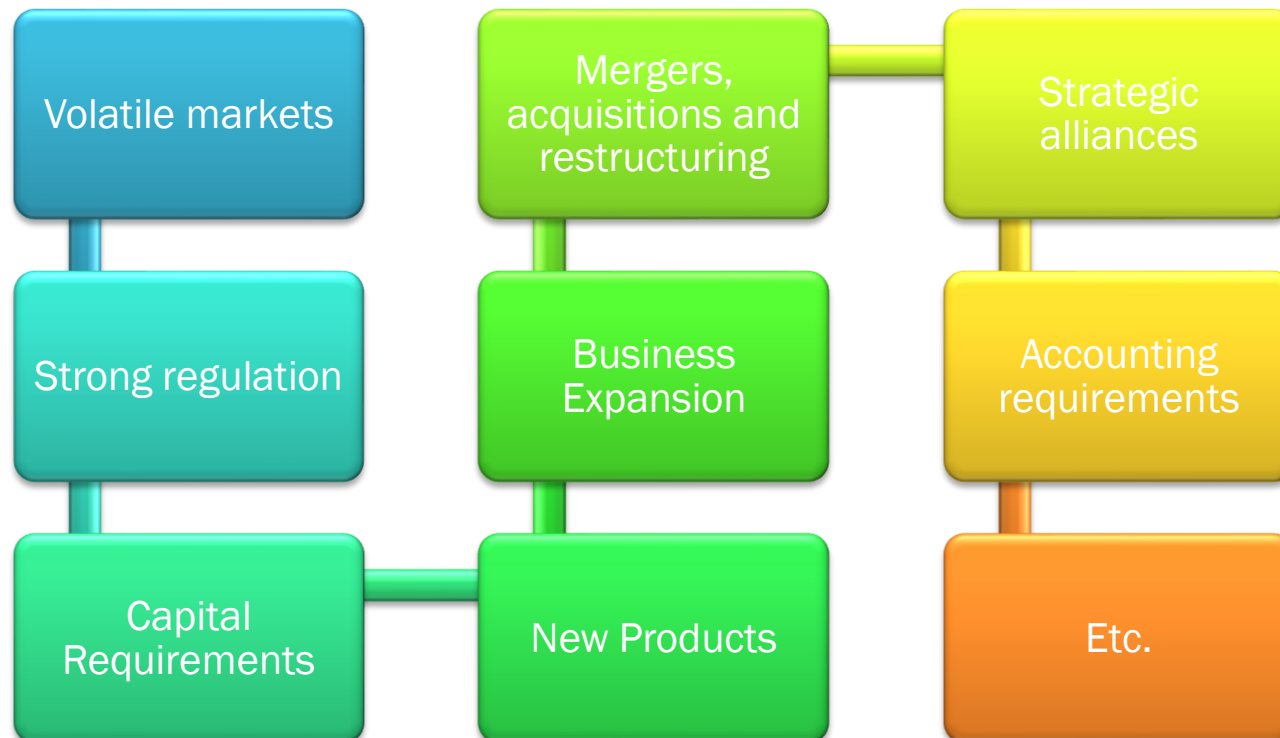
The **business risk** is **more comprehensive** than the MMR(\*) of financial statements but **includes the latter**. Most of the business risks have consequences on the FS.

(\*) MMR - Material misstatement risk

## 8. Audit Planning

### ✘ Business knowledge - business risk vs MMR

📄 Appendix 2 of ISA 315: business risks that indicate MMR – Material Misstatement Risk



## 8. Audit Planning

### ✘ Business knowledge - business risk vs MMR

 Factors to consider when assessing the **intrinsic risk**

Business nature

Results from  
previous years  
audit

1st audit or  
recurring

Related parties

Complex or non-  
routine  
transactions

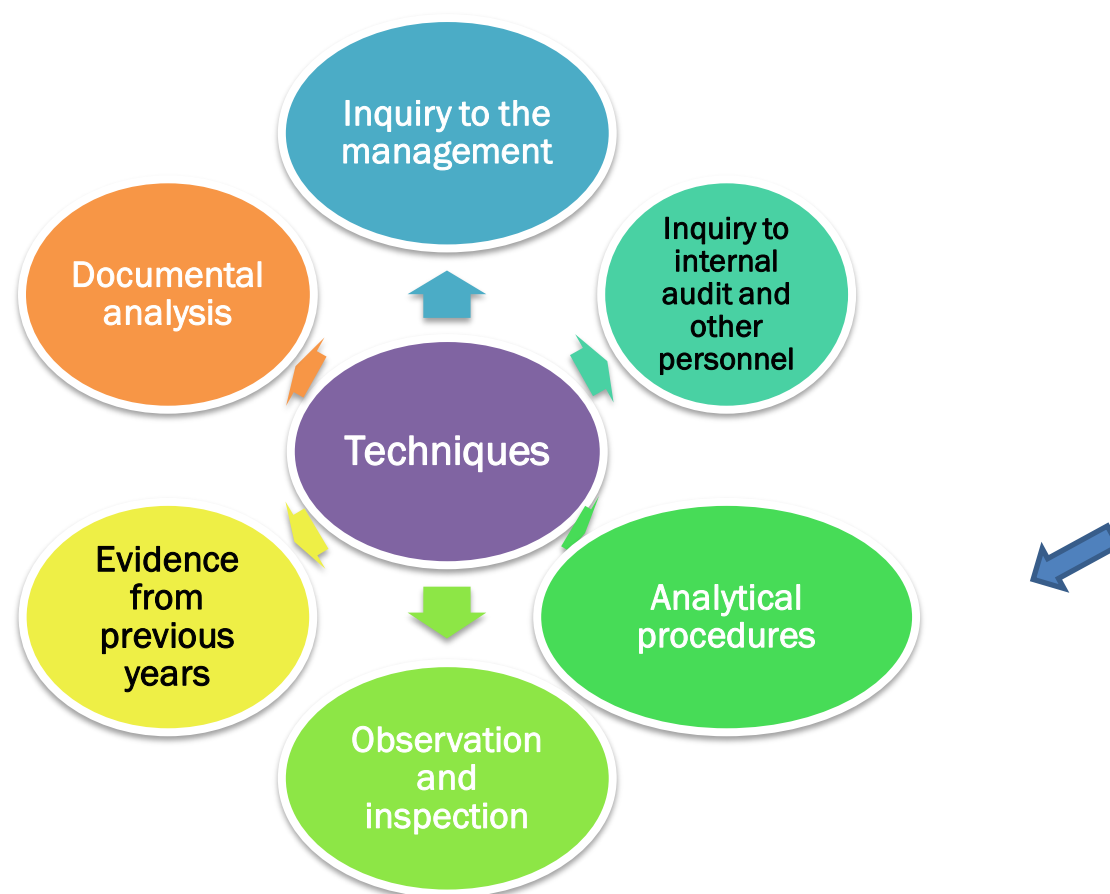
Requested  
judgment

Population  
composition

Fraud risk

## 8. Audit Planning

### ✘ Business knowledge - procedures used



## 8. Audit Planning

### ✘ Business knowledge - analytical procedures

Objectives	Planning Phase (mandatory) (ISA 315)	Substantive Tests Phase (ISA 520)	Phase preceding issuance of Report (mandatory) (ISA 520)
Know the client, sector and business	Main		
Assess the going concern risk	Secondary		Secondary
Indicate possible misstatements (directing attention)	Main	Secondary	Main
Reduce substantive tests to account balances ( <i>saldos</i> )	Secondary	Main	

(\*) MMR - Material misstatement risk

#### In the Planning Phase

- ✓ Useful to identify the existence of **unusual transactions or events** and **trends** that may indicate matters with impact on the FS and on the audit
- ✓ Develop expectations about **plausible relationships** that are expected to exist
- ✓ The results of their implementation should be considered together with other evidence collected when identifying the MMR\* (they are only corroborative or indicative evidence)

## 8. Audit Planning

### ✘ Business knowledge - analytical procedures

#### 📄 Examples of financial ratios

Liquidity	<ul style="list-style-type: none"> <li>• General = current assets / current liabilities</li> <li>• Reduced = current assets - inventories / current liabilities</li> <li>• Immediate = Cash and cash equivalents / current liabilities</li> </ul>
Exploration/ operational cycle	<ul style="list-style-type: none"> <li>• Average payment term = suppliers * 365 days / purchases</li> <li>• Average receivables term = clients * 365 days / turnover</li> <li>• Duration of inventories in warehouse = inventories * 365 days / cost of goods sold</li> </ul>
Financing structure	<ul style="list-style-type: none"> <li>• Financial autonomy = equity / assets</li> <li>• Coverage of financial charges = operating profit / interest expenses</li> </ul>
Profitability	<ul style="list-style-type: none"> <li>• Contribution margin % = contribution margin / turnover</li> <li>• Operational sales = operational result / turnover</li> <li>• Net sales = net profit / turnover</li> <li>• Asset = operating result / asset</li> <li>• Equity = net income / equity</li> </ul>



## 8. Audit Planning

### ✘ Business knowledge - Risk Matrix

Assessment of intrinsic risk						
Source/Event risk	Risk Factor Implications	Assertion	Probability to occur	Monetary impact	Combined Score	Significant Risk
Salesmen's remuneration based on sales commissions	Sales may be fictitious, recorded in the wrong period, exaggerated, or in terms different from the standard terms and conditions, in order to achieve the bonus goals	Occurrence and accuracy	4	4	16	No
Failure to comply with financing clauses are covered up to avoid investigations by banks	Accounting records differ recognition of expenses, bias in management estimates, etc.	FS	2	5	10	No

Likelihood of occurrence: 1 (remote), ..., 5 (almost certain)

Magnitude: 1 (immaterial), ..., 5 (material)

## 8. Audit Planning

### ✘ Business knowledge - significant risk of material misstatement

- 📄 A risk of material misstatement identified and assessed which, in the auditor's judgment, requires special consideration within the audit
- 📄 The auditor must determine whether any of the risks identified is a significant risk - § 27 of ISA 315.
- 📄 Causes for significant risks - §27 of ISA 315
  - Fraud risk
  - Risk is related to recent economic, accounting or other significant developments and therefore requires special attention
  - Complexity of transactions
  - Risk involves significant transactions with related parties
  - High degree of subjectivity in measuring financial information
  - Significant transactions that are outside the normal course of business
- 📄 If you consider that there is a significant risk, you should be aware of the relevant controls for that risk - §28 of ISA 315

## 8. Audit Planning

### ✘ Business Knowledge - Consideration of Laws and Regulations (ISA 250)

❏ Failure to comply with laws and regulations may result in fines, litigation or other consequences for the entity that may have a material effect on the financial statements.

❏ Auditor's Responsibility:

- ✓ The provisions of laws and regulations generally recognized as having a direct effect on the determination of amounts and material disclosures in financial statements such as tax laws and regulations.



**Need to collect appropriate and sufficient evidence**

- ✓ Other laws and regulations that do not have a direct effect on the determination of amounts and disclosures in the financial statements, but whose compliance may be fundamental to the operational aspects of the business.

## 8. Audit Planning

### ✘ Consideration of Laws and Regulations (ISA 250)

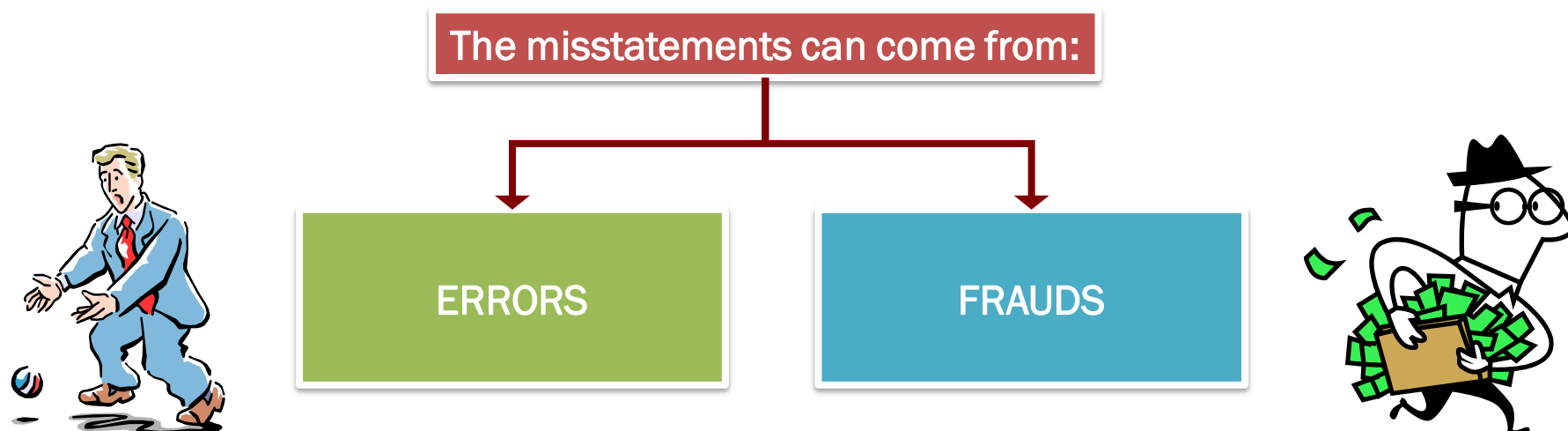
#### Examples of laws with impact on the FS

- ✓ Format and content of the financial statements;
- ✓ Sector-specific financial reporting aspects;
- ✓ Accounting for transactions under government contracts; or
- ✓ Accrual or recognition of expenses related to income tax or pensions.

