INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF UGANDA

EXTERNAL AUDIT MANUAL

PART II

APPENDIX

2011

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ABOUT ICPAU

The Institute of Certified Public Accountants of Uganda (ICPAU) was established in 1992 by The Accountants Act, Cap 266. The functions of the Institute, as prescribed by the Act, are to regulate and maintain the standard of accountancy in Uganda and to prescribe or regulate the conduct of accountants in Uganda. Under its legal mandate, the Institute prescribes professional standards to be applied in the preparation and auditing of financial reports in Uganda.

Vision

To be a world class professional accountancy institute.

Mission

To develop and promote the accountancy profession in Uganda and beyond.

Core Values

1) Professional Excellence.
2) Integrity.
3) Commitment.
4) Good Governance.
5) Social Responsiveness.

International Affiliations

The Institute is a member of the International Federation of Accountants (IFAC), the Eastern Central and Southern African Federation of Accountants (ECSAFA) and the Pan African Federation of Accountants (PAFA).

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APPENDIX 1: ANNUAL INDEPENDENCE CONFIRMATION

Objective: To obtain reasonable assurance that all partners and staff required to be independent by the Code of Ethics have complied with the firm's policies and procedures on independence.

	YES/NO
1. Do you or any members of your family (spouse or equivalent, dependents, parents, non dependent child or siblings) have a family or personal relationship with directors or employees in positions of influence in the firm's clients?	
2. Do you or any member of your family (spouse or equivalent, dependents, parents, non dependent child or siblings) have a dire to financial interest or material indirect financial interest or material indirect financial interest in any of the firm's clients?	
3. Do you or any member of your family (spouse or equivalent, dependents, parents, non- dependent child or siblings) hold shares on trust for any of the firm's clients?	
4. Have you or any member of your family (spouse or equivalent, dependents' parents, non dependent child or siblings received any financial support or any benefit from any of the firm's clients? N.B: this includes loans, grants, gifts of significant value, any other financial support, either directly or indirectly.	
5. Are you aware of any conflicts of interest that an engagement may create with any of the film's existing clients?	
6. Do you provide any services to any of the firm's clients directly or indirectly through your family (spouse or equivalent, dependents, parents, non- dependent child or siblings) or other business associates?	
7. Do you have any potential employment with, or have you been employed in the last two years by any of the firm's clients?	
If the answer to any of the above question is yes, or if you are aware of any other threat to your independence, provide full details including the client names in the space below or as an attachment	

I confirm that I and my family (spouse or equivalent, dependents, parents, non- dependent child or siblings) have except where noted above, complied with all requirements of the firm's independence policies and that the above details are correct to the best of my knowledge and based on the information I have to the date of this declaration. I undertake to keep the firm fully informed of any changes, within a week of them arising. I also acknowledge that I am fully aware that the firm has the right to take disciplinary and other appropriate action if any of the declaration above turns out to be false.

Name:______________________ Signature:__________________ Date:_____________

APPENDIX 2: CURRENT AUDIT FILE INDEX

Client: ____

Period ended: ____

1. Financial Statements and Reports (Final)

1.01. Signed financial statement
1.02. Management letter with client comments
1.03. Signed letter of representation

2. Financial Statements and Reports

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2.02. Management letter
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2.04. Other information to be issued with financial statements.

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3.14. Summary of unadjusted errors
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5.06. Analytical review conclusion
5.07. Analytical review working papers
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H.02 Audit programme
H.03 Working papers
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H.04 Test controls

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K.02 Lead schedule – finance leases
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K.05 Working papers
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M.023 Tax account
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O.03 Audit programme
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Q.02 Lead schedule – capital commitments
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APPENDIX 3: PERMANENT AUDIT FILE INDEX

Client: ____

Period ended: ____

1. General Information

1.1 Address (physical, postal, telephone, fax, e mail) and branch network
1.2 Organisation chart and details of principal contacts
1.3 Principal and secondary activities and nature of income streams
1.4 Market standing and relevant industry statistics and benchmarks
1.5 Professional advisers
1.6 Related party information
1.7 Knowledge of client's business and documentation of the internal control
1.8 Understanding the client's governance and internal audit functions
1.9 Summary of key accounting policies
1.10 Copies of management letters

2. Memorandum and Articles of Association, Other legal Documents

3. Statutory and other Information

3.1 Brief history of the business
3.2 Capital structure, employee share schemes, substantial shareholders, history of reserves
3.3 Accounting reference date, certificate of incorporation business name, registered office company secretary
3.4 Copy of register of charges, debentures and trust deeds
3.5 Extracts of minutes of continuing importance
3.6 Correspondence of continuing importance

4. Audit Information

4.1 Engagement letter and subsequent written instructions
4.2 Client acceptance questionnaire
4.3 Letter(s) of authority to bankers/ other third parties
4.4 Bank mandates and specimen

5. Legal Agreements

5.1 Property titles
5.2 Assets leased to third parties (including hire purchase)
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5.5 Directors' service agreements
5.6 Guarantees, indemnities and other contingent liabilities.
5.7 Pension fund deeds and rules
5.8 Other contracts and agreements

6. Group Information

6.1 Brief history of the development of the group
6.2 Group structure (details of holding company , subsidiaries and associates)
6.3 Details of group auditors
6.4 Nominee shareholdings / letters of trust
6.5 Permanent consolidation adjustments
6.6 Group accounting / auditing requirements

APPENDIX 4: SPECIMEN AUDIT ENGAGEMENT LETTER

Date ____________________________________

The Directors,

______________________________________**Ltd**

P.0. Box__________________________________

Dear Sirs,

RE: SPECIMEN AUDIT ENGAGEMENT LETTER

Following our appointment as auditors of the company, we set out here below the basis on which *we* are to act as the auditors of ______________________ Ltd and the respective areas of responsibility of the directors and of ourselves.

Respective responsibilities of directors and auditors

1. As directors of the company, you are responsible for maintaining accounting records, for the selection and application of appropriate accounting policies and for preparing financial statements in conformity with International Financial Reporting Standards and the requirements of the Companies Act which give a true and fair view of the state of the financial affairs of the company. You are also responsible for making available to us, as and when required, all the company's accounting and other records and information including minutes of all management, directors' and shareholders' meetings and information and explanations which we consider necessary for the performance of our duties as auditors. We are also entitled to attend all general meetings of the company and to receive notices of all such meetings.

2. We have a statutory responsibility to report to the members of the company whether in our opinion the financial statements give a true and fair view and have been prepared in accordance with the Companies Act In arriving at our opinion, we shall consider the following matters and report on:

   a) Whether proper books of account have been kept by the company;
   b) Whether the balance sheet, profit and loss account and the cash flow statement are in agreement with the books of account;
   c) Whether we have obtained all the information and explanations; which to the best of our knowledge and belief were necessary for the purposes of our audit.

3. We also have a professional responsibility to report if the financial statements have been prepared in conformity with International Financial Reporting Standards. We have to report on all areas of non-compliance and give our opinion as to whether we concur or not with any departures.

   In determining whether or not the departure is justified, we shall consider:

   a) Whether the departure is required in order for the financial statements to give a true and fair view; and.

b) Whether adequate disclosure has been made concerning the departure.

4. Our professional responsibility also extends to considering whether other information in documents containing the audited financial statements is consistent with those financial statements.

5. Assistance with the preparation of financial statements does not form part of the audit. We shall however, during the course of our audit, discuss the company's accounting policies with the directors and management particularly in any problem areas and we may propose adjusting entries for your consideration. The directors will be responsible for reviewing and passing of all such proposed adjustments.

6. The audit will be coordinated by one of our partners. In providing audit services, we will obtain both formal and informal consultations involving other partners and staff in order that the advice we give represents the breath of knowledge and collective experience of our firm. We may also seek independent professional advice or involve a specialist as part of our engagement team.

7. We require strict adherence of all our partners, staff and specialists on our team to the ethical rules of our profession. Therefore, in all respects of our practice, we maintain strict confidentiality towards information obtained while carrying out our professional duties. In addition, the firm's partners, staff and specialists maintain complete independence and mental attitude in relationships with clients.

8. Where the firm and \ or its associates offer other services to the company, we shall not be treated as having note, for the purposes of our audit, of information provided to the firm, its associates and members of staff other than those engaged on the audit.

9. The company may identify in writing those directors and staff who are authorised to act on behalf of your company on audit issues. In absence of any such identification by the company, we will assume that any of the directors or key management staff are so authorised.

10. The company may identify in writing those persons charged with governance with whom audit matters of governance will be communicated. In absence of any such identification, we will determine the appropriate level of communication based on the nature'-of the issue to be communicated.

11. It is fundamental to our engagement that the company provides us in good time all information and supporting documentation that is relevant to the audit, and that all matters of uncertainty are brought to our attention.

Scope of audit

12. Our audit will be conducted in accordance with International Standards on Auditing and will include such tests of controls, transactions and of the existence, ownership and valuation of assets and liabilities, as we consider necessary. We shall obtain an understanding of the accounting and internal financial control systems to the extent necessary in order to consider their suitability as a basis for the preparation of the financial statements and to establish whether adequate accounting records have been maintained by the company.

We shall expect to obtain such appropriate evidence as we consider sufficient to enable us to draw reasonable conclusions there from. The nature and extent of our procedures will vary according to our assessment of the control environment, the company's system of internal controls and of the accounting system.

Our work may be varied on the basis of our findings during the course of an audit and from year to year. Accordingly, we may modify our audit scope, rotate our audit emphasis and propose matters of special audit emphasis, as the circumstances dictate.

As our responsibility is to report on the financial statements as a whole rather than those of the individual units or divisions, the nature and extent of our tests and enquiries at each unit or division will vary according to our assessment of the accounting system and internal financial controls. Thus, we may carry out limited work at certain units or divisions, rather than the full audit that would be necessary if we were to report on the separate accounts of the unit or division concerned.

Our audit includes assessing the significant estimates and judgments made by the directors in the preparation of the financial statements and whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

In forming our opinion, we will also evaluate the overall presentation of information in the financial statements.

Management representations

13. As part of our normal audit procedures, we shall request appropriate directors or management to confirm to us in writing each year matters material to the financial statements when other sufficient appropriate audit evidence cannot be reasonably expected to exist. We may also ask them to confirm in that letter that all important and relevant information has been brought to our attention.

Detection of fraud, error and non-compliance with laws and regulations

14. The directors are responsible for safeguarding the assets of the company, the maintenance of adequate internal financial and operating controls, and the prevention and detection of fraud, error and non-compliance with law or regulations. We shall maintain an attitude of professional scepticism recognising that material misstatements and fraud could exist notwithstanding our past experience. However, because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any accounting and internal control systems, there is an unavoidable risk that some material misstatements and frauds may remain undiscovered.

Reports to management

15. An audit is not designed to identify all significant weaknesses in the company's system of internal financial controls. However, where we consider it appropriate, we shall report to the management following our audit those significant weaknesses in the financial internal control systems or other business matters which come to our notice during the course of our normal audit work and which, in our view, require management's attention.

Our review of internal financial control systems is only performed to the extent required to express an opinion on the company's financial statements and therefore our comments on these systems should not necessarily be regarded as a comprehensive list of all possible improvements to financial internal controls or to operational procedures, which a more extensive review might reveal. Moreover, such reports form part of a continuing dialogue between us therefore it is not intended to include every matter that comes to our attention.