## 8. Audit Planning

### ✘ Business knowledge - fraud risk

- By determining that there is a risk of material misstatement for a particular account or class of transactions, the auditor is assuming that misstatements in the assertions underlying the financial statements may occur.



Fraud materializes in financial reporting and/or misappropriation of assets.

## 8. Audit Planning

### ✘ Business knowledge - fraud risk

#### Characteristics of fraudulent financial reporting



- ✓ Manipulation, falsification or alteration of records and supporting documents, from which the FS were prepared
- ✓ Misrepresentation or intentional omission in the FS of events, transactions or other significant information
- ✓ Lack of intentional application of accounting principles relating to measurement, recognition, classification, presentation or disclosure

## 8. Audit Planning

### ✘ Business knowledge - fraud risk

#### 📄 Responsibilities - Auditor

- ✓ Obtain reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error
- ✓ Is not and cannot be held responsible for the occurrence of fraud or errors
- ✓ It is a dissuasion factor
- ✓ To have into consideration: professional skepticism and consistency in evidence
- ✓ The risk of not detecting a material misstatement resulting from fraud is greater than the risk of not detecting a material misstatement resulting from error
- ✓ The risk of not being detected a material misstatement resulting from fraud practiced by management is greater than if practiced by employees
- ✓ The fact that the auditor's opinion is based on the concept of reasonable assurance does not guarantee that material misstatement will be detected (fraud or error)

## 8. Audit Planning

### ✘ Business knowledge - fraud risk (ISA 240)

1

- Generic conditions for the existence of fraud (incentives, opportunities, attitudes)

- ☑ Management or other employees are motivated or pressured;
- ☑ Existing circumstances provide the opportunity;
- ☑ Those involved in the process are individuals whose character and values allow them to participate in the fraudulent act => don't look at means to achieve the objectives.



Incentives / Pressures

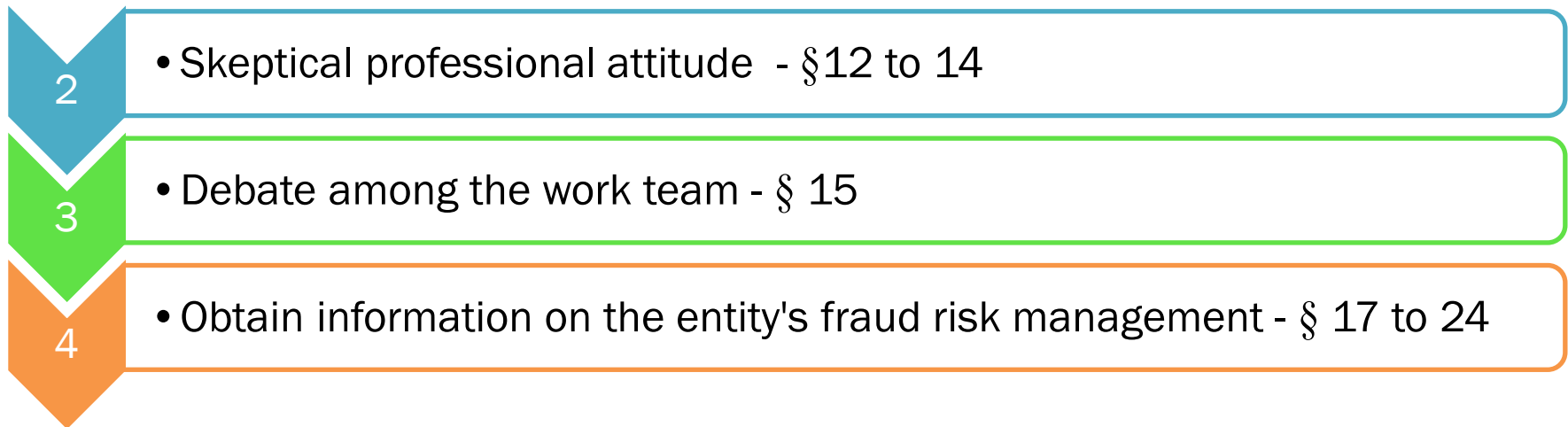
Opportunity



Attitudes/Rationality



## 8. Audit Planning

### ✘ Business knowledge - fraud risk (ISA 240)



-  Inquiring management, internal audit and the supervisory board
-  Analytical procedures reveal unusual or unexpected relationships

## 8. Audit Planning

### ✘ Business knowledge - fraud risk

4

- Obtain information on the entity's **fraud risk management** - § 17 to 24

#### Responsibilities - Management and governance

- ✓ It is up to the management board to implement a system that minimizes the risk of fraud



## 8. Audit Planning

### ✘ Business knowledge - fraud risk

4

- Obtain information on the entity's fraud risk management - § 17 to 24

#### 📄 Elements to prevent, deter and detect fraud

- ✓ **Culture of honesty and ethics** - control environment





## 8. Audit Planning

### Exercise

Develop a working plan including a questionnaire to assess culture of honesty, values and ethics in a banking institution.

## 8. Audit Planning

### ✘ Business knowledge - fraud risk

4

- Obtain information on the entity's fraud risk management - § 17 to 24

📄 Elements to prevent, dissuade and detect fraud

✓ Direct fraud risk management

Identify and measure  
fraud risk

Design and  
implement  
appropriate controls  
to mitigate the fraud  
risk

Monitoring the results  
achieved in fraud risk  
controls

## 8. Audit Planning

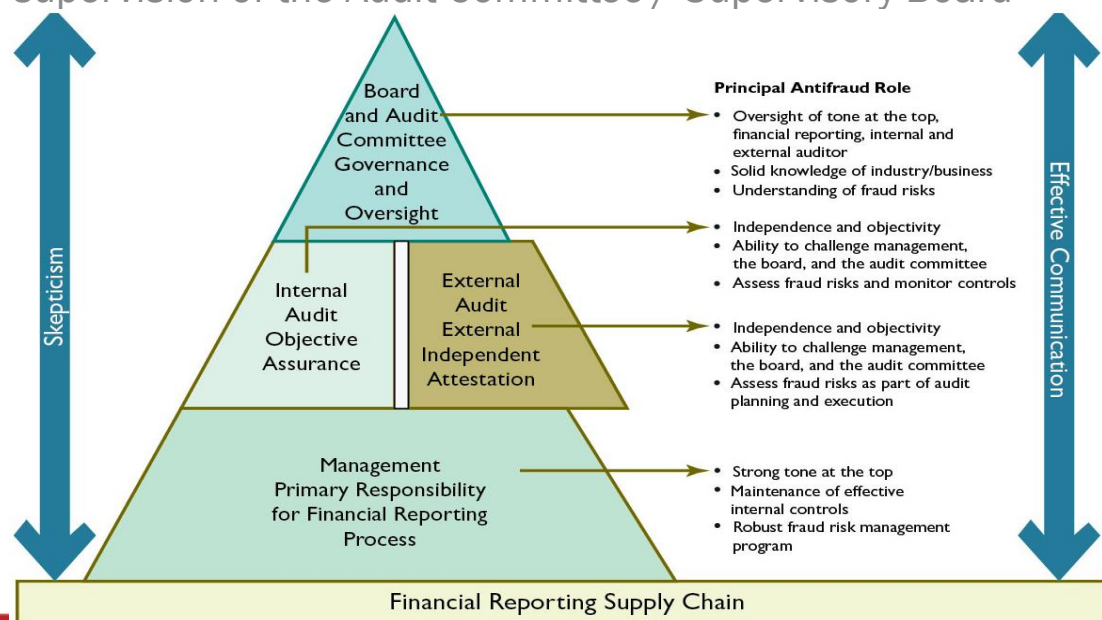
### ✘ Business knowledge - fraud risk

4

- Obtain information on the entity's fraud risk management - § 17 to 24

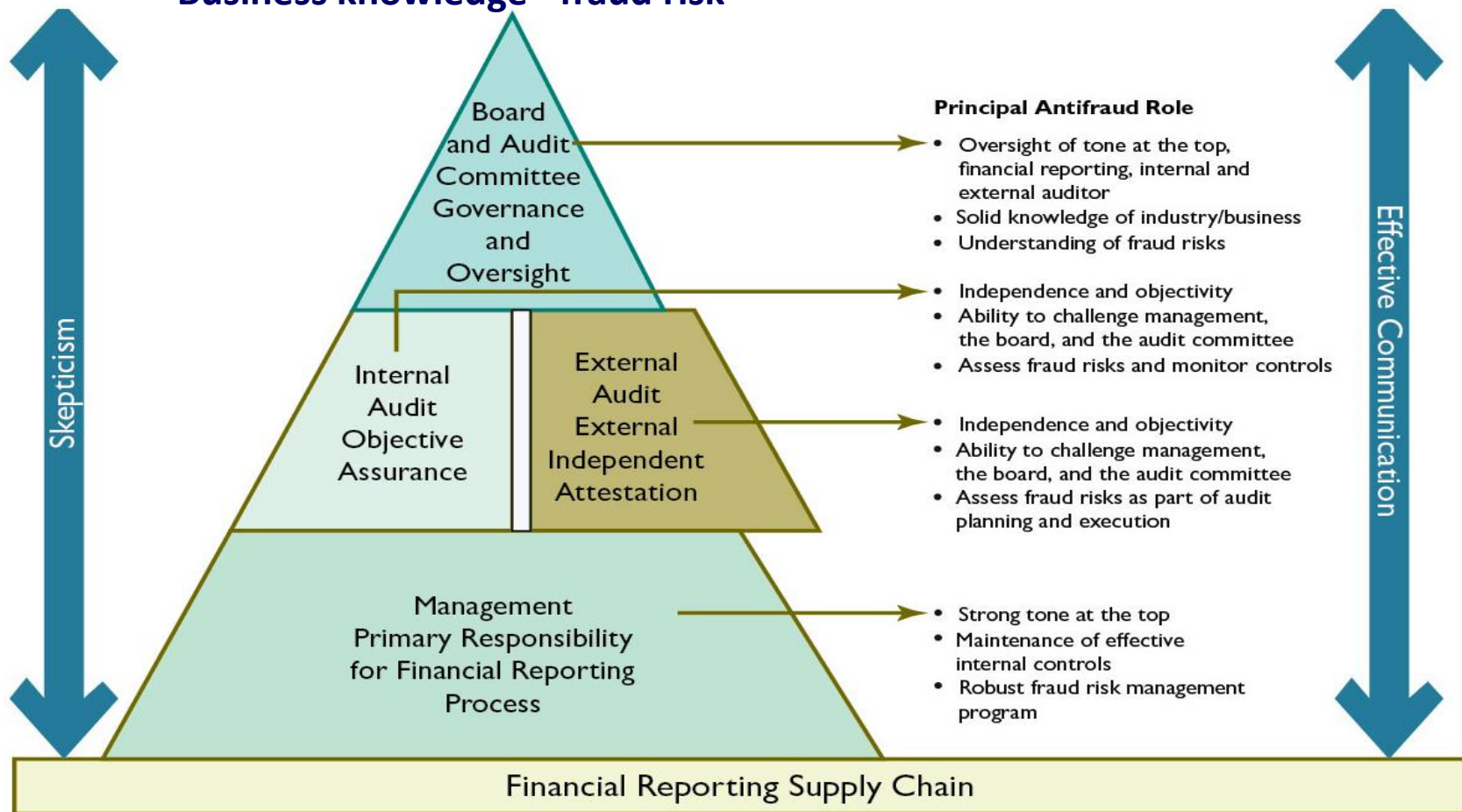
#### 📄 Elements to prevent, dissuade and detect fraud

- ✓ Effective supervision of the Audit Committee / Supervisory Board



## 8. Audit Planning

### Business knowledge - fraud risk



## 8. Audit Planning

### ✘ Business knowledge - fraud risk (ISA 240)

5

- Identify and assess the risks of material misstatements due to fraud - §26

Consider at the level of fraud

Type

Importance

Probability

Frequency

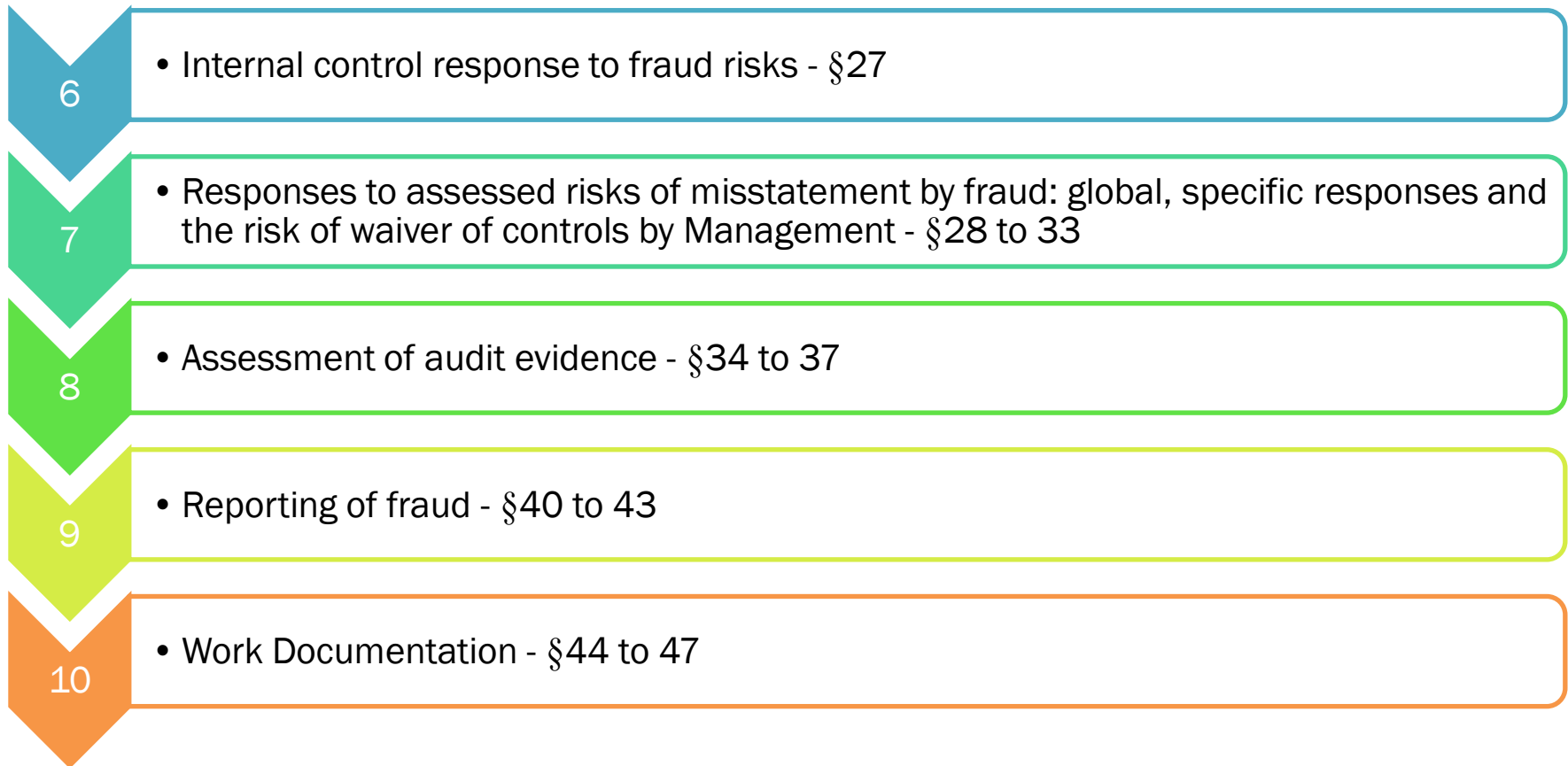
Auditor should assume that there is a risk of fraud in the recognition of revenues, assess what types of revenue and assertions are the source of that risk

Auditor should consider the risk of management overriding controls



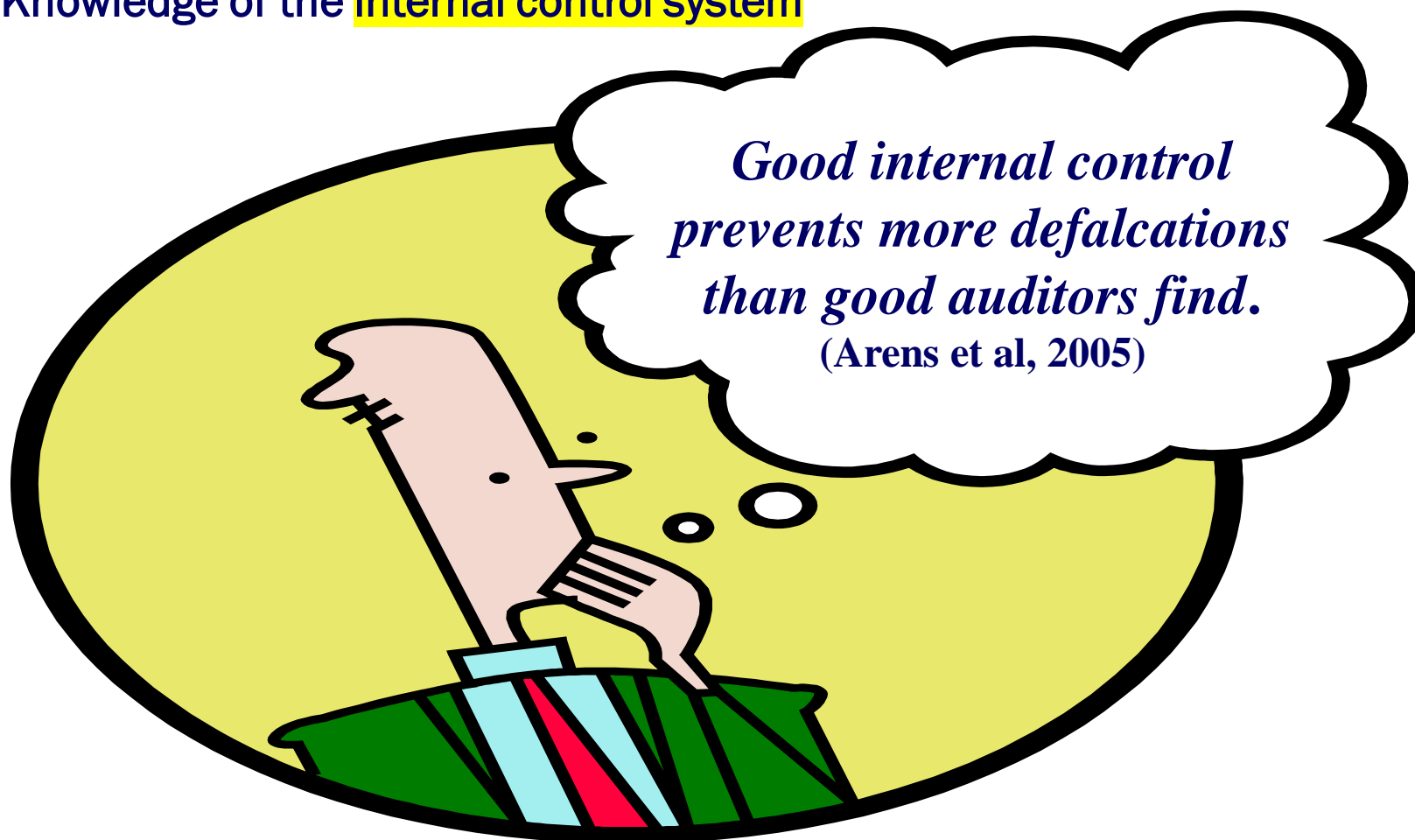
## 8. Audit Planning

### ✘ Business knowledge - fraud risk (ISA 240)



## 8. Audit Planning

- ✘ Knowledge of the internal control system



## 8. Audit Planning

### ✘ Knowledge of the internal control system

- ✓ Importance of ICS for the company

#### Control Deficiencies and Poor Decisions at Reliable Insurance Co.

#### AUDITING IN PRACTICE

Reliable Insurance Co. of Madison, Wisconsin, introduced a new insurance policy to provide supplemental coverage to Medicare benefits for the elderly. The insurance was well received by elderly policyholders, many of whom were in nursing homes. The insurance policy was competitively priced and sold very well. To estimate reserves (liabilities) for future claims against the policies, the client used initial claims data to estimate costs and to build a model to estimate the reserves. For example, claims data for the first year could be compared with premiums for the same time period to estimate the needed reserve for claims. Unfortunately, the client's accounting system had control deficiencies that delayed the processing of claims. As a result, the internal estimation model was comparing claims

data for one month with premiums for three months, which resulted in the model significantly underestimating the needed reserves for future claims.

Because the internal control system failed to record claims on a timely basis, the company underpriced the policies and misrepresented its financial condition to shareholders and lenders. The low price attached to the policies allowed the company to greatly expand its sales. Unfortunately, the company was forced into bankruptcy when it could not meet policyholder claims. Had the internal control processes been properly designed, implemented, and maintained, management would have made better decisions. The internal control deficiency led not only to unreliable financial statements, but ultimately to the failure of the business.



Source: Johnstone, K. M., Gramling, A. e Rittenberg, L. E., (2014), Auditing: a business risk approach, 9th edition, Cengage.

## 8. Audit Planning

### ✘ Knowledge of the internal control system

#### ✓ Concept (ISA 315. 4)

**Process** designed, implemented and maintained by governance responsables, and other personnel to provide reasonable assurance about achieving an entity's objectives regarding:

- i. the **reliability of financial reporting**;
- ii. effectiveness and efficiency of operations; and
- iii. compliance with applicable laws and regulations.



The term "controls" refers to any aspect of one or more of the components of internal control.

## 8. Audit Planning

### ✘ Knowledge of the internal control system

#### Responsibility for ICS

Management Body is responsible for creating and maintaining an appropriate internal control system to enable the preparation of financial statements free of material misstatement due to fraud or error.

#### Key assumptions underpinning the creation and maintenance of an ICS

##### → Reasonable assurance of a credible financial report

⇒ Depends on a **cost/benefit analysis** -> see the case of **Small Companies**

##### → Inherent limitations

⇒ Designed for normal and frequent transactions, although **errors are more likely to occur in unusual transactions**

⇒ Presupposes competence (control may not work as expected due to human error)

⇒ There is the possibility that the **management body overcomes the controls**, or that there is collusion of two or more employees

⇒ Control procedures may become inadequate due to **changes in the internal or external environment** in which the entity operates.

## 8. Audit Planning

### ✘ Knowledge of the internal control system

#### Auditor's responsibility

##### → Know the controls that affect the quality of financial information

⇒ The auditor must be aware of the internal control relevant to the audit, especially that which directly and indirectly influences the financial reporting (§12 ISA 315).

- Controls over assertions related to **transactions** and related disclosures (e.g. **How is it ensured that the goods invoiced were those shipped to the client?**)
- Controls on the assertions related to **balances and related disclosures** (e.g. how is it determined if an asset is impaired?)

##### → Test the identified controls

⇒ In the process of understanding the controls that are relevant to the audit, the auditor should **assess the design of those controls** and determine whether or not they have been implemented, carrying out **procedures** in addition to **inquiries** to the personnel of the entity (§13 ISA 315).