The report is in addition to, over and above our legal responsibilities as auditors and will be prepared for use exclusively within your organisation. The report may not be provided to any third party without our prior written consent. Such consent will be granted only on the basis that such reports are not prepared with the interests of anyone other than the company in mind and that we accept no duty or responsibility to any other party.

Information published with financial statements

16. In order to assist us with the examination of other information to be published with the financial statements, we require early sight of all documents or statements including the directors' report, chairman's statement and operating, financial and other information which is to be published with the financial statements. We will need to satisfy ourselves that the information is consistent with the audited financial statements.

If the company intends to publish or reproduce in printed form or electronically our report together with the financial statements or otherwise make reference to our firm in a document that contains other information, the company hereby agrees to:

a) Provide us with copies of all such information to be published with the financial statements; and
b) Obtain our approval in writing for inclusion of our report before the document is finalised and distributed. Where our audit report is reproduced in any medium, the complete financial statements including notes must also be presented or a note to the effect that the information is only an extract consistent with the financial statements and that the complete set of the financial statements is available for inspection.

Responsibility of auditors after issue of the audit report

17. Once we have issued our report, we have no further direct responsibility in relation to the financial statements for that financial year. However, we expect that the directors will inform us of any material event thereafter, which have an effect on the financial statements.

Reliance in the audit by third parties

18. Our audit opinion is addressed to the shareholders of the company in their capacity as shareholders. The audit will not be planned or conducted in contemplation of reliance by any third party or with respect to any specific transaction. Therefore, items of possible interest to a third party will not be specifically addressed and matters may exist that would be assessed differently by a third party, possibly in connection with a specific transaction.

Working papers and ownership rights

19. The working papers and files for this engagement created by us including electronic documents and files are the sole property of the firm. Where we provide the company documentation or information during the course of our work, the ownership rights will be adhered to by the company.

20. Where we are required by legislation, or by the by-laws or professional guidelines issued by professional bodies that our partners and directors are members of and by our international affiliates to give access to our audit working papers to certain third parties for quality control reviews, we will avail the working papers to such parties without seeking the company's consent.

Internet communication

21. During the engagement, we may from time to time communicate with the company electronically. However, the electronic transmission of information cannot be guaranteed to be secure, error free or virus free and such information could be intercepted corrupted, lost, destroyed, arrive late or incomplete or otherwise be adversely affected or unsafe for use. We shall not have any liability of whatsoever nature to the company arising from or in connection with electronic transfer of communication and information to the company.

Fees

22. Our fees are based on the time spent on the engagement, the degree of responsibility involved and the category of staff involved and charged exclusive of Value Added Tax and disbursements.

23. The fees will be subject to an annual review and will vary with a number of factors, including developments in the business. It is our practice to provide estimates of our fees in advance of the work commencing. We shall require progress payments as our work progresses. Audit fees are payable on rendering of our fee note.

    We reserve the right to charge compounded service charge monthly effective from the month following the one in which the fee note is submitted. The rate of service charge will be 2% per month.

24. We shall have lien over the company's records for any unpaid fees and shall pass on to the company any costs and expenses incurred in the recovery of overdue fees and service charge.

Indemnity

25. The company will indemnify us and keep us fully and effectively indemnified at all times against any action against us or any costs or expenses incurred or any loss suffered by us as a result of acting for the company in good faith based on the information supplied by the company to us.

Terms of engagement

26. This letter supersedes any existing previous, express or inferred terms of engagement that the company had with us and shall remain effective until it is replaced or terminated. The engagement may be terminated by either party. Any termination of our appointment by the company will require a formal resolution at a validly convened shareholders meeting or resolution signed by all the shareholders.

27. If any of the terms of this engagement letter shall be found by any court or administrative body of competent jurisdiction to be invalid or unenforceable, the invalidity or enforceability of such provision shall not affect the other provisions of this letter of engagement and all provisions not affected by such invalidity or unenforceability shall remain in full force and effect. The parties hereby agree to attempt to substitute for any invalid or unenforceable provision as valid or enforceable provision, which achieves to the greatest extent possible the objectives of the invalid or unenforceable provision.

Applicable law

28. This engagement letter shall be governed by, and construed in accordance with the Laws of Uganda

Arbitration

29. The parties hereto will make every reasonable effort to settle amicably between themselves any disputes or differences arising out of this engagement. In the event of their being unable to settle such disputes or differences, they will refer this to arbitration of a person to be agreed between the parties hereto. The decision of the arbitrator will be final and binding on both parties.

Acknowledgement, acceptance and termination

30. The engagement will be confirmed upon signing the letter in the space provided and initialling all the pages of the letter and returning it to us.

Yours faithfully,

……………………………………………………………………………………...

Certified Public Accountants

ACKNOWLEDGEMENT AND ACCEPTANCE

We have reviewed paragraphs 1 to 30 of the engagement letter and agree to the terms and conditions therein.

For and on behalf of: ____ Ltd.

____

Signature **Signature**

____

Director's Name **Director's Name**

____

Date **Date**

APPENDIX 5: MATTERS THAT AN AUDITOR MAY CONSIDER IN DEVELOPING AN AUDIT STRATEGY

Characteristics of the Engagement

- The financial reporting framework on which the financial information to be audited has been prepared, including any need for reconciliations to another financial reporting framework.
- Industry-specific reporting requirements such as reports mandated by industry regulators.
- The expected audit coverage, including the number and locations of components to be included.
- The nature of the control relationships between a parent and its components that determine how the group is to be consolidated.
- The extent to which components are audited by other auditors.
- The nature of the business segments to be audited, including the need for specialized knowledge.
- The reporting currency to be used, including any need for currency translation for the financial information audited.
- The need for a statutory audit of standalone financial statements in addition to an audit for consolidation purposes.
- The availability of the work of internal auditors and the extent of the auditor's potential reliance on such work.
- The entity's use of service organizations and how the auditor may obtain evidence concerning the design or operation of controls performed by them.
- The expected use of audit evidence obtained in previous audits, for example, audit evidence related to risk assessment procedures and tests of controls.
- The effect of information technology on the audit procedures, including the availability of data and the expected use of computer-assisted audit techniques.
- The coordination of the expected coverage and timing of the audit work with any reviews of interim financial information and the effect on the audit of the information obtained during such reviews.
- The availability of client personnel and data.

Reporting Objectives, Timing of the Audit, and Nature of Communications

- The entity's timetable for reporting, such as at interim and final stages.
- The organization of meetings with management and those charged with governance to discuss the nature, timing and extent of the audit work.
- The discussion with management and those charged with governance regarding the expected type and timing of reports to be issued and other communications, both written and oral, including the auditor's report, management letters and communications to those charged with governance.
- The discussion with management regarding the expected communications on the status of audit work throughout the engagement.
- Communication with auditors of components regarding the expected types and timing of reports to be issued and other communications in connection with the audit of components.
- The expected nature and timing of communications among engagement team members, including the nature and timing of team meetings and timing of the review of work performed.

- Whether there are any other expected communications with third parties, including any statutory or contractual reporting responsibilities arising from the audit.

Significant Factors, Preliminary Engagement Activities, and Knowledge Gained on Other Engagements

- The determination of materiality in accordance with ISA 320 and, where applicable:
    - The determination of materiality for components and communication thereof to component auditors in accordance with ISA 600:
    - The preliminary identification of significant components and material classes of transactions, account balances and disclosures.
- Preliminary identification of areas where there may be a higher risk of material misstatement.
- The impact of the assessed risk of material misstatement at the overall financial statement The manner in which the auditor emphasizes to engagement team members the need to maintain a questioning mind and to exercise professional scepticism in gathering and evaluating audit evidence.
- Results of previous audits that involved evaluating the operating effectiveness of internal control, including the nature of identified deficiencies and action taken to address them.
- The discussion of matters that may affect the audit with firm personnel responsible for performing other services to the entity.
- Evidence of management's commitment to the design, implementation and maintenance of sound internal control, including evidence of appropriate documentation of such internal control.
- Volume of transactions, which may determine whether it is more efficient for the auditor to rely on internal control.
- Importance attached to internal control throughout the entity to the successful operation of the business.
- Significant business developments affecting the entity, including changes in information technology and business processes, changes in key management, and acquisitions, mergers and divestments.
- Significant industry developments such as changes in industry regulations and new reporting requirements.
- Significant changes in the financial reporting framework, such as changes in accounting standards.
- Other significant relevant developments, such as changes in the legal environment affecting the entity.

Nature, Timing and Extent of Resources

- The selection of the engagement team (including, where necessary, the engagement quality control reviewer) and the assignment of audit work to the team members, including the assignment of appropriately experienced team members to areas where there may be higher risks of material misstatement.
- Engagement budgeting, including considering the appropriate amount of time to set aside for areas where there may be higher risks of material misstatement.

APPENDIX 6: CONTENTS OF THE AUDIT PLAN

A. Preliminary Analytical Review

Review of key business ratios, trends and other financial information available at this stage as a risk assessment procedure to obtain an understanding of the entity and its environment.

B. Preliminary Risk Assessment

A preliminary review of overall risk and key risks in individual audit areas and their impact on the audit taking into account:

- Past experience.
- Areas large in materiality.
- Changes in financial reporting standards and accounting policies.
- Areas where there is a significant risk of material misstatement or fraud.
- Complex accounting areas including those involving accounting estimates.
- The impact of information technology.
- Conditions requiring special attention, such as the existence of related party transactions, contingencies, market and industry conditions.
- Any taxation aspects which may affect the audit.
- Appropriateness of the going concern assumption.

C. Sources of Reliance

D. Materiality

Details of the materiality level chosen and the reason for choosing it.

E. Auditor's Response to Assessed Risk

This will include the risks identified for each key audit area above and the planned response to such risks including the use of specialised audit tools including Computer Assisted Audit Techniques (CAATs).

F. Sampling Techniques

The sampling techniques to be adopted.

G. Audit Timetable and Requirements

- Determination and communication of the accounting work and audit schedules that will be prepared by the client and by the auditor.
- Consideration of independence requirements where accounting and tax work is carried by the auditor.
- Overall audit timetable including:
  - Client and legal reporting deadlines.
  - Availability of accounting records for audit commencement.
  - Year-end procedures.
  - Audit needs at different client locations.
- Time and cost budgets.

APPENDIX 7: RISK FACTORS RELATING TO MISSTATEMENTS ARISING FROM FRAUDULENT FINANCIAL REPORTING

Although the fraud risk factors given here cover a broad range of situations, they are only examples and, accordingly, the auditor may identify additional or different risk factors. The order of the examples provided does not reflect their relative importance or frequency of occurrence.

Incentives / Pressures

- Financial stability or profitability is threatened by economic, industry, or entity operating conditions such as:
  - High degree of competition or market saturation, accompanied by declining margins.
  - High vulnerability to rapid changes, such as changes in technology, product obsolescence, or interest rates.
  - Significant declines in customer demand and increasing business failures either within the industry or overall economy.
  - Operating losses making the threat of bankruptcy, foreclosure, or hostile takeover imminent.
  - Recurring negative cash flows from operations or an inability to generate cash flows from operations while reporting earnings and earnings growth.
  - Rapid growth or unusual profitability especially compared to that of other companies in the same industry.
  - New accounting, statutory, or regulatory requirements.