## 8. Audit Planning

### ✘ Knowledge of the internal control system

- ✓ Importance of control risk assessment in auditing

#### Entity's Objective

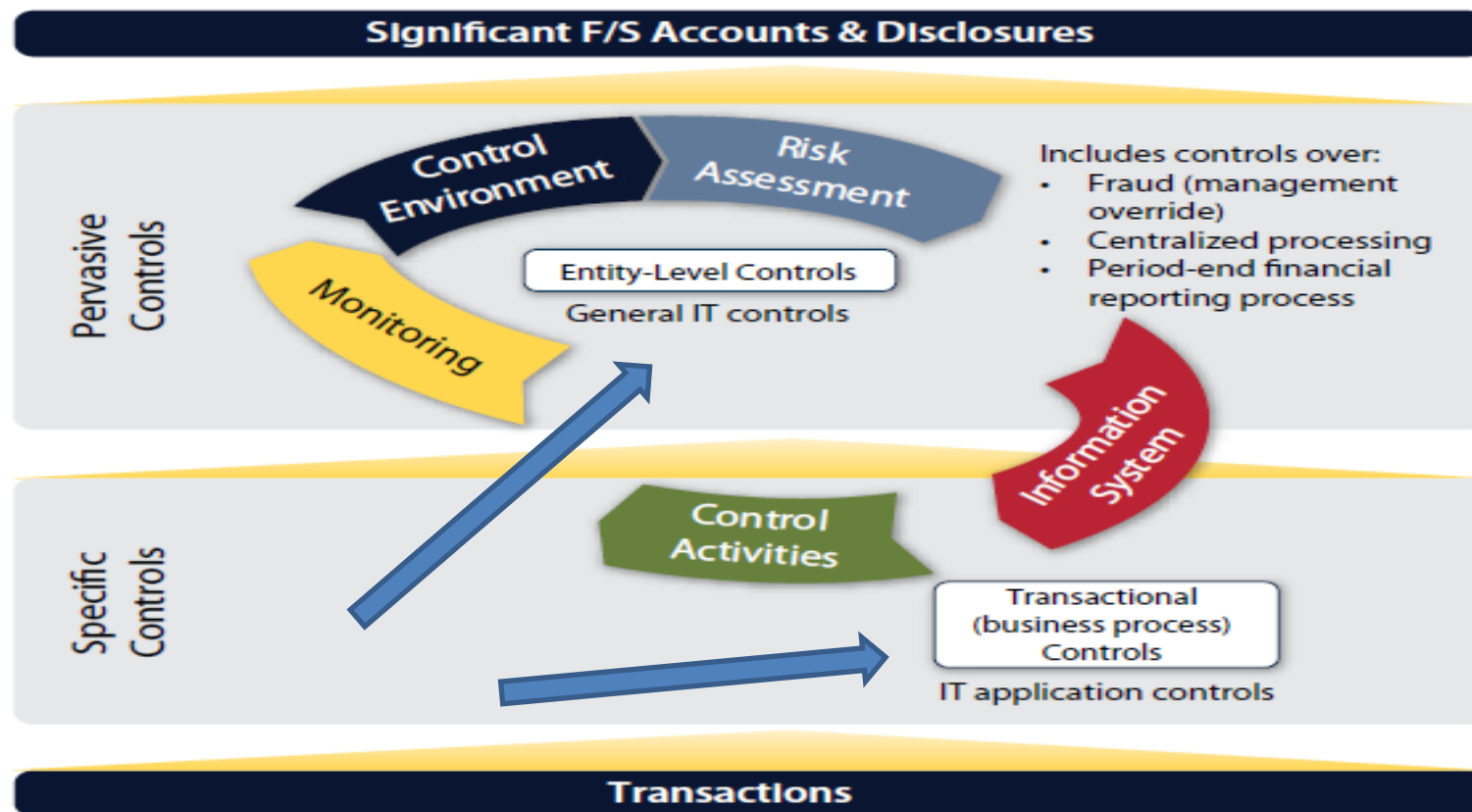
Prepare Financial Statements free of errors and frauds



## 8. Audit Planning

### ✗ Knowledge of the internal control system

#### ✓ Internal control components





## 8. Audit Planning

### ✘ Knowledge of the internal control system

#### ✓ Internal Control Components and its Principles

The control environment consists of the actions, policies and procedures that reflect the attitudes of the Management, directors and shareholders regarding internal control and its importance to the entity. The control environment establishes the climate of an organization, influencing the awareness of the people who work in it to control.

Component	Principles
Control Environment	<ol style="list-style-type: none"> <li>1. Communication and imposition of integrity and ethical values.</li> <li>2. Commitment to competence</li> <li>3. Participation of Governance Officers</li> <li>4. Philosophy and style of management</li> <li>5. Organizational structure</li> <li>6. Assignment of authority and responsibility</li> <li>7. Human resources policies and practices</li> </ol>

## 8. Audit Planning

### ✘ Knowledge of the internal control system

#### ✓ Internal Control Components

It involves a process to identify and analyze risks that may prevent the organization from achieving its objectives

Component	Principles
<b>Risk Assessment by the Entity</b>	<p>The way the <b>management body</b> identifies the <b>business risks</b> relevant to the objectives of the financial reporting, estimates the importance of these risks, assesses the probability of their occurrence and decides on the response and management measures for these risks, as well as their results.</p> <p>Relevant risks for reliable financial reporting include <b>events</b> that may occur and that adversely affect the entity's ability to initiate, record, process and report financial information consistent with management's assertions in the financial statements</p> <p>Examples: <b>new IFRS</b>, <b>changes in IT systems</b>, new products, <b>corporate restructuring</b>, etc.</p>

## 8. Audit Planning

### ✘ Knowledge of the internal control system

#### ✓ Internal Control Components

#### Ineffective Internal Control Over Financial Reporting Leads to Embezzlement at Citigroup

AUDITING IN PRACTICE

Gary Foster was a mid-level accountant in Citigroup's Long Island City office, with an annual salary of about \$100,000. His embezzlement of about \$19 million from the company was revealed in June 2011. It appears that Foster transferred money from various Citigroup accounts to his personal bank account at JPMorgan Chase. He did so by making adjusting journal entries from interest expense accounts and debt adjustment accounts to Citigroup's main cash accounts. Then, on at least eight occasions, he transferred the money to a personal bank account at Chase. To conceal the transactions, he used a false contract number in the

reference line of the wire transfer. This series of actions continued for at least a year, undetected by the company's internal controls. During that time, Foster traveled extensively internationally, owned six expensive homes, and owned Maserati and BMW automobiles.

The revelation of this fraud serves as another embarrassment to the embattled Citigroup, which lost billions during the financial crisis and was criticized for taking over a month to disclose that hackers stole data from over 360,000 Citigroup credit card accounts. Clearly, the internal controls at Citigroup are causing major problems for the company.

Source: Johnstone, K. M., Gramling, A. e Rittenberg, L. E., (2014), Auditing: a business risk approach, 9th edition, Cengage.

## 8. Audit Planning

### ✘ Knowledge of the internal control system

#### ✓ Internal Control Components

Policies and procedures that help ensure that the necessary actions are taken to deal with risks that affect the achievement of the entity's objectives

Component	Principles
Control activities	<ul style="list-style-type: none"> <li data-bbox="483 785 1868 985">• The organization selects and develops control activities that contribute to the reduction, to acceptable levels, of the risks to the achievement of the objectives, namely, to reduce the risk of misstatements in financial reporting.</li> <li data-bbox="483 1042 1868 1142">• The organization selects and develops <b>general control activities</b> on technology to support the achievement of objectives.</li> <li data-bbox="483 1199 1868 1342">• The organization establishes control activities through policies that establish what is expected and the procedures that put these policies into practice.</li> </ul>

## 8. Audit Planning

### ✘ Knowledge of the internal control system

#### ✓ Internal Control Components

##### Types of control activities

⇒ Physical control over assets and records

⇒ Appropriate levels of authorization of transactions and activities

##### ➡ General authorization

Policies that define powers and their limits that subordinates must implement when approving all transactions that fall within the defined limits (e.g. vendors may stay overnight in hotels 3\*\*\*; deadline for receipt is 2 months)

##### ➡ Specific authorization

In concrete situations, the management body prefers to make the decision (e.g. the choice of the hotel for the annual meeting of executives)



## 8. Audit Planning

### ✘ Knowledge of the internal control system

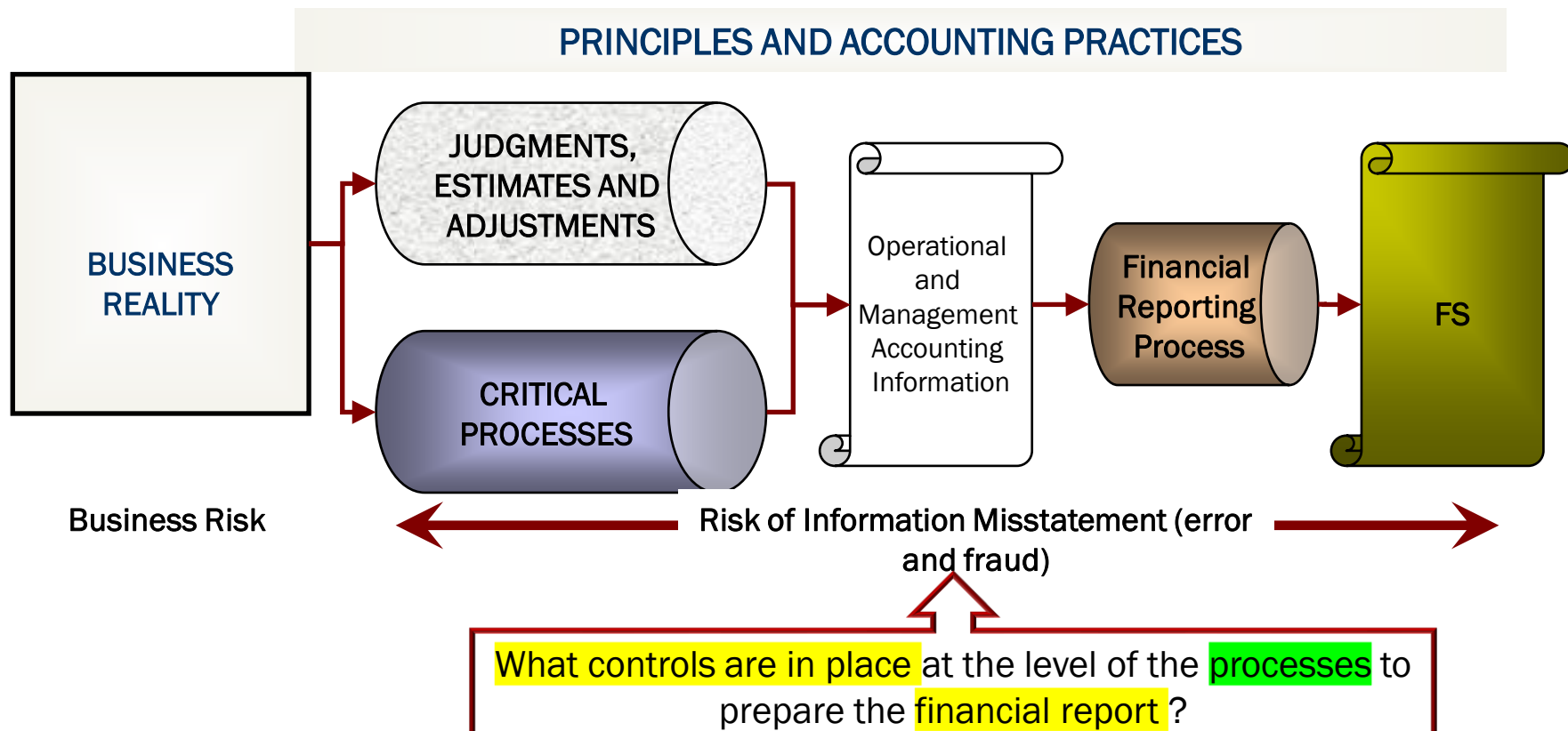
#### ✓ Internal Control Components

Component	Principles
<p>Relevant Information System for financial reporting, including business processes and communication</p>	<p>It comprises the tasks established to <b>initiate, register, process, summarize and report the entity's transactions</b> (as well as the events and conditions) and to maintain <b>credible information</b> regarding assets, liabilities and equity.</p> <p>It covers methods and records that:</p> <ul style="list-style-type: none"> <li>• Identify and record all valid transactions</li> <li>• Describe transactions in sufficient detail in due time to allow for proper classification of transactions</li> <li>• They determine the value of the transaction and a way to record its appropriate monetary value in the financial statements</li> <li>• Identify the moment of the transaction to allow the registration in the correct accounting period</li> <li>• Properly present the transactions and their disclosures in the financial statements.</li> </ul>

## 8. Audit Planning

### ✗ Knowledge of the internal control system

- ✓ Information system relevant to financial reporting



## 8. Audit Planning

### ✘ Knowledge of the internal control system

#### ✓ Information system relevant to financial reporting

The auditor shall also be made aware of **how the entity communicates** the functions, responsibilities and relevant matters related to the financial reporting, including:

⇒ communications between management and governance officers (directors)

⇒ external communications, including with **regulatory authorities**.