- Excessive pressure on management to meet the requirements or expectations of third parties due to the following:
  - Unduly aggressive or unrealistic profitability or trend level expectations of investment analysts, institutional investors, significant creditors, or other external parties, including expectations created by management in, for example, overly optimistic press releases or annual report messages.
  - Need to obtain additional debt or equity financing to stay competitive, including financing of major research and development or capital expenditures.
  - Marginal ability to meet exchange listing requirements or debt repayment or other debt covenant requirements.
  - Perceived or real adverse effects of reporting poor financial results on significant pending transactions, such as business combinations or contract awards.

- Information available indicates that the personal financial situation of management or those charged with governance is threatened by the entity's financial performance arising from:
  - Significant financial interests in the entity.
  - Significant portions of their compensation (for example, bonuses) being contingent upon achieving aggressive targets for share price, operating results, financial position, or cash flow.
  - Personal guarantees of debts of the company.

- Excessive pressure on management or operating personnel to meet financial targets established by those charged with governance, including sales or profitability incentive goals

Opportunities

- The nature of the industry or the entity's operations e.g.:

  - Significant related party transactions not in the ordinary course of business or with related entities that are not audited or are audited by another firm.
  - A strong financial presence or the ability to dominate a certain industry sector that allows the entity to dictate terms or conditions to suppliers or customers that may result in inappropriate or non-arm's length transactions.
  - Assets, liabilities, revenues, or expenses based on significant estimates involving subjective judgments or uncertainties that are difficult to corroborate.
  - Significant, unusual, or highly complex transactions, especially those close to the period end that raise difficult 'substance over form' questions.
  - Significant operations located or conducted across international borders in jurisdictions where differing business environments and cultures exist.
  - Use of business intermediaries for which there appears to be no clear business justification.
  - Significant bank accounts or subsidiary or branch operations in tax haven jurisdictions for which there appears to be no clear business justification.

- Ineffective monitoring of management as a result of:

  - Domination of management by a singe person or small group without compensating controls.
  - Ineffective oversight by those charged with governance over the financial reporting process and internal control.

- Complex or unstable organisational structure, as evidenced by:

  - Difficulty in determining the organisation or individuals that have controlling interest in the entity.
  - Overly complex organisational structure involving unusual legal entities or managerial lines of authority.
  - High turnover of senior management, legal counsel, or those charged with governance.

- Internal control components are deficient as a result of:

  - Inadequate monitoring of controls, including automated controls and controls over interim financial reporting (where external reporting is required).
  - High turnover rates or employment of ineffective accounting, internal audit, or information technology staff.
  - Ineffective accounting and information systems, including situations involving material weaknesses in internal control

Attitudes / Rationalisations

- Ineffective communication, implementation, support, or enforcement of the entity's values or ethical standards by management or the communication of inappropriate values or ethical standards.
- Non-financial management's excessive participation in or preoccupation with the selection of accounting policies or the determination of significant estimates.
- Known history of violations of stock market laws or other laws and regulations, or claims against the entity, its senior management, or those charged with governance alleging fraud or violations of laws and regulations.
- Excessive interest by management in maintaining or increasing the entity's share price or earnings trend.
- Practice by management of committing to analysts, creditors, and other third parties to achieve aggressive or unrealistic forecasts.
- Management failing to correct known material weaknesses in internal control on a timely basis.
- An interest by management in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
- Low morale among senior management.
- The owner-manager makes no distinction between personal and business transactions.
- Dispute between shareholders in a closely held entity.
- Recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
- The relationship between management and the current or predecessor auditor is strained, as exhibited by the following:

    - Frequent disputes with the current or predecessor auditor on accounting, auditing, or reporting matters.
    - Unreasonable demands on the auditor, such as unreasonable time constraints regarding the completion of the audit or the issuance of the auditor's report.
    - Formal or informal restrictions on the auditor that inappropriately limit access to people or information or the ability to communicate effectively with those charged with governance.
    - Domineering management behaviour in dealing with the auditor, especially involving attempts to influence the scope of the auditor's work or the selection or continuance of personnel assigned to or consulted on the audit engagement.

APPENDIX 8: RISK FACTORS ARISING FROM MISSTATEMENTS ARISING FROM MISAPPROPRIATION OF ASSETS

Incentives / Pressures

- Personal financial pressures on management or employees with access to cash or other assets susceptible to fraud.
- Adverse relationships between the entity and employees with access to cash or other assets susceptible to theft. For example, adverse relationships may be created by the following:

  - Known or anticipated future employee layoffs.
  - Recent or anticipated changes to employee compensation or benefit plans.
  - Promotions, compensation, or other rewards inconsistent with expectations.

Opportunities

Certain characteristics and circumstances increase the susceptibility of assets to misappropriation. For example:

- Large amounts of cash on hand.
- Inventory items that are small in size, of high value, and in high demand.
- Easily convertible assets such as bearer bonds.
- Property, plant and equipment items that are small in size, marketable, or lacking observable identification of ownership.

Inadequate internal control over assets increases the susceptibility of misappropriation of those assets. For example:

- Inadequate segregation of duties or independent checks.
- Inadequate oversight of senior management expenditure, such as travel and other reimbursements.
- Inadequate management oversight of employees responsible for assets, e.g. inadequate supervision or monitoring of remote locations.
- Inadequate job applicant screening.
- Inadequate record keeping with respect to assets.
- Inadequate system of authorisation and approval of transactions.
- Inadequate physical safeguards over cash, inventory or property, plant and equipment.
- Lack of complete and timely reconciliations of assets.
- Lack of timely and appropriate documentation of transactions, e.g. credits for return of goods.
- Lack of mandatory leave for employees performing key control functions.
- Inadequate management understanding of information technology (IT), which enables IT personnel to perpetrate a misappropriation.
- Inadequate access controls over automated records, including controls over and review of computer systems event logs.

Attitudes / Rationalisations

- Disregard for the need for monitoring or reducing risks related to misappropriation of assets.
- Disregard for the need for internal controls related to the misappropriation of assets by overriding existing controls or by failing to correct known internal control deficiencies.
- Behaviour indicating displeasure or dissatisfaction with the entity or its treatment of the employees.
- Changes in behaviour or lifestyle that may indicate that assets have been misappropriated.
- Tolerance of petty theft.

APPENDIX 9: AUDIT PROCEDURES TO ADDRESS THE ASSESSED RISK OF FRAUD

Although the audit procedures given here cover a broad range of situations, they are only examples and, accordingly, they may not be the most appropriate nor necessary in each circumstance. Also the order of procedures given is not intended to reflect their relative importance.

Consideration **at** *the Assertion Level*

- Visiting certain locations or performing certain tests on a surprise or unannounced basis. E.g., observing inventory count or counting cash at a particular date on a surprise basis.
- Requesting that inventories be counted at the end of the reporting period or on a date closer to period end to minimize the risk of manipulation of balances in the period between the date of completion of the count and the end of the reporting period.
- Altering the audit approach in the current year. E.g., contacting major customers and suppliers orally in addition to sending written confirmation, sending confirmation requests to a specific party within an organization, or seeking more or different information.
- Performing a detailed review of the entity's quarter-end or year-end adjusting entries and investigating any that appear unusual as to nature or amount.
- For significant and unusual transactions, particularly those occurring at or near year-end, investigating the possibility of related parties and the sources of financial resources supporting the transactions.
- Performing substantive analytical procedures using disaggregated data. For example, comparing sales and cost of sales by location, line of business or month to expectations developed by the auditor.
- Conducting interviews of personnel involved in areas where a risk of material misstatement due to fraud has been identified, to obtain their insights about the risk and whether, or how, controls address the risk.
- When other independent auditors are auditing the financial statements of one or more subsidiaries, divisions or branches, discussing with them the extent of work necessary to be performed to address the risk of material misstatement due to fraud resulting from transactions and activities among these components.
- If the work of an expert becomes particularly significant with respect to a financial statement item for which the risk of misstatement due to fraud is high, performing additional procedures relating to some or all of the expert's assumptions, methods or findings to determine that the findings are not unreasonable, or engaging another expert for that purpose.
- Performing audit procedures to analyse selected opening balance sheet account of previously audited financial statements to assess how certain issues involving accounting estimates and judgments, for example an allowance for sales returns, were resolved with the benefit of hindsight.
- Performing procedures on account or other reconciliations prepared by the entity, including considering reconciliations performed at interim periods.
- Performing computer-assisted techniques, such as data mining to test for anomalies in a population.
- Testing the integrity of computer-produced records and transactions.
- Seeking additional audit evidence from sources outside of the entity being audited.

Specific Responses - Misstatement Resulting From Fraudulent Financial Reporting

Revenue Recognition

- Performing substantive analytical procedures relating to revenue using disaggregated data, for example, comparing revenue reported by month and by product line or business segment during the current reporting period with comparable prior periods. Computer-assisted audit techniques may be useful in identifying unusual or unexpected revenue relationships or transactions.
- Confirming with customers certain relevant contract terms and the absence of side agreements, because the appropriate accounting often is influenced by such terms or agreements and basis for rebates or the period to which they relate are often poorly documented. For example, acceptance criteria, delivery and payment terms, the absence of future or continuing vendor obligations, the right to return the product, guaranteed resale amounts, and cancellation or refund provisions often are relevant in such circumstances.
- Inquiring of the entity's sales and marketing personnel or in-house legal counsel regarding sales or shipments near the end of the period and their knowledge of any unusual terms or conditions associated with these transactions.
- Being physically present at one or more locations at period end to observe goods being shipped or being readied for shipment (or returns awaiting processing) and performing other appropriate sales and inventory cut-off procedures.
- For those situations for which revenue transactions are electronically initiated, processed, and recorded, testing controls to determine whether they provide assurance that recorded revenue transactions occurred and are properly recorded.

Inventory Quantities

- Examining the entity's inventory records to identify locations or items that require specific attention during or after the physical inventory count.
- Observing inventory counts at certain locations on an unannounced basis or conducting inventory counts at all locations on the same date.
- Conducting inventory counts at or near the end of the reporting period to minimize the risk of inappropriate manipulation during the period between the count and the end of the reporting period.
- Performing additional procedures during the observation of the count, for example, more rigorously examining the contents of boxed items, the manner in which the goods are stacked or labelled, and the quality (that is, purity, grade, or concentration) of liquid substances such as perfumes or specialty chemicals. Using the work of an expert may be helpful in this regard.
- Comparing the quantities for the current period with prior periods by class or category of inventory, location or other criteria, or comparison of quantities counted with perpetual records.
- Using CAA Ts to further test the compilation of the physical inventory counts - for example, sorting by tag number to test tag controls or by item serial number to test the possibility of item omission or duplication.

Management Estimates

- Using an expert to develop an independent estimate for comparison to management's estimate.
- Extending inquiries to individuals outside of management and the accounting department to corroborate management's ability and intent to carry out plans that are relevant to developing the estimate.

Specific Responses - Misstatements Due* to *Misappropriation* of *Assets

- Counting cash or inventories at or near year-end.
- Confirming directly with customers the account activity (including credit memo and sales return activity as well as dates payments were made) for the period under audit.
- Analyzing recoveries of written-off accounts.
- Analysing inventory shortages by location or product type.
- Comparing key inventory ratios to the industry norm.
- Reviewing supporting documentation for reductions to the perpetual inventory records.
- Performing a computerized match of the vendor list with a list of employees to identify matches of addresses or phone numbers.
- Performing a computerized search of payroll records to identify duplicate addresses, employee identification or taxing authority numbers or bank accounts.
- Reviewing personnel files for those that contain little or no evidence of activity, for example, lack of performance evaluations.
- Analysing sales discounts and returns for unusual patterns or trends.
- Confirming specific terms of contracts with third parties.
- Obtaining evidence that contracts are being carried out in accordance with their terms.
- Reviewing the propriety of large and unusual expenses.
- Reviewing the authorisation and carrying value of senior management and related party loans.
- Reviewing the level and propriety of expense reports submitted by senior management.

APPENDIX 10: CIRCUMSTANCES THAT INDICATE POSSIBILITY OF FRAUD

Discrepancies in the accounting records, including:

- Transactions that are not recorded in a complete or timely manner or are improper} recorded as to amount, accounting period, classification, or entity policy.
- Unsupported or unauthorised balances or transactions.
- Last-minute adjustments that significantly affect financial results.
- Evidence of employees' access to systems and records inconsistent with that necessary to perform their authorised duties.
- Tips or complaints to the auditor about alleged fraud.

Conflicting or missing evidence such as:

- Missing documents.
- Documents that-appear to be altered.
- Unavailability of original documentation, i.e. documents available are photocopies or electronically transmitted.
- Significant unexplained items on reconciliations.
- Unusual balance sheet changes or changes in trends or important financial statement ratios or relationships, e.g., receivables growing faster than revenues.
- Inconsistent, vague or implausible responses from management or employees arising from inquiries or analytical procedures.
- Unusual discrepancies between the entity's records and confirmation replies. . Large number of credit entries and other adjustments made to the accounts receivable records.
- Unexplained or inadequately explained differences between the accounts receivable ledgers and control account, or between the customers' statements and the accounts receivable ledgers.
- Missing or non-existent cancelled cheques.
- Missing inventory or other tangible assets of significant magnitude.
- Unavailable or missing electronic evidence, inconsistent with the entity's record retention practices or policies.
- Fewer responses to confirmations than anticipated or a greater number of responses than anticipated.
- Inability to produce evidence of key systems development and program change testing and implementation activities for current-year system changes and deployments.

Problematic or unusual relationships between the auditor and management, including the following:

- Denial of access to records, facilities, certain employees, customers, vendors, or others from whom audit evidence might be sought.
- Undue time pressures from management to resolve complex or contentious issues.
- Complaints by management about the conduct of the audit or management intimidation of engagement team members, particularly in connection with the auditor's critical assessment of audit evidence or in the resolution of potential disagreements with management.
- Unusual delays by the entity in providing requested information.
- Unwillingness to facilitate auditor access to key electronic files for testing through the use of
- CAATs.
- Denial of access to key IT operations staff and facilities, including security, operations, and systems development personnel.

- Unwillingness to add or revise disclosures in the financial statements to make them more complete and understandable.
- Unwillingness to address identified weaknesses in internal control on a timely basis.
- Unwillingness of management to permit the auditor to meet privately with those charged with governance.

Others:

- Accounting policies that are not in line with industry norms.
- Frequent changes in accounting estimates that do not appear to result from changes in circumstances.
- Tolerance of violations of the entity's code of conduct.

APPENDIX 11: INHERENT RISK CONSIDERATIONS

A. Factors That Normally Indicate A High Inherent Risk:

1. Overall business factors

- Going concern difficulties will mean that inherent risk for most audit areas will be high.
- Certain factors connected with management can also mean inherent risk is assessed as high.

These include:

  - A single individual dominating the board.
  - The finance function being headed by a non-financial person.
  - The board and management remuneration is influenced heavily by the results of the entity.
  - Information that creates doubt about management integrity.

2. Individual audit areas

- The following factors are likely to imply that the assessment of inherent risk is high:
  - Any problems encountered in the previous audits, especially cut-off errors and fraud.
  - Complex areas which require the use of complex accounting techniques e.g. warranty provisions.
  - Balances derived from estimates.
  - Recent changes in accounting and control systems.
  - Recent changes in key personnel.
  - Assets easily susceptible to theft.
- Alternatively, the existence of the following factors is likely to imply that the assessment of inherent risk is low:
  - A stable business environment.
  - Capable, long-serving staff.
  - Balances and transactions that can easily be accounted for.
  - No previous history of errors.

B. Inherent Risk - Factors Affecting the Business as a Whole

1. General business environment

- Nature of the business.
- The effect of the general economic climate/ the economic climate within the industrial sector in which the entity operates.
- Changes in technology.
- Whether there are an abnormal number of business failures in the sector.
- Market stability (demand and prices) and patterns, or seasonal trends including:
  - The likelihood of adverse developments in the sector.
  - The risks associated with the entity's method of production or the provision of service.

  - Whether the entity takes account of changes in the economic climate and legal and regulatory environment.

- The entity's relationships with regulatory authorities.

2. Position in the industry

- Significant competitors and the entity's position in the market.
- Key competitive advantages and the entity's exploitation of them.
- Whether the entity's performance has differed significantly from the industry average without adequate reason.
- Whether the entity's accounting policies differ from those generally adopted in the industry.

3. Ownership of the business

- The identity and involvement of the owners in the business.
- Significant changes in ownership or the likelihood of significant changes in the foreseeable future.
- The relationships between the owners, those charged with governance and the management.

4. Management of the business

- The expertise of management.
- Significant changes in management or the likelihood of significant changes in the foreseeable future.
- Whether a single individual dominates the management, in a manner which prevents other managers acting effectively.
- The governance and:
  - Independence from executive management.
  - High turnover of those charged with governance.
  - Infrequent board and management meetings.
- Whether the management has appropriate knowledge of the business and the environment in which the entity operates including new sectors that been developed and new businesses that have been acquired by the entity.
- Personal interests of the management including:
  - Remuneration by commissions / bonuses based on performance.
  - Their interests in earnings per share / market value.
  - Conflicts of interest.
  - Their apparent personal financial status and standard of living beyond their earnings.
- Any information (for example, a conviction or sanction by a regulatory body) that brings into doubt the integrity of management or raises a question as to the extent of reliance that can be placed on management representations.
- Management's view of the business - does it appear prudent or over-confident. Consider whether management may be in difficulty through setting unrealistic targets, in particular, whether management takes high risks in respect of:

  - Sales through special arrangements, excessive discounting, bulk sale arrangements.
  - Capital projects.
  - Research and development.
  - Legal and contractual obligations.

- General and long-term finance.

5. Going concern

- A review of past results and industry averages including:
  - A high break-even point.
  - Tight margins.
- Whether there are exceptionally good reasons for tolerating unprofitable sectors (if the reasons are unsatisfactory, consider the effect on the client's liquidity).
- Product range:
  - Whether efforts are concentrated upon a few major profitable products or services lines.
  - The current phase of the "life cycle" (new, mature or declining) of the client's products or services and their expected future market.
  - Whether there is excessive dependence on a new product with uncertain potential.
- Whether there is a dependence on very few customers or suppliers.
- The capital structure taking into account the relationship with the client's bank and whether the client has significant debt from unusual sources or on unusual terms.
- The entity's long-term planning taking into consideration:
  - Long-term budgets.
  - Future market potential.
  - Projected changes in demand.
  - Development of new products or services lines.
  - Future financial and capital strategy.
  - Whether the business appears to have overextended management and its administration.

Other signs of going concern problems

- A history (or forecast) of serious operating losses or declining profitability.
- A rapidly developing business, which may lead to cash flow problems and a lack of a suitable debt / equity structure.
- Uneconomic long-term commitments, including substantial investment in a new product, or research and development which have not yet proved successful.
- Persistently exceeding the overdraft limit and / or deterioration in relationship with bankers.
- Insufficient working capital or liquidity problems (either current or forecast).
- Long term assets being financed by short or medium term borrowings.
- Having reached, or nearing current borrowing limits, with no sign of reduction.
- External factors, such as the undue influence of a market dominant competitor; the political environment; frequent failures of enterprises in the same industry.
- Debt collection problems.
- Increasing dependence on short-term finance including suppliers' credit.
- Failing to comply with borrowing agreements.
- Major loan repayments being due in the near future.
- Reduced or cancelled capital projects.
- Non-replacement of property, plant and equipment or switching necessary capital expenditure to leasing agreements.
- Deferring purchases, thereby reducing inventories to dangerously low levels.
- Major litigation, legislation or regulatory sanctions which could affect operations.'
- Potential losses on long-term contracts.

- Heavy dependence on the holding company for finance or trade (particularly if overseas).
- Under-capitalisation, particularly if there is a deficiency of share capital and reserves and/or non compliance with legal minimum capital requirements.
- Dividends not being voted or in arrears.
- Excessive or obsolete inventories.
- Size and content of order book.
- Work stoppages or other labour difficulties.

C. Inherent Risk - Factors Affecting Most Audit Areas

1. Previous history

- Qualified audit reports.
- Previous audits leading to significant adjustments in the financial statements.
- Significant weaknesses and their resolution.
- Any frauds, irregularities and errors found on previous audits.

2. The nature of account balances / classes of transactions

- Complexity, technicality and sensitivity of the accounting area / item.
- Whether the results or financial position depend on a small number of critical items.
- Risks associated with the accounting process, new accounting systems and new accounting policies.
- The availability of supporting documentation.
- Account balances derived from estimates taking into account:
  - Prior experience.
  - The availability of relevant data and the adequacy of the system for collecting data.
  - The process used to develop the estimate.
- Unsettled and settled transactions. Settled transactions are subject to a lower risk, since a third party has accepted the transaction and hence provided assurance as to its validity.
- Unusual and complex transactions:
  - Normal procedures being over-ridden.
  - The skill of personnel dealing with them.
  - Off-balance sheet financing.
  - The possibility of related party transactions.
- Unexpected balances (for example debit balances appearing on the purchase ledger).
- Cut-off and accruals
  - Whether they are dealt with under time pressure.
  - The susceptibility to manipulation.
- The extent of unexplained cash flows.
- The reversal of transactions after the accounting year-end.

3. Assets susceptible to theft

- Whether assets are easily convertible into cash.
- Whether assets can be easily moved.
- An unusual investment of funds.
- Payments made for goods and assets not received or not required. ~ Disposal of goods or assets at less than fair value.

- Assets used for private benefit.
- The possibility of theft via the computer.

4. Staff

- The identity and changes in key staff.
- The strength of the organisational structure taking into account:
  - Lines of responsibility.
  - Definition of duties.
  - Co-ordination of activities.
- The treatment of staff taking into account:
  - Pay and benefits including incentive plans.
  - Promotion.
  - Signs of excessive staff turnover or absenteeism.
  - Signs of excessive workload.
- The position with industrial relations.
- The skills and experience of the client's staff especially senior finance staff considering their:
  - Qualifications.
  - Experience.
  - Competence.

  Training programmes.
- The reliability of staff considering:
  - Checking of their references.
  - Any remuneration or performance judged by results.
  - Conflicts of interest.
- Apparent personal financial position - any indication that staff are living beyond their earnings.

Inherent Risk - Factors Affecting Major Audit Areas

1. Property, plant and equipment
- Existence of excess capacity in the industry and within the entity.
- Changes expected in utilisation of production capacity.
- Revaluations.
- Significant disposals.
- Level of unused property, plant and equipment.
- Management estimates of useful lives.
- Amount of capitalised internal production costs.
- Leasing.
- Research and development activity.
- Restrictions on use of property, plant and equipment (for example legal or charges on assets).
- Technological advances.

2. Investments
- Nature and value of investments.
- Diversity of investments made.
- Risk level of investments.
- Disposal prices of investments.
- Indications of decrease in values.

  - Market value.
  - Default or bankruptcy of the entities invested in.
  - Restrictions or threatened restrictions on foreign investments.
- The availability of information from investees'.