## 8. Audit Planning

### ✘ Knowledge of the internal control system

#### ✓ Internal Control Components

Component	Principles
Monitoring	<ul style="list-style-type: none"> <li>• The organization selects, develops and conducts continuous and/or independent assessments* to ensure the presence and functioning of the internal control components.</li> <li>• The organization assesses and communicates deficiencies in internal control in a timely manner to those responsible for taking corrective actions, including directors and Management Board and Supervisory Board, as applicable.</li> <li>• Monitoring may be developed on a continuous or periodic basis. Examples:               <ul style="list-style-type: none"> <li>❖ Document review</li> <li>❖ Supervision of subordinates</li> <li>❖ Internal audit =&gt; auditor can use his/her work as a support</li> <li>❖ Review of clients´ complaints</li> </ul> </li> </ul>

\* Typically outsourced to Audit firms

## 8. Audit Planning

### ✘ Knowledge of the internal control system

#### 📁 Information technologies in internal control

IT can strengthen an Entity's internal control system, but it can also present challenges.

#### ➔ Risks associated with IT

- Incorrect data processing
- Loss of confidentiality, completeness and availability of information
- Access and disclosure of confidential information
- Unauthorized changes to computer systems
- Unavailability of computer systems, delay, or even stop, the activities of the Entity

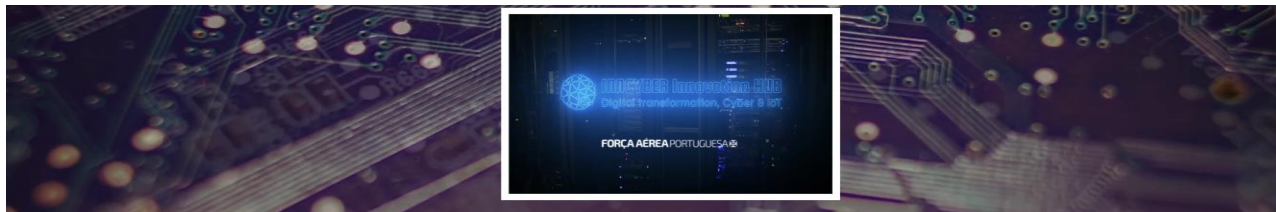


Cybersecurity is a topic every time more important to consider in organizations.

## 8. Audit Planning

### Exercise

Search and present some examples of Cybersecurity events that happened recently in organizations and identify what are the possible main impacts.



## 8. Audit Planning

### ✘ Knowledge of the internal control system

#### 📄 Information technologies in internal control

- To deal with the risks associated with IT, the Entity may adopt:

#### General Controls

Covers all the management processes of the Entity's information systems



#### Applicable controls

They are directly related to transactions, master data, specific to an application.  
They ensure the completeness and accuracy of the records, as well as the validity of the inputs in transactions and master data resulting from manual or automatic processing.

## 8. Audit Planning

### ✘ Knowledge of the internal control system

#### General IT controls

Types of controls	Examples
IT function management	IT Director (CIO) reports to the Board of Management
IT Task Separation	Separation in programming responsibility, operation and data control
Systems Development	User teams, system analysts and programmers develop and test the software in detail
Backup and contingency plans	Written backup plan and regular testing throughout the year (*)
Security Management	Password access, limited access to user ID, data and programs protected by encryption and firewalls
Hardware Controls	Memory failures or other problems in the program give rise to monitor error messages

\* Very important in case of cyber attack

## 8. Audit Planning

### ✘ Knowledge of the internal control system

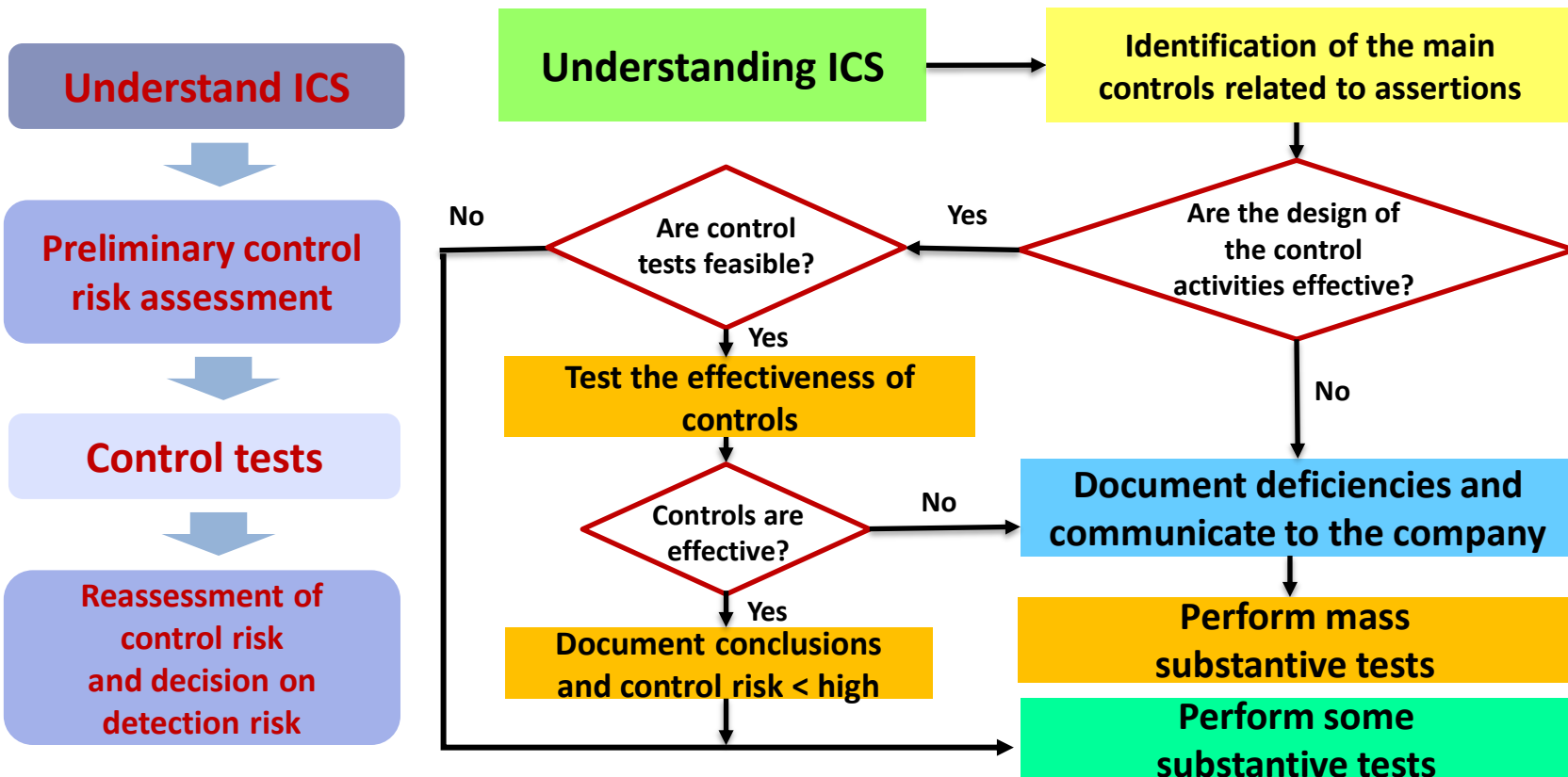
#### IT application controls (manual or computerized)

Types of controls	Examples
Input	<ul style="list-style-type: none"> <li>Menu with the available options</li> <li>Validation of client number with the one registered in the Client List</li> </ul>
Processing	<ul style="list-style-type: none"> <li>Gross wage is equal to net wage + discounts</li> <li>Wage processing includes employee number, employee name, department, working days, .....</li> <li>Reasonableness tests check the hourly cost used to process the salaries.</li> </ul>
Output	<ul style="list-style-type: none"> <li>Check processing dates and times to identify any event outside the expected sequence</li> <li>Compare the number of units processed with the number of units submitted to production</li> </ul>

## 8. Audit Planning

### ✘ Knowledge of the internal control system

✓ Assessment process of the Control risk



## 8. Audit Planning

### ✘ Knowledge of the internal control system

✓ **Control risk assessment process** (e.g. Sales)



Control Type		Occurrence	Plenitud e	Cut	Rigor	Presentation	Classification
Controls	Statement is sent monthly to the client	C			C	C	
	Sales price is taken from an approved price list				C		
	Credit is automatically approved by the computer compared to the authorized credit limit	C					
	Registered sales are supported by authorized shipping documents and approved ordering	C			C		
	.....						
Deficiencies	Failure of internal verification for the possibility of duplicate registration of a sale	D					
	Control failure to test the specialization of the exercise in sales			D			
<b>Preliminary risk assessment control</b>		<b>Average</b>	<b>Low</b>	<b>Average</b>	<b>Low</b>	<b>Low</b>	<b>Low</b>



## 8. Audit Planning

### ✘ Knowledge of the internal control system

#### Control risk assessment process

Auditors should assess whether **key controls** are absent in the design and implementation of internal control over the FS as part of the assessment of **control risk** and the **risk of material misstatement** at the FS.

#### → Levels of absence of internal controls

Deficient  
control

Significant  
Deficiency

Material  
weakness

## 8. Audit Planning

### ✘ Knowledge of the internal control system

#### Control risk assessment process

##### → Deficient control

The deficiency exists if the design or the functioning of the control does not allow the management or some employees, in the normal course of their functions, to prevent or detect and correct misstatements in the FS in due time.

##### ⇒ Design deficiency

There is no control, or it was not well designed, or it was not well implemented

##### ⇒ Deficiency of functioning

Although it has been well formulated it is not working as expected (e.g., employees without skills)

## EXHIBIT 3.8

### Examples of Material Weaknesses in Internal Control Over Financial Reporting

#### Weaknesses in the Design of Controls

- Absence of appropriate segregation of duties over important processes
- Absence of appropriate reviews and approvals of transactions, accounting entries, or systems output
- Inadequate controls to safeguard assets
- Absence of controls to ensure that all items in a population are recorded
- Inadequate processes to develop significant estimates affecting the financial statements, for example, estimates for pensions, warranties, and other reserves
- Undue complexity in the design of the processing system that obfuscates an understanding of the system by key personnel
- Inadequate controls over access to computer systems, data, and files
- Inadequate controls over computer processing
- Inadequate controls built into computer processing

## EXHIBIT 3.8

### Examples of Material Weaknesses in Internal Control Over Financial Reporting

#### Weaknesses in the Operation of Controls

- Independent tests of controls at a division level indicate that the control activities are not working properly; for example, purchases have been made outside of the approved purchasing function
- Controls fail to prevent or detect significant misstatements of accounting information
- Misapplication of accounting principles
- Credit authorization processes overridden by the sales manager to achieve sales performance goals
- Reconciliations (a) not performed on a timely basis or (b) performed by someone independent of the underlying process
- Testing reveals evidence that accounting records have been manipulated or altered
- Evidence of misrepresentation by accounting personnel
- Computerized controls leading to items identified for nonprocessing systematically overridden by employees to process the transactions
- The completeness of a population, for example, prenumbered documents or reconciling items logged on to the computer with those processed, not accounted for on a regular basis

## 8. Audit Planning

### ✘ Knowledge of the internal control system

#### Control risk assessment process

##### → Significant Deficiency

Deficiency or combination of deficiencies in the IC which, in the auditor's judgment, is of sufficient importance to merit the attention of those in charge of governance

⇒ Importance depends on

- Effective occurrence of a misstatement
- Possibility that a misstatement will occur
- Potential magnitude

Significant deficiencies may exist even if no misstatement have been identified during work