3. Inventories

- Product characteristics.
- The complexity of the production process.
- Problems with the product.
- Introduction of new products, technological advances.
- Discontinuance of product lines.
- Level of plant utilisation.
- Level of activity near the accounting year-end.
- Sales or purchases on unusual terms.
- Long-term contracts involving quality standards commitments or penalties. Disputes over long-term contracts.
- Government regulations and restrictions.
- The nature of the costing system.

- **4. Trade and Other Receivables**

- The number of new customers or customers lost.
- Dependence on a small number of customers.
- The level of activity in customers' industries.
- The financial strength of the customer.
- The seasonal nature of the business.
- Changes in product or service lines.
- Distribution channels used.
- The rights of return.
- Adverse sale commitments.
- Long-term contractual commitments.
- The accuracy of management estimates of levels of returns, discounts, allowances and impairment provisions.

4. Bank and cash

- Changes in bank accounts and signatories.
- The number of locations at which cash is received.
- The existence of large or unusual receipts and payments, or bank transfers.
- Significant cash transactions near to the accounting year-end.
- Currency restrictions.

6. Trade and other payables

- The nature of purchases.
- The centralisation of purchase procedures.
- Dependence on suppliers.
- Changes in the conditions of supply.
- Threats to supply.
- Significant outstanding or onerous purchase commitments.
- Threatened litigation.

- Warranties.

7. Borrowings

- Use of short-term borrowings.
- Borrowings with related parties.
- The complexity of the equity structure.
- Borrowing in foreign currencies and fluctuation in the exchange rates.
- Financing the activities of a subsidiary.

8. Taxation

- Whether tax assessments are up-to-date.
- Any disputes with or assessments from the tax authorities.
- Tax loss situations.
- Transactions with unusual tax implications.
- Changes in tax legislation.
- The extent of international operations.
- Deferred tax implications.

9. Equity

- Complex capital structures.
- The complexity of the 'earnings per share' calculation.
- Conditions on issues of shares.
- Recent issues of options or warrants.
- Client responsibility for maintenance of shareholder records, stock transfer and dividend payments.

10. Salaries and wages

- The number of employees.
- The nature of the salary structures.
- Methods of payment.
- Changes in terms of employment.
- Unusual arrangements with employees.
- Basis of allocating employee costs.
- Arrangements for remunerating management.
- The nature of any pension plans.
- The funding of pension plans especially deficits.
- Changes in terms of any pension plans.
- Significant use of casual or seasonal labour.

APPENDIX 12: FACTORS TO CONSIDER IN UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

1. Industry, Regulatory and Other External Factors, Including the Applicable Financial Reporting Framework

- Industry conditions:
  - The market and competition, including demand, capacity, and price competition.
  - Cyclical or seasonal activity.
  - Product technology relating to the entity's products.
  - Energy supply and cost.

- **Regulatory environment:**
  - Accounting principles and industry specific practices.
  - Regulatory framework for a regulated industry.
  - Legislation and regulation that significantly affect the entity's operations:
    - Regulatory requirements.
    - Direct supervisory activities.
  - Taxation (corporate and other).
  - Government policies currently affecting the conduct of the entity's business:
    - Monetary, including foreign exchange controls.
    - Fiscal.
    - Financial incentives (for example, government aid programs).
    - Tariffs, trade restrictions.
    - Environmental requirements affecting the industry and the entity's business:
  - Other external factors currently affecting the entity's business:
  - General level of economic activity (for example, recession, growth).
  - Interest rates and availability of financing.
  - Inflation, currency revaluation.

2. Nature of the Entity

- Nature of business operations:
  - Nature of revenue sources (for example, manufacturer, wholesaler, banking, insurance or other financial services, import/export trading, utility, transportation and technology products and services).
  - Products or services and markets (for example, major customers and contracts, terms of payment, profit margins, market share, competitors, exports, pricing policies, reputation of products, warranties, order book, trends, marketing strategy and objectives, manufacturing processes).
  - Conduct of operations (for example, stages and methods of production, business segments, delivery or products and services, details of declining or expanding operations).
  - Alliances, joint ventures, and outsourcing activities.
  - Involvement in electronic commerce, including Internet sales and marketing activities.
  - Geographic dispersion and industry segmentation.
  - Location of production facilities, warehouses, and offices.
  - Key customers.

- Important suppliers of goods and services (for example, long-term contracts, stability of supply, terms of payment, imports, methods of delivery such as "just-in-time").
- Employment (for example, by location, supply, wage levels, union contracts, pension and other post employment benefits, stock option or incentive bonus arrangements, and government regulation related to employment matters). . Research and development activities and expenditures.
- Transactions with related parties.

♦ **Investments**

- Acquisitions, mergers or disposals of business activities (planned or recently executed).
- Investments and dispositions of securities and loans.
- Capital investment activities, including investments in plant and equipment and technology, and any recent or planned changes.
- Investments in non-consolidated entities, including partnerships, joint ventures and special purpose entities.

♦ **Financing**

- Group structure - major subsidiaries and associated entities, including consolidated and non consolidated structures.
- Debt structure, including covenants, restrictions, guarantees, and off-balance-sheet financing arrangements.
- Leasing of property, plant or equipment for use in the business.
- Beneficial owners (local, foreign, business reputation and experience).
- Related parties.
- Use of derivative financial instruments.

♦ **Financial reporting**

- Accounting principles and industry specific practices.
- Revenue recognition practices.
- Accounting for fair values.
- Inventories (for example, locations, quantities).
- Foreign currency assets, liabilities and transactions.
- Industry-specific significant categories (for example, loans and investments for banks, accounts receivable and inventory for manufacturers, research and development for pharmaceuticals).
- Accounting for unusual or complex transactions including those in controversial or emerging areas (for example, accounting for stock-based compensation). Financial statement presentation and disclosure.

3. Objectives and Strategies and Related Business Risks

♦ Existence of objectives (i.e. how the entity addresses industry, regulatory and other external factors) relating to, for example, the following:

- Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
- New products and services (a potential related business risk might be, for example, that there is increased product liability).

  - Expansion of the business (a potential related business risk might be, for example, that the demand has not been accurately estimated).
  - New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation, or increased costs).
  - Regulatory requirements (a potential related business risk might be, for example, that there is increased legal exposure).
  - Current and prospective financing requirements (a potential related business risk might be, for example, the loss of financing due to the entity's inability to meet requirements).
  - Use of IT (a potential related business risk might be, for example, that systems and processes are incompatible).

- Effects of implementing a strategy, particularly any effects that will lead to new accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation).

4. Measurement and Review of the Entity's Financial Performance

  - Key ratios and operating statistics.
  - Key performance indicators.
  - Employee performance measures and incentive compensation policies.
  - Trends.
  - Use of forecasts, budgets and variance analysis.
  - Analyst reports and credit rating reports.
  - Competitor analysis.
  - Period-on-period financial performance (revenue growth, profitability, leverage).

APPENDIX 13: CONDITIONS AND EVENTS THAT MAY INDICATE RISKS OF MATERIAL MISSTATEMENT

- Operations in regions that are economically unstable, for example, countries with significant currency devaluation or highly inflationary economies.
- Operations exposed to volatile markets, for example, futures trading.
- High degree of complex regulation.
- Going concern and liquidity issues including loss of significant customers.
- Constraints on the availability of capital and credit.
- Changes in the industry in which the entity operates.
- Changes in the supply chain.
- Developing or offering new products or services, or moving into new lines of business.
- Expanding into new locations.
- Changes in the entity such as large acquisitions or reorganisations or other unusual events.
- Entities or business segments likely to be sold.
- Complex alliances and joint ventures.
- Use of off-balance-sheet finance, special-purpose entities, and other complex financing arrangements.
- Significant transactions with related parties.
- Lack of personnel with appropriate accounting and financial reporting skills.
- Changes in key personnel including departure of key executives.
- Weaknesses in internal control, especially those not addressed by management.
- Inconsistencies between the entity's IT strategy and its business strategies.
- Changes in the IT environment.
- Installation of significant new IT systems related to financial reporting.
- Inquiries into the entity's operations or financial results by regulatory or government bodies.
- Past misstatements, history of errors or a significant amount of adjustments at period end.
- Significant amount of non-routine or non-systematic transactions including inter-company transactions and large revenue transactions at period end.
- Transactions that are recorded based on management's intent, for example, debt refinancing, assets to be sold and classification of marketable securities.
- Application of new accounting pronouncements.
- Accounting measurements that involve complex processes.
- Events or transactions that involve significant measurement uncertainty, including accounting estimates.
- Pending litigation and contingent liabilities, for example, sales warranties, financial guarantees and environmental remediation.

APPENDIX 14: INTERNAL CONTROL COMPONENTS

A. Control Environment

The control environment encompasses the following elements:

- **Communication and enforcement of integrity and ethical values.**

The effectiveness of controls cannot rise above the integrity and ethical values of the people who create, administer, and monitor them. Integrity and ethical values are essential elements of the control environment which influence the effectiveness of the design, administration, and monitoring of other components of internal control. Integrity and ethical behaviour are the product of the entity's ethical and behavioural standards, how they are communicated, and how they are reinforced in practice. They include management's actions to remove or reduce incentives and temptations that might prompt personnel to engage in dishonest, illegal, or unethical acts. They also include the communication of entity values and behavioural standards to personnel through policy statements and codes of conduct and by example.

- **Commitment to competence**.

Competence is the knowledge and skills necessary to accomplish tasks that define the individual's job. Commitment to competence includes management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

- **Participation by those charged with governance.**

An entity's control consciousness is influenced significantly by those charged with governance. Attributes of those charged with governance include independence from management, their experience and stature, the extent of their involvement and scrutiny of activities, the appropriateness of their actions, the information they receive, the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external engagement teams. The importance of responsibilities of those charged with governance is recognised in codes of practice and other regulations or guidance produced for the benefit of those charged with governance. Other responsibilities of those charged with governance include oversight of the design and effective operation of whistle blower procedures and the process for reviewing the effectiveness of the entity's internal control. The following additional points may be considered:

- The independence of the board.
- The frequency of board meetings.
- Domination by one person or a small group.
- The qualifications, experience and competence of those charged with governance.
- The turnover of board members.
- The independence of an independent audit function and of the audit committee.
- The speed at which any internal or external audit recommendations are responded to.

- **Management's philosophy and operating style**.

Management's philosophy and operating style encompass a broad range of characteristics. Such characteristics may include the following:

- Short and long-term objectives;
- Management’s philosophy and operating style
- Approach to taking and monitoring business risks;

- Management's attitudes and actions toward financial reporting (conservative or aggressive selection from available alternative accounting principles, and conscientiousness and conservatism with which accounting estimates are developed); and
- Management's attitudes toward information processing and accounting functions and personnel.

➢ **Organisational structure.**

An entity's organisational structure provides the framework within which its activities for achieving entity-wide objectives are planned, executed, controlled, and reviewed. Establishing a relevant organisational structure includes considering key areas of authority and responsibility and appropriate lines of reporting. An entity develops an organisational structure suited to its needs. The appropriateness of an entity's organisational structure depends, in part, on its size and the nature of its activities. The following additional factors may be considered:

- The appropriateness of centralisation policies.
- The responsibilities of divisional management
- The extent to which delegation is understood.
- The systems of communication.
- The work load.
- Management harmony with lower grades of staff.

Assignment of authority and responsibility.