## 8. Audit Planning

### ✘ Knowledge of the internal control system

📄 **Control risk** assessment process

→ Assessment method

Identify existing controls

Identify deficiencies in controls

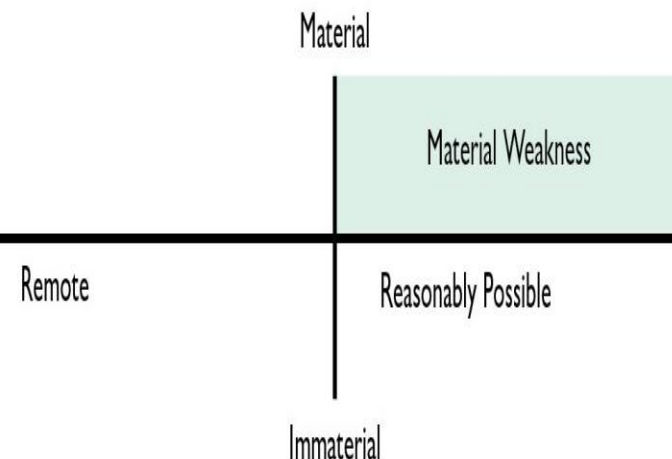
Identify compensatory controls

Decide whether it is a significant deficiency or material weakness

Determine the potential misstatements that may result

LIKELIHOOD

SIGNIFICANCE



## 8. Audit Planning

### ✘ Knowledge of the internal control system

#### 📄 Control risk assessment process

##### → Communication of the deficiencies of the ICS (ISA 265)

⇒ The auditor shall report in writing to the governance bodies (Management Board, Supervisory Board and control functions) in a timely manner on significant internal control weaknesses identified during the audit

⇒ The **auditor** should also **communicate** in a **timely manner** to the Management Board and Supervisory Board, at an appropriate level of responsibility:

- **In writing, significant deficiencies** in the **IC** that he has communicated or intends to communicate to the Governance Body, unless in the circumstances it is not appropriate (e.g. if he is faced with fraud practiced by the Management Board)
- Other deficiencies in the IC that he considers relevant



## 9. Additional audit procedures and misstatement evidence

### ✘ Overview

#### ✓ Objective

Obtain evidence that internal controls are in place and effective, and obtain sufficient and appropriate audit evidence as to whether there are material misstatements in the FS

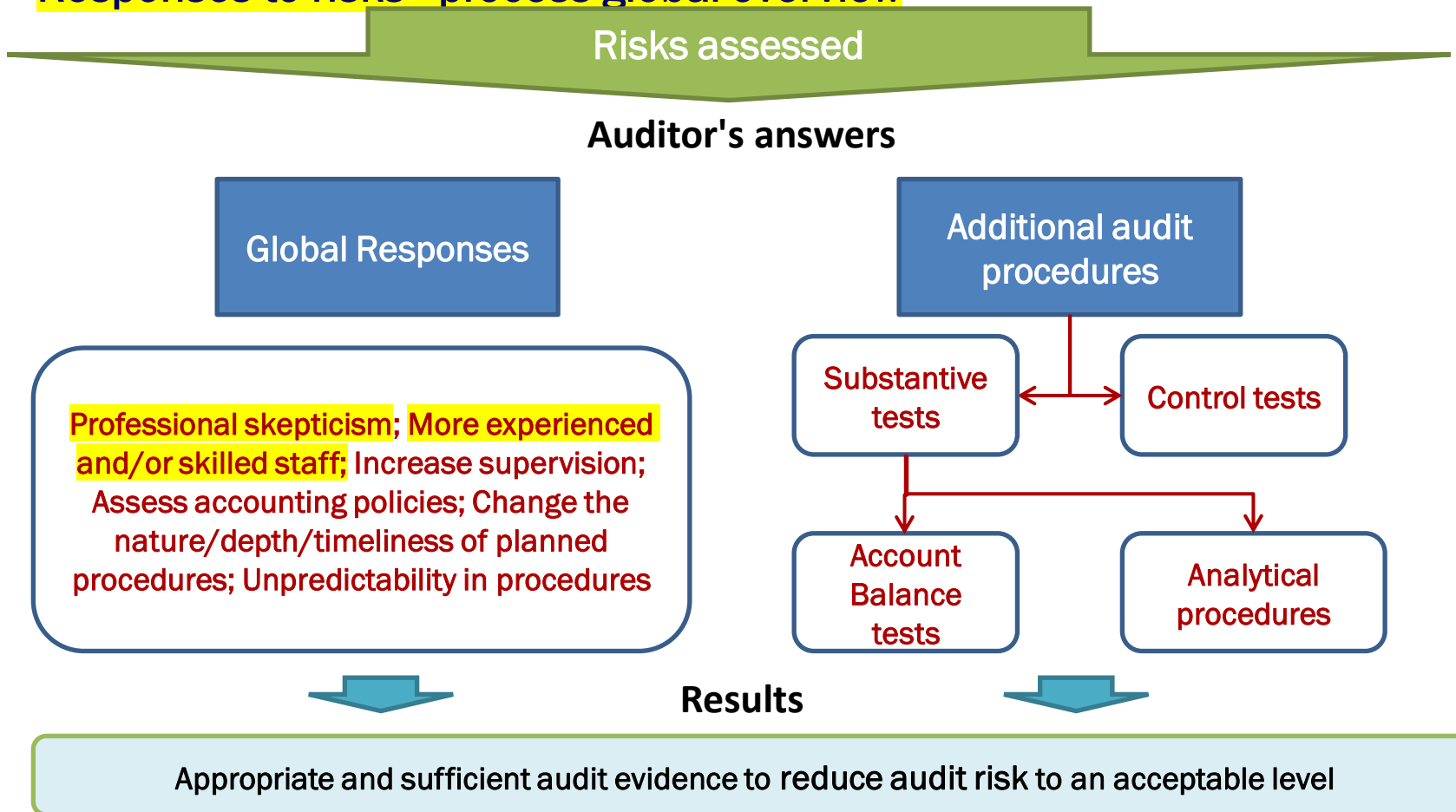
#### ✓ Procedures

- Control tests
- Substantive procedures for the content of transactions
- Substantive procedures to account balances
- Investigation of unregistered transactions



## 9. Additional audit procedures and misstatement evidence

### ✗ Responses to risks - process global overview



## 9. Additional audit procedures and misstatement evidence

### ✘ Matrix of material misstatement risk assessment (MMR)

Area	Assertion	IR	CR	MMR	Risk factors
FS	All	M	B	B	<p>The sector is in decline with the emergence of new technologies. But sales continue to hold and the company is investing in R&amp;D</p> <p>Management's attitude is quite positive about internal control.</p> <p>Governance structure is composed of family members.</p> <p>Exemption of controls is possible but new policies have been implemented to detect such situations.</p>
Sales	Completeness	E	B	M	<p>Management intends to minimize taxes.</p> <p>Recognition of sales has been inconsistent.</p>
Sales	Existence	M	B	B	Relevant internal controls have been identified.

## 9. Additional audit procedures and misstatement evidence

### ✘ Risk response plan - tests choice

#### Control tests – ISA 330.8

The auditor shall design and perform tests to the controls to obtain sufficient and appropriate audit evidence as to the operational effectiveness of the relevant controls if:

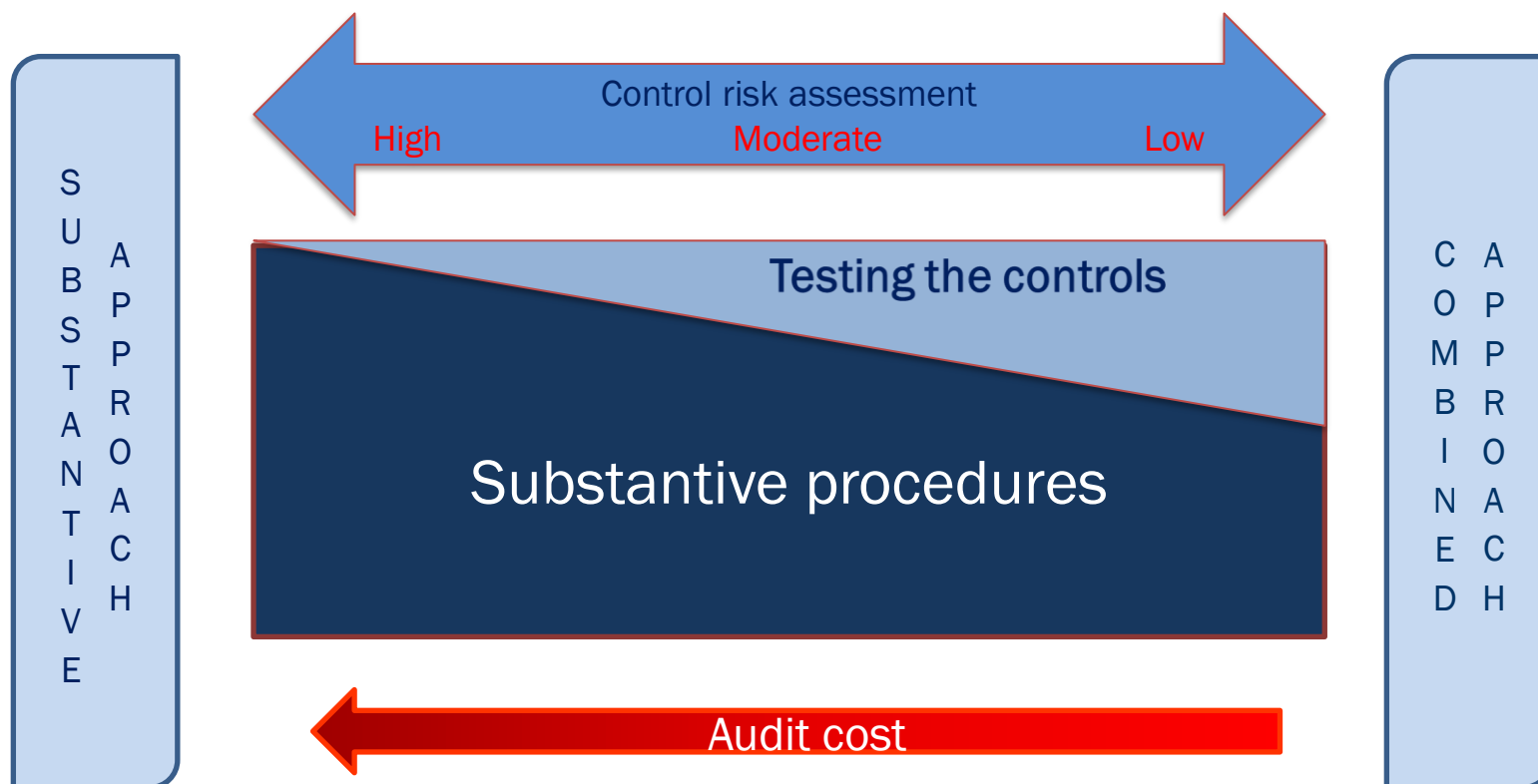
- Its assessment of the risks of material misstatement includes an expectation that the controls are operating effectively
- Substantive procedures alone cannot provide sufficient and appropriate audit evidence to the level of assertion

#### Substantive tests – ISA 330.18

Regardless of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each class of transaction, account balance and material disclosures

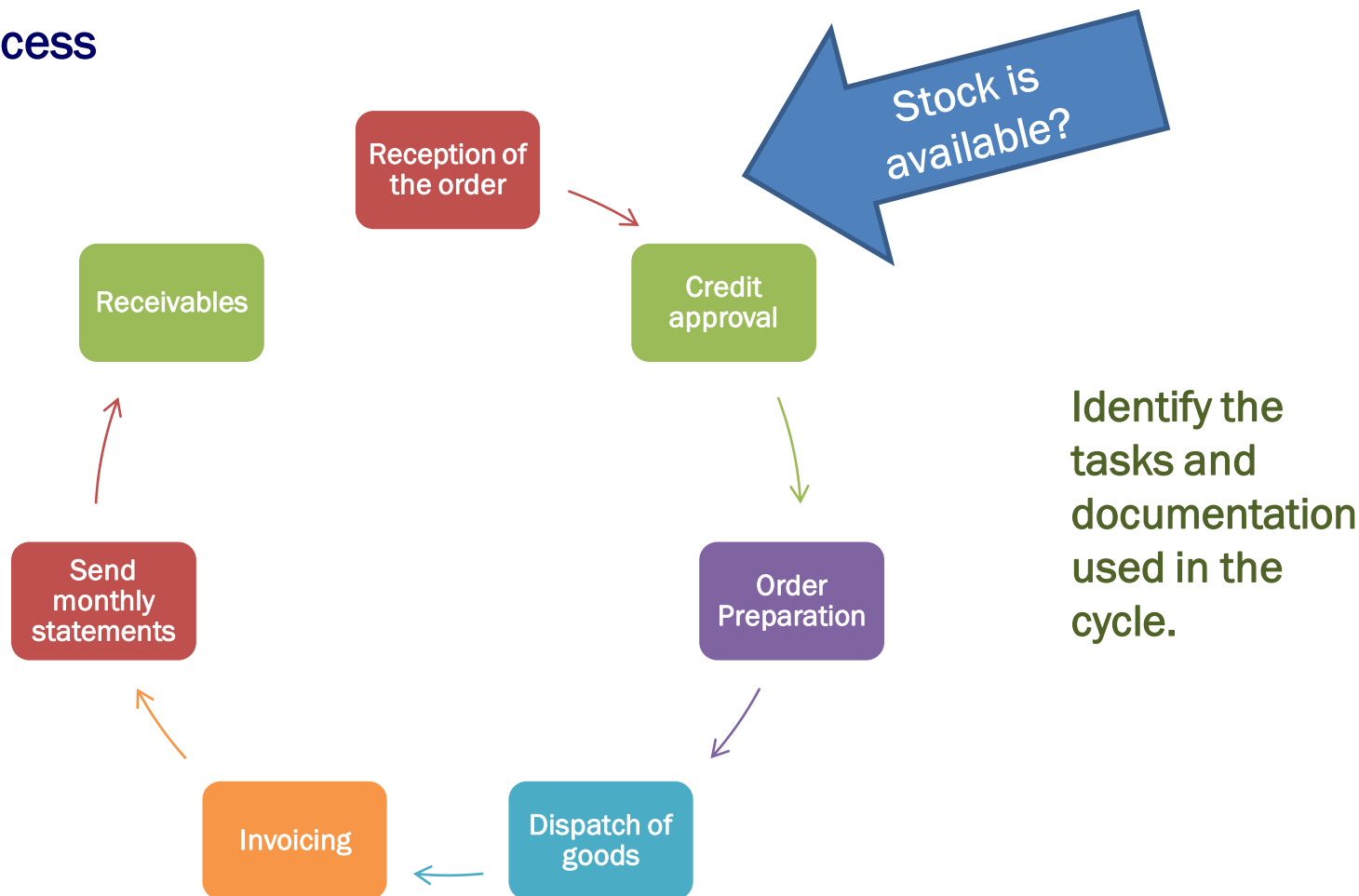
## 9. Additional audit procedures and misstatement evidence

### ✘ Risk response plan - tests choice



## 10. Auditing the sales cycle, accounts receivable

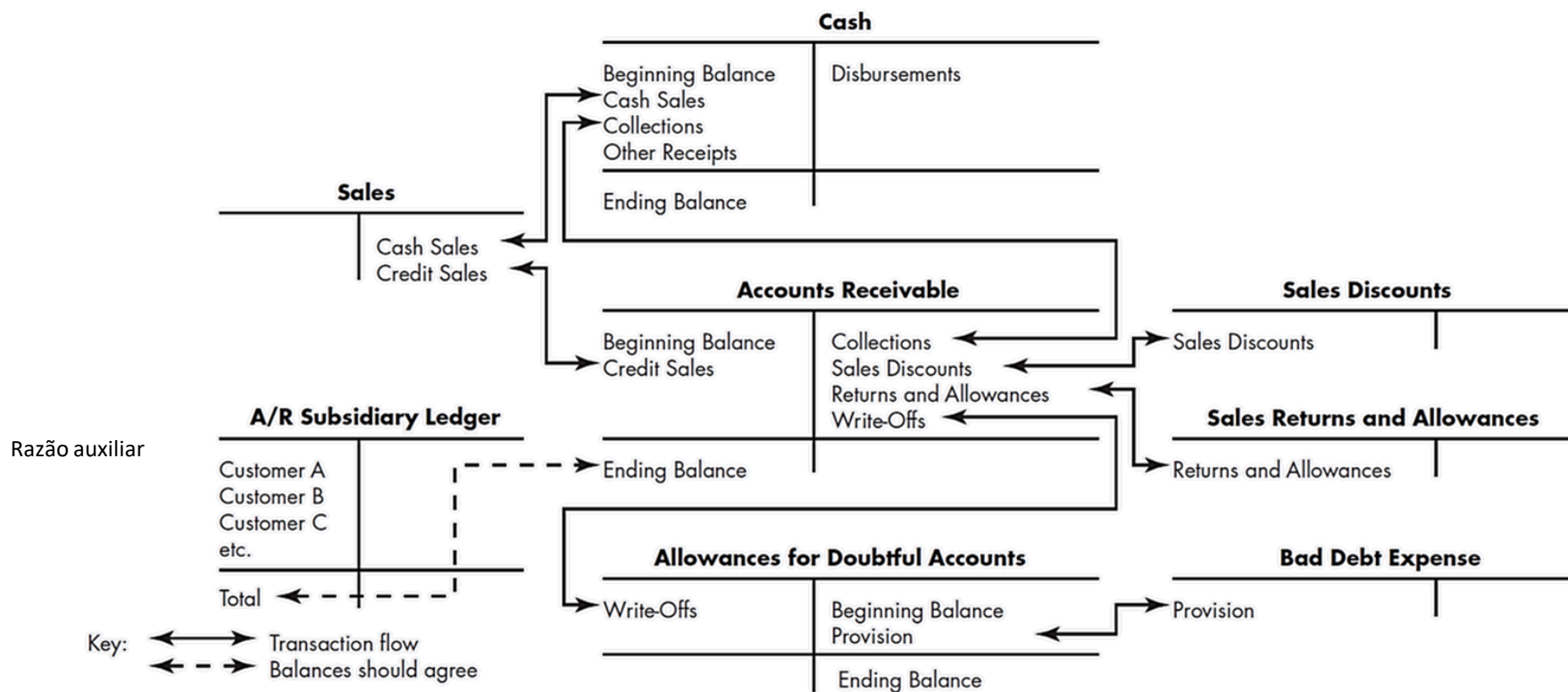
### ✘ Sales process



## 10. Auditing the sales cycle, accounts receivable

### ✘ Main accounts involved in the cycle

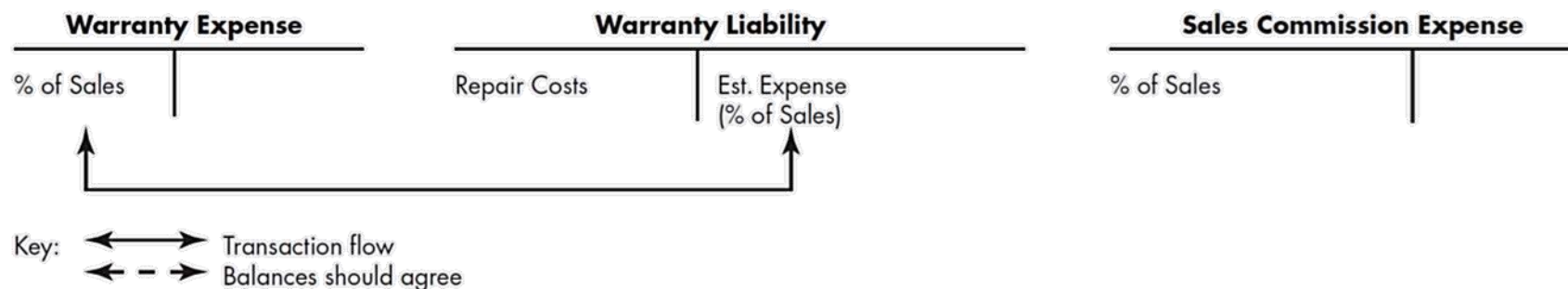
#### Directly Related Accounts



## 10. Auditing the sales cycle, accounts receivable

### ✘ Main accounts involved in the cycle

#### Indirectly Related Accounts



✓ What are the requirements of accounting standards (recognition, measurement and disclosure) on these accounts? (e.g. credit balances of clients, balances in foreign currency)

## 10. Auditing the sales cycle, accounts receivable

### ✘ Assessment of intrinsic risk

#### Risk factors:

- Sector and economy related (legislation, competitiveness, technology, substitute products, economic recession)
- Complexity and the litigious tendency in the recognition of revenue
  - ✓ Transfer of ownership and risk
  - ✓ Obligations arising after sale (e.g. technical assistance)
  - ✓ Client's right to return products
- Difficulty in auditing transactions and accounts (e.g. estimating impairments)
- Misstatements detected in previous years
- System of incentives for managers and employees
- Accounting is not centralized
- Auditor must assume that there is fraud in revenue recognition (ISA 240)
- Client balances are pledged (*penhorados*) or given as collateral to creditors
- Classification of credits according to the actual estimated time of receipt
- Collection is dependent on unpredictable contingent factors
- Sales to bad debtors (clientes incobráveis)



## 10. Auditing the sales cycle, accounts receivable

### ✘ Assessment of intrinsic risk

#### INTERNET SALES

Company B operates an Internet site from which it sells Company C's products. Customers place their orders for a product by selecting the product directly from the Internet site and providing a credit card number for the payment. Company B receives the order and authorization from the credit card company, and passes the order on to Company C. Company C ships the product directly to the customer. Company B does not take title to the product and has no risk of loss or other responsibility for the product. Company C is responsible for all product returns, defects, and disputed credit card charges. The product is typically sold for \$200, of which Company B receives \$30. If a credit card transaction is rejected, Company B loses its margin on the sale (i.e., the \$30).

#### Question

Should Company B recognize revenue of \$200 or \$30?

#### Answer

The SEC's position is that Company B should recognize only \$30. "In assessing whether revenue should be reported gross with separate display of cost of sales to arrive at gross profit or on a net basis, the staff considers whether the registrant:

1. Acts as principal in the transaction,
2. Takes title to the products,
3. Has risks and rewards of ownership, and
4. Acts as an agent or broker (including performing services, in substance, as an agent or broker) with compensation on a commission or fee basis."

Source: SEC Staff Accounting Bulletin: No. 101—Revenue Recognition in Financial Statements, December 3, 1999.

Source: Johnstone, K. M., Gramling, A. e Rittenberg, L. E., (2014), Auditing: a business risk approach, 9th edition, Cengage.

## 10. Auditing the sales cycle, accounts receivable

### ✘ Assessment of intrinsic risk

#### ✓ Methods used to intentionally misstate Sales cycle accounts

- ✦ Early recognition of sales
- ✦ Fictitious sales
- ✦ Unregistered sales
- ✦ Consignment sales recognized as final sales
- ✦ Returns and non-registered trade discounts
- ✦ Finishing percentage
- ✦ Transactions with related parties
- ✦ *Channel stuffing* (push sales to a distribution channel above its sale capacity)
- ✦ Omit contingent liabilities and expenses



## 10. Auditing the sales cycle, accounts receivable

### ✘ Identification and assessment of control risk

- ✓ The auditor needs to understand the controls that exist and are in place to deal with the **intrinsic** and **fraud risk** and that therefore can lead to material misstatements in the FS.
- ✓ To this end, the auditor considers

#### Global Controls

- Management commitment to integrity and other ethical values
- Culture of accountability in the execution of internal procedures
- Monitoring

#### Transaction-specific controls

- Multiplicity for the different phases of the cycle

## 10. Auditing the sales cycle, accounts receivable

### ✘ Identification and assessment of control risk

# Example of transaction-specific controls

- Monthly statements sent to clients, sales authorization, credit limit authorization, order form has an associated purchase order (occurrence/existence)
- Pre-numeration of documents, daily reconciliation between shipments and invoicing (plenitude)
- Conference between dispatched goods and ordered goods (occurrence/ plenitude)
- Approved price list, limitations on discounts, credit risk analysis (rigor/valuation)
- Delivery notes are followed daily by the invoicing department (cut)
- Use of accounts table (classification)
- Segregation of functions (e.g. occurrence, rigor)

## 10. Auditing the sales cycle, accounts receivable

### ✘ Preliminary analytical procedures

---

Gross margin

---

Average term of receivables

---

Weight of clients in current assets

---

Monthly evolution of sales and other accounts of this cycle

---

Percentage of returns and rebates against gross sales

---

Percentage of client impairments against gross sales

---

Seniority categories of balances as a percentage of client account

---

Percentage of unrecoverable clients Expenses in relation to the balance of clients or sales

---

## 10. Auditing the sales cycle, accounts receivable

### ✘ Response to material misstatement risks

Additional audit procedures include:

---

Control tests (possibly)

---

Substantive tests to the content of transactions

---

Substantive tests on account balances

---

Analytical procedures (possibly)

---

- ✓ The adequacy and sufficiency of the audit procedures to be performed vary depending on the assertion analyzed.

Questions???!!!