This factor includes how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established. It also includes policies relating to appropriate business practices, knowledge and experience of key personnel, and resources provided for carrying out duties. In addition, it includes policies and communications directed at ensuring that all personnel understand the entity's objectives, know how their individual actions interrelate and contribute to those objectives, and recognise how and for what they will be held accountable.

Human resource policies and practices.

Human resource policies and practices relate to recruitment, orientation, training, evaluating, counselling, promoting, compensating, and remedial actions. For example, standards for recruiting the most qualified individuals - with emphasis on educational background, prior work experience, past accomplishments, and evidence of integrity and ethical behaviour - demonstrate an entity's commitment to competent and trustworthy people. Training policies that communicate prospective roles and responsibilities and include practices such as training schools and seminars illustrate expected levels of performance and behaviour. Promotions driven by periodic performance appraisals demonstrate the entity's commitment to the advancement of qualified personnel to higher levels of responsibility.

Application to Small Entities

Small entities may implement the control environment elements differently than larger entities. For example, small entities might not have a written code of conduct but, instead, develop a culture that emphasises the importance of integrity and ethical behaviour through oral communication and by management example. Similarly, those charged with governance in small entities may not include an independent or outside member.

B. Entity's Risk Assessment Process

The entity's risk assessment process for financial reporting includes how management identifies risks relevant to the preparation of financial statements that give a true and fair view in accordance with the entity's applicable financial reporting framework, estimates their significance, assesses the likelihood of their occurrence, and decides upon actions to manage them. For example, the entity's risk assessment process may address how the entity considers the possibility of unrecorded transactions or identifies and analyses significant estimates recorded in the financial statements. Risks relevant to reliable financial reporting also relate to specific events or transactions.

Risks relevant to financial reporting include external and internal events and circumstances that may occur and adversely affect an entity's ability to initiate, record, process, and report financial data consistent with the assertions of management in the financial statements. Once risks are identified, management considers their significance, the likelihood of their occurrence, and how they should be managed. Management may initiate plans, programs, or actions to address specific risks or it may decide to accept a risk because of cost or other considerations. Risks can arise or change due to circumstances such as the following:

- **Changes in operating environment**: Changes in the regulatory or operating environment can result in changes in competitive pressures and significantly different risks.
- **New personnel:** New personnel may have a different focus on or understanding of internal control.
- **New or revamped information systems**: Significant and rapid changes in information systems can change the risk relating to internal control.
- **Rapid growth:** Significant and rapid expansion of operations can strain controls and increase the risk of a breakdown in controls.
- **New technology:** Incorporating new technologies into production processes or information systems may change the risk associated with internal control.
- **New business models, products, or activities:** Entering into business areas or transactions with which an entity has little experience may introduce new risks associated with internal control.
- **Corporate restructurings:** Restructurings may be accompanied by staff reductions and changes in supervision and segregation of duties that may change the risk associated with internal control.
- **Expanded foreign operations**: The expansion or acquisition of foreign operations carries new and often unique risks that may affect internal control, for example, additional or changed risks from foreign currency transactions.
- **New accounting pronouncements**: Adoption of new accounting principles or changing accounting principles may affect risks in preparing financial statements.

Application to Small Entities

The basic concepts of the entity's risk assessment process are relevant to every entity, regardless of size, but the risk assessment process is likely to be less formal and less structured in small entities than in larger ones. All entities should have established financial reporting objectives, but they may be recognised implicitly rather than explicitly in small entities. Management may be aware of risks related to these objectives without the use of a formal process but through direct personal involvement with employees and outside parties.

C. Information Systems, Including the Related Business Processes, Relevant to Financial Reporting and Communication

An information system consists of infrastructure (physical and hardware components), software, people, procedures, and data. Infrastructure and software will be absent, or have less significance, in systems that are exclusively or primarily manual. Many information systems make extensive use of information technology (IT).

The information system relevant to financial reporting objectives, which includes the financial reporting system, consists of the procedures and records established to initiate, record, process, and report entity transactions (as well as events and conditions) and to maintain accountability for the related assets, liabilities, and equity. Transactions may be initiated manually or automatically by programmed procedures. Recording includes identifying and capturing the relevant information for transactions or events. Processing includes functions such as edit and validation, calculation, measurement, valuation, summarisation, and reconciliation, whether performed by automated or manual procedures. Reporting relates to the preparation of financial reports as well as other information, in electronic or printed format, that the entity uses in measuring and reviewing the entity's financial performance and in other functions. The quality of system-generated information affects management's ability to make appropriate decisions in managing and controlling the entity's activities and to prepare reliable financial reports. Accordingly, an information system encompasses methods and records that:

- Identify and record all valid transactions.
- Describe on a timely basis the transactions in sufficient detail to permit proper classification of transactions for financial reporting.
- Measure the value of transactions in a manner that permits recording their proper monetary value in the financial statements.
- Determine the time period in which transactions occurred to permit recording of transactions in the proper accounting period.
- Present properly the transactions and related disclosures in the financial statements.

Communication involves providing an understanding of individual roles and responsibilities pertaining to internal control over financial reporting. It includes the extent to which personnel understand how their activities in the financial reporting information system relate to the work of others and the means of reporting exceptions to an appropriate higher level within the entity. Open communication channels help ensure that exceptions are reported and acted on.

Communication takes such forms as policy manuals, accounting and financial reporting manuals, and memoranda. Communication also can be made electronically, orally, and through the actions of management.

Application to Small Entities

Information systems and related business processes relevant to financial reporting in small entities are likely to be less formal than in larger entities, but their role is just as significant. Small entities with active management involvement may not need extensive descriptions of accounting procedures, sophisticated accounting records, or written policies. Communication may be less formal and easier to achieve in a small entity than in a larger entity due to the small entity's size and fewer levels as well as management's greater visibility and availability.

D. Control Activities

Control activities are the policies and procedures that help ensure that management directives are carried out, for example, that necessary actions are taken to address risks that threaten the achievement of the entity's objectives. Control activities, whether within IT or manual systems, have various objectives and are applied at various organisational and functional levels.

Generally, control activities that may be relevant to an audit may be categorised as policies and procedures that pertain to the following:

- **Performance reviews:** These control activities include reviews and analyses of actual performance versus budgets, forecasts, and prior period performance; relating different sets of data - operating or financial - to one another, together with analyses of the relationships and investigative and corrective actions; comparing internal data with external sources of information; and review of functional or activity performance, such as a bank's consumer loan manager's review of reports by branch, region, and loan type for loan approvals and collections.
- **Information processing**: A variety of controls are performed to check accuracy, completeness, and authorisation of transactions. The two broad groupings of information systems control activities are application controls and general IT -controls.

  - **Application controls** apply to the processing of individual applications. These controls help ensure that transactions occurred, are authorised, and are completely and accurately recorded and processed. Examples of application controls include checking the arithmetical accuracy of records, maintaining and reviewing accounts and trial balances, automated controls such as edit checks of input data and numerical sequence checks, and manual follow-up of exception reports.
  - **General IT -controls** are polices and procedures that relate to many applications and support the effective functioning of application controls by helping to ensure the continued proper operation of information systems. General IT-controls commonly include controls over data centre and network operations; system software acquisition, change and maintenance; access security; and application system acquisition, development, and maintenance. These controls apply to mainframe, miniframe, and end-user environments. Examples of such general IT-controls are program change controls, controls that restrict access to programs or data, controls over the implementation of new releases of packaged software applications, and controls over system software that restrict access to or monitor the use of system utilities that could change financial data or records without leaving an audit trail.

- **Physical controls:** These activities encompass the physical security of assets, including adequate safeguards such as secured facilities over access to assets and records; authorisation for access to computer programs and data files; and periodic counting and comparison with amounts shown on control records (for example comparing the results of cash, security and inventory counts with accounting records). The extent to which physical controls intended to prevent theft of assets are relevant to the reliability of financial statement preparation, and therefore the audit, depends on circumstances such as when assets are highly susceptible to misappropriation. For example, these controls would ordinarily not be relevant when any inventory losses would be detected pursuant to periodic physical inspection and recorded in the financial statements. However, if for financial reporting purposes management relies solely on perpetual inventory records, the physical security controls would be relevant to the audit.

- **Segregation of duties**: Assigning different people the responsibilities of authorising transactions, recording transactions, and maintaining custody of assets is intended to reduce the opportunities to allow any person to be in a position to both perpetrate and concea1 errors or fraud in the normal course of the person's duties. Examples of segregation of duties include reporting, reviewing and approving reconciliations, and approval and control of documents.

Certain control activities may depend on the existence of appropriate higher level policies established by management or those charged with governance. For example, authorisation controls may be delegated under established guidelines, such as investment criteria set by those charged with governance; alternatively, non-routine transactions such as major acquisitions or divestments may require specific high level approval, including in some cases that of shareholders.

Application to Small Entities

The concepts underlying control activities in small entities are likely to be similar to those in larger entities, but the formality with which they operate varies. Further, small entities may find that certain types of control activities are not relevant because of controls applied by management. For example, management's retention of authority for approving credit sales, significant purchases, and draw-downs on lines of credit can provide strong control over those activities, lessening or removing the need for more detailed control activities. An appropriate segregation of duties often appears to present difficulties in small entities. Even companies that have only a few employees may be able to assign their responsibilities to achieve appropriate segregation or, if that is not possible, to use management oversight of the incompatible activities to achieve control objectives.

E. Monitoring of Controls

An important management responsibility is to establish and maintain internal control on an ongoing basis. Management's monitoring of controls includes considering whether they are operating as intended and that they are modified as appropriate for changes in conditions. Monitoring of controls may include activities such as management's review of whether bank reconciliations are being prepared on a timely basis, internal engagement teams' evaluation of sales personnel's compliance with the entity's policies on terms of sales contracts, and a legal department's oversight of compliance with the entity's ethical or business practice policies.

Monitoring of controls is a process to assess the quality of internal control performance over time. It involves assessing the design and operation of controls on a timely basis and taking necessary corrective actions. Monitoring is done to ensure that controls continue to operate effectively. For example, if the timeliness and accuracy of bank reconciliations are not monitored, personnel are likely to stop preparing them. Monitoring of controls is accomplished through ongoing monitoring activities, separate evaluations, or a combination of the two.

Ongoing monitoring activities are built into the normal recurring activities of an entity and include regular management and supervisory activities. Managers of sales, purchasing, and production at divisional and corporate levels are in touch with operations and may question reports that differ significantly from their knowledge of operations. In many entities, internal engagement teams or personnel performing similar functions contribute to the monitoring of an entity's controls through separate evaluations. They regularly provide information about the functioning of internal control, focusing considerable attention on evaluating the design and operation of internal control. They communicate information about strengths and weaknesses and recommendations for improving internal control.

Monitoring activities may include using information from communications from external parties that may indicate problems or highlight areas in need of improvement. Customers implicitly corroborate billing data by paying their invoices or complaining about their charges. In addition, regulators may communicate with the entity concerning matters that affect the functioning of internal control, for example, communications concerning examinations by bank regulatory agencies. Also, management may consider communications relating to internal control from external engagement teams in performing monitoring activities.

Application to Small Entities

Ongoing monitoring activities of small entities are more likely to be informal and are typically performed as a part of the overall management of the entity's operations. Management's close involvement in operations often will identify significant variances from expectations and inaccuracies in financial data leading to corrective action to the control.