## 10. Auditing the sales cycle, accounts receivable

✘ Examples of substantive tests on classes of transactions and events and disclosures

Assertion	Nature of the test
Occurrence	For a sample of transactions recorded in the sales journal, follow the trail from the sales invoice -> delivery note -> client order
Completeness	Follow the trail for a sample of delivery notes -> sales invoice -> sales journal -> customer account ledger
Accuracy	Compare prices and other commercial conditions in a sample of invoices with the company's official price list or with the contracts signed with clients Read the notes in the Annex and other information to ensure that the information is accurate and properly presented by the appropriate values.
Cutoff	Compare the dates of a sample of invoices with the shipping dates and the dates of the record of the operations in the accounting Select some delivery notes just before the end of the year and develop the previous procedure
Classification	Examine a sample of invoices for the correct classification in the accounts
Presentation	The disclosures relating to the cycle have been disclosed and are understandable



## 10. Auditing the sales cycle, accounts receivable

### ✘ Examples of substantive tests to account balance assertions and disclosures

Assertion	Nature of the test
Existence	Request for external confirmation from some clients Checking the existence of high amount and long overdue balances
Completeness	Obtaining the seniority balance and third-party trial balances and checking if the totals cross with the customer account in the general ledger Select some customers and check if their balances are included in the third party and general trial balance
Accuracy, valuation and allocation	Request for external confirmation from some clients Examine whether the value of impairments to clients is appropriate Examine whether the balances expressed in foreign currency have been converted correctly Review some transactions with credit balances on client accounts Read the notes in the Annex and other information to ensure that the information is accurate and properly presented by the appropriate values.
Rights and obligations	Review of banks' responses to the request for external confirmation on the existence of any guarantee granted on accounts receivable. Inquire Management, reviewing all loan contracts and reviewing the Minutes of the Board of Directors meetings for any indication that the receivables have been pledged (penhorados), subject to factoring contracts. Determine whether these items require disclosure.
Classification	Review the third-party balance for material credits, non-current debts and non-commercial debts (other receivables). Determine whether such items require explanation in the Appendix.

## 10. Auditing the sales cycle, accounts receivable

### ✘ Evidence assessment

After performing the substantive tests, the auditor determines the amount of the probable misstatement (projected misstatement + sampling error) in accounts receivable and sales.

Probably the misstatement  
*is inferior to* materiality



Accept the account  
as fairly presented

Probably the misstatement  
*is superior to* materiality



Account is not fairly  
presented.

## 10. Additional audit procedures and misstatement evidence

### ✘ Example of an Audit Plan on Clients Accounts

Procedures	Assertions	WP ref.	Staff	Comments
<p>1. <b>Analytical procedures</b> Develop expectations for customer balances at the end of the year based on business knowledge. Investigate significant changes or trends in:</p> <ul style="list-style-type: none"> <li>• Client balance</li> <li>• Seniority of the balances</li> <li>• Days of sales in client accounts</li> <li>• Client credit balances</li> </ul>	<p>Completeness Occurrence Accuracy</p>	C.120	MAG	<p>Customer account increased 60% over the previous year. The average period of receivables went from 39 days to 45 days</p>
<p>2. <b>Listing</b> Obtain the detailed listing (and seniority) of the client account at the end of the year:</p> <ul style="list-style-type: none"> <li>• Check the arithmetic accuracy and agreement with the general ledger</li> <li>• Check the name and amount with the ledger of each client</li> <li>• Ask the Company's staff about: special clients, changed business conditions, <b>transactions with related parties</b>, waived (derrogados) credit limits</li> </ul>	<p>Occurrence  O + R</p>	C.110	MAG	<p>After interviews with Arjan and Karla, we obtained information that the commercial conditions of sales varied among the clients but this situation was approved by Arjan.</p>

## 10. Additional audit procedures and misstatement evidence

### ✘ Example of an Audit Plan on Clients Accounts

Procedures	Assertions	WP ref.	Staff	Comments
<p><b>3. Impairments for clients</b></p> <p>Ensure that client impairments are adequate:</p> <ul style="list-style-type: none"> <li>Review the balance sheet seniority and compare with the previous year</li> <li>Review subsequent payments made by clients (obtain seniority balance at the date of the fieldwork)</li> </ul>	<p>Completeness Valuation</p> <p>Accuracy/ valuation</p>	C.120	MAG	<p>Percentage of overdue balances over 60 days in the total customer balance increased compared to the previous year.</p> <p>Review the list of overdue debts with Arjan and get <b>details on provisions</b></p>
<p><b>4. Cutting operations</b></p> <p>Perform cutoff tests on sales, returns, credit notes, debit notes and receipts to the operations that occurred at the end of the year and the beginning of the following year.</p>	Cut-off	C.115	MAG	There were significant returns at the end of the year
<p><b>5. External confirmations</b></p> <ul style="list-style-type: none"> <li>Select 15 clients . For non-respondents perform <b>alternative procedures</b></li> <li>Use random sampling for the selection of balances</li> </ul>	<p>E/O Completeness Accuracy/ valuation</p>	C.130	MAG	We got a response rate of only 45%.

## 10. Auditing the sales cycle, accounts receivable

### ✘ Substantive tests on balances

#### ✓ External confirmation request

Type of confirmation: negative or positive

Main clients

Date: 31/12/N or 30/11/N

Confirmation procedures: text, control answers, analysis of exceptions

In the letter is referred the balance -> ask the client for the account statement (extrato de conta)

Reconciliation and investigation of differences

Execute procedures for non-responses

## 10. Auditing the sales cycle, accounts receivable

### ✘ External confirmation

(Date)

Subject: Balance confirmation

Dear Sirs,

Our Statutory Auditors, ....., with headquarters at ....., telephone ....., fax ..... and e-mail address ....., are auditing our financial statements and would like to obtain confirmations for the following balances existing in our books as of the date of .....

Balance at our favor:    xxxxxxx Euros

Balance at your favor:   xxxxxxx Euros

This request corresponds to an urgent need of our Auditors, so please send them a reply, with your agreement or repairs, if any, as soon as possible, using the fax or e-mail indicated above, (with a copy to us) ”.

Without any other subject, we would like to send you our best regards,

Signature

---

We confirm the above balance

We do not confirm the above balance

Observations: \_\_\_\_\_

\_\_\_\_\_

\_\_\_\_\_

Signature

## 11. Assessment and Audit Report

### ✘ Overview

✓ **Objective:** to conclude the audit, form an opinion based on the collected evidence and communicate the results

#### Completion of field work

- Subsequent review
- Reading of minutes of the various corporate bodies of the company
- Evidence on contingent assets and liabilities
- Declaration by the management board
- Analytical procedures

#### Assessment of conclusions

- Final assessment of materiality and audit risk
- Assessment of going concern risk
- Technical review of the FS
- Formulation of the opinion and drafting of the audit report
- Internal control over EPI Reports to be issued - art 80 EROC

#### Communication with the Client (ISA 260)

- Communication of the weak points of the ICS => see ISA 265
- Communication of detected acts of fraud to the competent body
- Delivery of the audit report

## 11. Assessment and Audit Report

### ✘ *Assessing the going concern assumption*

- ✓ When the going concern assumption is appropriate, it is assumed that the entity will be able to realize its assets and settle its liabilities within the scope of the normal activity of its activity => it is assumed that the entity has no intention or need to cease or significantly reduce its activity
- ✓ 2.2.1 SNC (DL 158/2009) requires management to make an assessment of an entity's ability to proceed in going concern.
- ✓ The auditor is responsible for obtaining sufficient and appropriate audit evidence about the adequacy of the management's use of the assumption of going concern in the preparation and presentation of the FS
- ✓ The statutory audit does not include a guarantee as to the future viability of the audited entity, nor as to the efficiency or effectiveness with which the management body conducted the activities of the audited entity - no. 5 art. 44 EROC.



## 11. Assessment and Audit Report

### ✘ Assessing the **going concern assumption**

✓ Facts that may indicate difficulties in the pursuit of the company's future activity – ISA 570

#### Financial

- Difficulties in debt repayment
- **Negative operating cash flows**
- Inability to pay creditors
- Adverse financial ratios

#### Operational

- **Loss of key managers** without replacement.
- Loss of a market, a privilege, a major license or the main supplier.
- Difficulties in working relationships or major supply disruptions.

#### Others

- Failure to comply with the company's articles of association
- Litigation whose consequences may lead to bankruptcy
- Legislative change that seriously affects the company

## 11. Assessment and Audit Report

### ✘ *Assessing the going concern assumption*

✓ Auditor has doubts about the company going concern

1

- Review management plans for future actions based on their assessment of going concern

2

- Collect appropriate and sufficient audit evidence to confirm or rule out whether or not there is material uncertainty through the execution of audit procedures deemed necessary, including consideration of the effect of any **management plans and other mitigating factors**; and

3

- Seek written management statements with respect to its plans for future action (ex. **Business Plans**).

## 11. Assessment and Audit Report

### ✘ *Assessing the going concern assumption*

#### ✓ Conclusions on going concern

- Taking into account the evidence obtained, **it is necessary to conclude whether there is material uncertainty** related to events or conditions that may place significant doubts on the ability of the entity to proceed on a going concern basis
- There is material uncertainty when the order of magnitude of its potential impact and probability of occurrence is such that its **disclosure is necessary for a proper understanding of the FS**

## 11. Assessment and Audit Report

### ✘ *Assessing the going concern assumption*

#### ✓ Conclusions on going concern

⇒ Going concern assumption is being used correctly but there is a material uncertainty

- If proper disclosure is made in the FS, the auditor shall express an **unmodified opinion** and **include a Material Uncertainty Section Regarding Going Concern** in his report to:
  - ✓ To point out the existence of this material uncertainty
  - ✓ Draw attention to the note in the FS that discloses the fact
- If adequate disclosure is **not** made in the FS, the auditor must express a **qualified opinion or an adverse opinion** (ISA 705)
- If there are multiple material uncertainties that are significant for the FS as a whole, a **disclaimer opinion** can be expressed.

## 11. Assessment and Audit Report

### ✘ *Assessing the going concern assumption*

#### ✓ Conclusions on going concern

⇒ Assumption of continuity is **NOT being used correctly**

- If the FS are prepared on a going concern basis but the use of this assumption is not appropriate, the auditor should express an **adverse opinion**
- If accounts are prepared on a **liquidation basis**, an **unmodified opinion** on the FS may be expressed, provided they include adequate disclosure, and an **Emphasis paragraph** should be included to draw readers' attention to that alternative basis and the reasons for its use

## 12. Assessment and Audit Report

### ✘ **Assessment of misstatements** identified in the audit

✓ ISA 450 requires that the auditor

⇒ Accumulate the misstatements detected in the financial statements

❖ Factual misstatements

❖ Judgment misstatements

❖ Projected misstatements (resulting from the process of extrapolation of the sample results to the population)

⇒ Examine the effect of uncorrected misstatements (including from the previous year): are they material?

⇒ Report the misstatements and assess if they have been corrected

⇒ Document the conclusions about the misstatements

## 12. Assessment and Audit Report

### ✘ Assessment of misstatements identified in the audit

Description	Circumstances of Occurrence	WP Ref.	Amount of Over (Under) Statement				Corrected?
			Assets	Liabilities	Pre-tax Income	Equity	
<i>Errors in inventory valuation calculation.</i>	<i>New clerk made some mistakes.</i>	<i>D.300</i>	<i>(19,000)</i>		<i>(19,000)</i>	<i>(15,200)</i>	<i>Yes</i>
<i>Personal expenses paid through Dephta and not added to shareholder account.</i>	<i>Found during expense testing. This prompted some additional work to find similar items.</i>	<i>550.8</i>		<i>(4,800)</i>	<i>(4,800)</i>	<i>(3840)</i>	<i>Yes</i>
<i>Customer account over 90 days and no subsequent payments received.</i>	<i>Review of aging and subsequent payments.</i>	<i>C.305</i>	<i>12,000</i>		<i>12,000</i>	<i>9,600</i>	<i>Yes</i>
Total of identified misstatements during the audit			<i>(7,000)</i>	<i>(4,800)</i>	<i>(11,800)</i>	<i>(9,440)</i>	
Misstatements corrected by management			<i>(7,000)</i>	<i>(4,800)</i>	<i>(11,800)</i>	<i>(9,440)</i>	
Total uncorrected misstatements			<i>0</i>	<i>0</i>	<i>0</i>	<i>0</i>	



*“I’m not telling you it’s going to be easy. I’m telling you it’s going to be worth it!”*

**Art Williams**