APPENDIX 15: FRAMEWORK FOR ASSESSING CONTROLS

Tests of control can be grouped under the following headings:

- Tests by observation.
- Tests by enquiry.
- Tests involving inspection of documentary evidence.
- Tests by re-performance.

Those controls subject to testing by enquiry combined with inspection or re-performance provide more assurance that those subject solely to enquiry and observation. When examining programmed procedures in an IT environment, the following factors should be considered:

- The reliability of general controls over program integrity.
- The duration that the program has been in use (one-off or new programs should always be subject to a higher level of test).
- Whether the size of transactions has gone beyond that expected when the program was originally designed.
- The effect on the financial statements of an error in the programmed procedures.

Nature of Tests of Controls

The engagement team selects audit procedures to obtain assurance about the operating effectiveness of controls. In circumstances where it is not possible or practicable to obtain sufficient appropriate audit evidence only from substantive procedures or where the engagement team adopts an approach primarily consisting of test of controls, the engagement team ordinarily performs tests of controls to obtain a higher level of assurance about their operating effectiveness.

In testing the operating effectiveness of controls, the engagement team performs other audit procedures in combination with inquiry, since inquiry alone may not provide sufficient evidence. Those controls subject to testing by performing inquiry combined with inspection or re-performance ordinarily provide more assurance than those controls for which the audit evidence consists solely of inquiry and observation.

The absence of misstatements detected by a substantive procedure does not provide audit evidence that controls related to the assertion being tested are effective. However, misstatements detected by the engagement team when performing substantive procedures, is indicative of the existence of a material weakness in internal control.

Timing of Tests of Control

The timing of tests of controls depends on the engagement team's objectives and determines the period of reliance on those controls. If the engagement team tests controls at a particular time, the engagement team obtains audit evidence that the controls operated effectively at that time. If the engagement team wants to obtain the evidence of the effectiveness of the operations of controls throughout the period, then the engagement team should obtain evidence of their effectiveness by testing them at appropriate interval during the period.

Where the engagement team obtains evidence about the operating effectiveness of controls during an interim period, the engagement team should determine what additional audit evidence should be obtained for the remaining period taking into account any changes in the information systems, processes and personnel. In making this determination, the engagement team considers the:

- Significance of assessed risk of material misstatement at the assertion level;
- Specific controls that were tested during the interim period;
- Degree to which audit evidence about the operating effectiveness of those controls was obtained; and
- Length of the remaining period;
- Control environment; and
- Extent to which the engagement team intends to perform further substantive tests based on the reliance of controls.

Where the engagement team plans to rely on the operating effectiveness of controls obtained in the prior year, the engagement team should ascertain whether changes in those specific controls have taken place subsequently. However, in such cases the engagement team should test the operating effectiveness of controls at least once in every three audits. The required audit evidence is obtained by performing inquiry combined with observation or inspection. Where controls have changed, the engagement team should obtain audit evidence by testing the operating effectiveness of the controls.

Extent of Tests of Controls

As a general rule, the more the engagement team plans to rely on the operating effectiveness of controls, the greater the extent of the engagement team's test of controls. In considering the extent of tests, the engagement team considers the:

- Frequency of the performance of the control by the entity during the period.
- Length of time during the audit period that the engagement team is relying on the operating effectiveness of the controls.
- Relevance and reliability of the audit evidence to be obtained in supporting that the control prevents, or detects and corrects material misstatements at the assertion levels.
- Extent to which audit evidence is obtained from tests of other controls related to the assertion.
- Extent to which the engagement team plans to rely on the operating effectiveness of the control in the assessment of audit risk.
- Expected deviation from the control.

The higher the level of inherent and analytical risk, the greater assurance tests of control need to give, if they are to be worthwhile. The following is a guide to the minimum number of items to test a sample of transaction control, but levels may need to vary according to the particular circumstances. The sample selected should be chosen from the whole of the accounting period.

INHERENT	ANALYTICAL	KEY CONTROLS Number of items to test
High	High	25-35
High	Medium	20-30
High	Low	15- 25
Medium	High	20-30
Medium	Medium	15-25
Medium	Low	10-20
Low	High	15-25
Low	Medium	10-20
Low	Low	8-10

A control is considered effective only if no exceptions are noted from the sample selected. If one to three exceptions are noted, a new sample is selected and tested. If one exception is noted in the second sample, the control is concluded not to be operating satisfactorily. If more than four exceptions are noted in the initial sample selected, the control is also concluded not to be operating satisfactorily.

APPENDIX 16: CONTROLS RELEVANT TO AN AUDIT

The entity's controls relate to financial reporting, operations and compliance controls. However, not all the controls are relevant to the engagement team's risk assessment. Usually the controls relevant to an audit are those relating to the entity's objective of preparing financial statements for external purposes that give a true and fair view in accordance with the applicable financial reporting framework and the management of risk that may give rise to a material misstatement.

The controls over completeness and accuracy of information may be relevant if the engagement team intends to make use of the information in designing and performing further audit procedures, while controls over safeguarding of assets against unauthorised acquisition, use or disposal may be relevant in relation to financial reporting. Controls relating to operations and compliance may only be relevant if they pertain to the data the engagement team evaluates and uses in applying audit procedures. Examples of such controls could include statistical data of production, which the engagement team plans to use in analytical procedures, or controls designed to detect non-compliance with laws and regulations, including the tax legislation, which may have a material effect on the financial statements.

The following are some of the types of control the engagement team may need to evaluate:

- **Management controls**

Management controls and reviews by independent persons are designed to detect errors Examples include reviewing financial information, exception reports and reconciliations.

Management controls also include authorisation, which is the approving of all transactions by a responsible person. In smaller entities, each transaction may be individually authorised. In larger entities, the authorisation procedures may be more broadly based e.g. an approved budget within which the budget holder can authorise the expenditure, or an assistant authorising an order from customers within the authorised parameters of prices and quantities.

- **Safeguarding of assets**

These controls are designed to ensure:

- Access to assets is limited to authorised personnel.
- Assets are safeguarded against the creation of documents that would authorise the use or disposal.
- Assets are safeguarded against theft.

Assets to be safeguarded include assets stated in the financial statements and information held on an IT system. Computerised data should be safeguarded by allowing authorised users to gain access only for the purpose of fulfilling their duties e.g. by a system passwords and / or restriction of physical access. Computer controls should always include safeguards against catastrophe.

♦ **Segregation**

The key aim of segregation of duties is that no one person should be in a position to control all stages of the processing of a transaction which include: o Initiating transactions;

- o Recording transactions;
- o Handling cash receipts and payments; and
- o Custody of assets.

♦ **Application controls**

These are specific controls in automated or manual procedures that are preventive or detective in nature and are designed to ensure the integrity of the accounting records that transactions are completely and accurately recorded. Such controls are designed to:

- o Ensure invalid items are rejected in processing, or
- o Transferred to suspense files, or
- o Reported to the user by means of an exception report.

When evaluating application controls, the engagement team should examine the procedures for resubmitting or otherwise dealing with rejected items and for preventing duplicate recording.

Application controls can be grouped under the following headings:

- o Completeness controls.
- o Accuracy controls.
- o Maintenance controls.

♦ **Completeness controls**

Completeness controls are designed to ensure all transactions are recorded. These are normally based on establishing an open item within the accounting system which cannot be cleared until all aspects of the transaction have been completed. For example, in a sales and receivables cycle, this includes ensuring that the sale is recorded, the inventory is updated and the receivable account is updated simultaneously.

Another more general example is a numerical sequence test such as sequential sales invoice numbering. Completeness procedures must be comprehensive such as covering customer claims for credit notes and claims on suppliers for faulty goods.

♦ **Accuracy controls**

Accuracy controls are designed to ensure entries within the accounting records are accurate. The system should cover data input and subsequent processing such as checking calculations, additions and analysis. In an automated environment this check is often carried out in conjunction with programmed procedures.

- **Maintenance controls**

  Maintenance controls are controls designed to ensure that files can only be altered by transactions processed through properly controlled procedures. With such controls e.g. the maintenance of a ledger control account under user control, users should be aware of unauthorised amendment. Maintenance controls should also ensure that the correct copy of a computer file is used when restoring from a back-up file.

  A review of application controls should start either with the transaction or the originating document. The identification of detailed controls will often not be straightforward.

- **General IT controls**

  General controls governing IT operations need to be examined, so as to form a view on the overall integrity and the programs.
  General controls are the controls which relate to the environment within which computer based accounting systems are developed, maintained and operated. These include:

  - Controls over the reliability of processing information.
  - Controls over the integrity of data input and output.
  - Controls over the integrity of programs used.
  - Controls over computer system development and implementation.

APPENDIX 17: GUIDANCE ON DOCUMENTING THE ACCOUNTING SYSTEMS

1. Flowcharting

A flowchart is a method of recording the stages in an accounting procedure. Flowcharts can be a useful tool, particularly for larger clients.

Advantages of flowcharting:

- Easier to understand and assimilate than pure narrative notes.
- Completion requires a full understanding of the system by the preparer.
- Encourages a logical and objective audit approach.
- Aids the completeness of systems records.
- Gives a perspective to the system description.
- Allows a rapid independent review.
- Communication is made easier.
- Easier to update than pure narrative notes.

Disadvantages of flowcharting:

- Requires careful and laborious attention to detail.
- Time consuming in preparation.
- Time wasting if applied to very simple systems, or where no real system is in operation.

Flowcharting Conventions

♦ Direction of flow

- Must be down the page or horizontally (either left or right) but **never** up the page.
- Diagonal flows must **not** be used.

♦ Narrative

- Confined to the narrative column.
- Directly opposite the chart operation to which it relates.
- If not obvious from the chart, one should explain (briefly) what each operation is, who does it, and its purpose.

♦ Numbering of operations

- Each and every operation should be numbered.
- Flow-lines

____ Document flow (vertical lines only).

---Information flow (horizontal lines only).

- If two unrelated document lines must cross then a "bridge" or other symbol should be used.

♦ Document description

The name of a document should be shown either on the document symbol or by the side of it.

- Placing of symbols

  All symbols should normally appear on a vertical flow line.

- Merging or separating

  This should be shown on the chart by merging or separating the appropriate document flow lines.

- Alternative procedures
  Depending on the complexity of alternatives, either:

  a. Detail both procedures on the main chart, if sufficiently simple; or
  b. Draw a subsidiary chart.

Preparing a Flowchart

- Obtain oral or written details of the system from the person exercising overall control. Information required includes:
  - The nature and source of significant transactions.
  - The key processes.
  - The flow of significant transactions.
  - Principal files supporting account balances.
  - Principal files used for comparison.
  - Output, its regularity and distribution.
- Prepare a rough copy of the system.
- Trace a transaction through the system by performing walk-through tests.
- Complete the final version of the flowchart.
- Review the completed charts to ensure all alternatives are charted and that all document flows have an end.
- Review the completed charts with the person exercising overall responsibility, to ensure they are correct and to draw attention to any divergence's from the original description.

2. Narrative Notes

In case of smaller entities with less complicated transactions, narrative notes describing the process flows may be sufficient. Even in such cases it is important to carry out walk-through tests and confirm the recording with the person exercising overall responsibility, to ensure that the notes are correct.

APPENDIX 18: GUIDANCE ON SETTING MATERIALITY

The range of values approach should normally be considered.

Other measures may be appropriate, for example a materiality level based on working capital, or on shareholders' funds if the users are interested in the equity base. Alternative approaches are used world-wide and the measures addressed here are for guidance only.

RANGE OF VALUES

Six possible measures of audit materiality are given for the financial statements as a whole:

- 0.5% of turnover or revenues;
- 1 % of turnover or revenues;
- 5% of pre-tax profit, before significant directors' profit-related bonuses, significant directors' remuneration (if substantial amounts of profit are voted as remuneration) and perhaps exceptional items (depending on their nature);
- 10% of pre-tax profit, before significant directors' profit-related bonuses, significant directors' remuneration (if substantial amounts of profit are voted as remuneration) and perhaps exceptional items (depending on their nature);
- 1 % of total assets (before deducting liabilities); or
- 2% of total assets (before deducting liabilities).

The materiality levels set should normally be within the range of factors stated above. Pre-tax profits should not be used if there are losses or profits are distorted for any reason.

APPENDIX 19: GUIDE TO DRAWING CONCLUSIONS FROM ANALYTICAL PROCEDURES

The Appendix provides a guide to some conclusions that may be drawn by the engagement team when using analytical procedures at the risk assessment and conclusion stages of an audit a~: issues that could be considered when carrying out analytical review. The list is not exhaustive a-: there may be other possible reasons for changes in trends and ratios. Significant changes need to be recorded in the Form 05.06 - Analytical Review and Form 05.01 - Audit Strategy and Plan as part of the risk assessment process.

KEY AUDIT AREAS

1. PROPERTY, PLANT AND EQUIPMENT

Possible Conclusions

- An increase in property, plant and equipment may be caused by:
  - Business expansion with possible consequences of increase in business volume.
  - Changes in the capitalisation policy.

- A decrease in property, plant and equipment may be caused by:
  - The business is being curtailed with possible consequences of lower sales volume redundancy claims etc.
  - Going concern issues especially where adequate capital is not available to acquisitions required to sustain business levels.
  - Changes in the capitalisation policy.
  - Significant changes in the depreciation charge may result from changes in the useful lives of the assets, changes in the estimate of residual values or errors in the computation of depreciation.

Issues to be Considered

- Changes in carrying values of property, plant and equipment.
- Significant additions and disposals, compared with previous years.
- The adequacy of depreciation rates taking into account:
  - The average useful life compared to the average age of property, plant and taken out of use due to scrapping / obsolescence.
  - Profit on disposal of property, plant and equipment and estimates of residual values.
- The proportion of assets due for replacement within a short period (say two years of the balance sheet date) and their impact on the future gearing and possible going concern implications.
- Assets yielding direct income from third parties when compared to the carrying value, income received, direct cost of maintenance including depreciation.

2. INVENTORY

Possible Conclusions

- An increase in inventory levels could be caused by:
  - Changes in purchasing policy.
  - Obsolete inventory and deteriorating trading conditions.
  - Absorption of cost which should have been written off to profit and loss.

- A decrease in inventory levels could be caused by:
  - Improved inventory control.
  - Overtrading, poor ordering or deterioration in supplier trading terms.
  - Cut-off errors.

- High levels of inventory write-offs may indicate:
  - Poor physical inventory management.
  - Theft.
  - Unrecorded sales.
  - A deteriorating market for the entity's products.

Issues to be Considered

- Inventory turnover ratio (Note: where purchases are not evenly spread throughout the year, it may be inappropriate to use annual figures and instead use an adjusted purchases figure).
- Inventory volume changes.
- Changes in unit inventory prices.
- Actual inventory value changes.
- Provisions.
- Production variances.
- The percentage of material, labour and overhead in production costs.
- Material usage and scrap or waste material.
- Labour standards, total labour costs and hours.
- Total production costs incurred and total production costs allocated to inventory.
- Production cost variances.
- Standard overhead rates and actual costs by type

3. TRADE RECEIVABLES AND TURNOVER

Possible Conclusions

- An increase in the level of trade receivables may be caused by:
  - Increase in turnover or trading activity. Consider overtrading.
  - Deterioration in the economic climate or in the entity's credit control or debt collection procedures. Considerations should be given to impairment of receivables.
  - Sales to fictitious customers to increase reported profit.
  - Unrecorded receipts from customers or delays in banking receipts.
  - Sales being inflated due to cut-off errors.
  - Subsequent or delay in the issue of credit notes.

- A decrease in the level of trade receivables may indicate:
  - A decrease in turnover or trading activity.
  - Improvement in debt collection procedures.
  - Sales cut-offs or subsequent receipts being reflected in the current year.

- A high or rising level of impairment provision may be caused by:
  - Deteriorating economic conditions.
  - Poor credit control.

- Amounts being written off without proper attempts at recovery or receipts not being banked
- Fictitious sales being reversed through write-offs.

Issues to be Considered

Trade receivables and impairment:

- Trade receivables to turnover.
- Impairment of trade receivables to trade receivables.
- Impairment of trade receivables to turnover.
- Sales
- Sales volume changes.
- Sales price changes.
- Theoretical turnover change (prior year actual sales being adjusted by volume and price;
- Actual turnover changes (in total or by monthly changes).
- Gross profit margin.

4. TRADE PAYABLES AND PURCHASES

Possible Conclusions

- A high or increasing level of trade payables may be caused by:
  - An increase in purchases or trading activity.
  - A management decision to delay payment (a corresponding increase in cash or a reduction in the bank overdraft would then be expected).
  - Difficulty in paying debts as they fall due. This may indicate a going concern problem.
  - A management decision to increase inventory near the year-end.
  - Payments made shortly before the year-end being recorded in the subsequent period to inflate cash balances or reduce the bank overdraft (again, this may indicate going concern problems).

- A low or declining level of trade payables may indicate:
  - Decrease in purchases or trading activity.
  - Acceleration in the payment of payables.
  - Payment orders or cheques being recorded in the cash book but withheld (cheques entered in the cash book around the year-end should be examined for subsequent clearance.
  - A high incidence of cash purchases which in turn may indicate deterioration in supplier terms and going concern problems.

Issues to be considered

- Trade payables to inventory and purchase volume changes.
- Purchase price changes and actual purchases changes (in total or monthly).
- Theoretical purchases changes (prior year actual purchases being adjusted by volume and price).

5. LABOUR COSTS

Issues to be Considered

- Activity:
  - The average annual wage per full-time employee.
  - Changes in bonuses and commissions (these could be compared with sales or profit levels).
- Efficiency:
  - Changes in productive employees.
  - Changes in the distribution of employees.
  - Changes in profit per employee.
  - Changes in turnover per employee.

6. PROFIT AND LOSS ACCOUNT

6.1. Gross Profit

Possible Conclusions

Changes in gross profit margin could be caused by changes in:

- Selling price without a corresponding increase in the cost.
- Product mix.
- Reduction in the cost of sale without a corresponding decrease in the sale price.
- Cut-off errors in sales, purchases or inventory.
- Under or over-valuation of inventories and work-in-progress.

Issues to be Considered

A desegregation of the gross profit margin should take place as far as practicable. The following should be considered when comparing gross margins:

- Product and service types.
- Seasonal variations.
- Geographical area.

APPENDIX 20: FACTORS INFLUENCING SAMPLE SIZE FOR TEST OF CONTROLS

The following are factors that the auditor would consider when determining the sample size for tests of controls. These factors, which need to be considered together, assume the engagement team does not modify the nature of timing of tests of controls or otherwise modify the approach to substantive procedures in response to assessed risks.

FACTOR	EFFECT ON SAMPLE SIZE
An increase in the extent to which the risk of material misstatement is reduced by the operating effectiveness of controls	Increase
An increase in the rate of deviation from the prescribed control activity that the auditor is willing to accept	Decrease
An increase in the rate of deviation from the prescribe control activity that the auditor expects to find in the population	Increase
An increase in the auditor’s required confidence level (or conversely, a decrease in the risk that the auditor will conclude that risk of material misstatement is lower than the actual risk of misstatement in the population)	Increase
An increase in the number of sampling units in the population	Negligible

1. ***The extent to which the risk of material misstatement is reduced by the operating effectiveness of controls.*** The more assurance the engagement team intends to obtain from the operating effectiveness of controls, the lower it's assessment of the risk of material misstatement will be, and the larger the sample size will need to be. When the engagement team's assessment of the risk of material misstatement at the assertion level includes an expectation of the operating effectiveness of controls, the team is required to perform tests of controls. Other things being equal, the more the engagement team relies on the operating effectiveness of controls in the risk assessment, the greater is the extent of the tests of controls (and therefore, the sample size is increased).

2. ***The rate of deviation from the prescribed control activity the engagement team is willing to accept (tolerable error).*** The lower the rate of deviation that the engagement team is willing to accept, the larger the sample size needs to be.

3. ***The rate of deviation from the prescribed control activity the engagement team expects to find in the population (expected error).*** The higher the rate of deviation that the engagement team expects, the larger the sample size needs to be so as to be in a position to make a reasonable estimate of the actual rate of deviation. Factors relevant to the engagement team's consideration of the expected error rate include the team's understanding of the business (in particular, risk assessment procedures undertaken to obtain an understanding of internal control), changes in personnel or in internal control, the results of audit procedures applied in prior periods and the results of other audit procedures. High expected error rates ordinarily warrant little, if any, reduction of the assessed risk of material misstatement, and therefore in such circumstances tests of controls would ordinarily be omitted.

4. ***The engagement team's required confidence level.*** The greater the degree of confidence that the engagement team requires that the results of the sample are in fact

indicative of the actual incidence of error in the population, the larger the sample size needs to be.

5. ***The number* of *sampling units in the population.*** For large populations, the actual size of the population has little, if any, effect on sample size. For small populations however, audit sampling is often not as efficient as alternative means of obtaining sufficient appropriate audit evidence.

APPENDIX 21: FACTORS INFLUENCING SAMPLE SIZE FOR SUBSTANTIVE TESTS

The following are factors that the auditor would consider when determining the sample size for tests of details. These factors, which need to be considered together, assume the engagement team does not modify the approach to tests of controls or otherwise modify the nature of timing of substantive procedure in response to the assessed risks.

FACTOR	EFFECT ON SAMPLE SIZE
An increase in the auditor's assessment of the risk of material misstatement.	Increase
An increase in the use of other substantive procedures directed at the same assertion	Decrease
An increase in the auditor's required confidence level (or conversely, a decrease in the risk that the auditor will conclude that a material error does not exist when in fact it does exist)	Increase
An increase in the tolerable error that the auditor is willing to accept	Decrease
An increase in the amount of error the auditor expects to find in the population	Increase
Stratification of the population when appropriate	Decrease
The of sampling units in the population	Negligible

1. *The engagement team's assessment of the risk of material misstatement.* The higher this is, the larger the sample size would need to be. The engagement team's assessment of the risk of material misstatement is affected by inherent risk and control risk. For example, if the engagement team does not perform tests of controls, the team's risk assessment cannot be reduced for the effective operation of internal controls with respect to the particular assertion. Therefore, in order to reduce audit risk to an acceptably low level, the engagement team needs a low detection risk and will rely more on substantive procedures. The more audit evidence that is obtained from tests of details (that is, the lower the detection risk), the larger the sample size will need to be.

2. *The use of other substantive procedures directed at the same assertion.* The more the engagement team is relying on other substantive procedures (tests of details or substantive analytical procedures) to reduce to an acceptable level the detection risk regarding a particular class of transactions or account balance, the less assurance it will require from sampling and, therefore, the smaller the sample size can be.

3. *The engagement team's required confidence level.* The greater the degree of confidence that the engagement team requires that the results of the sample are in fact indicative of the actual amount of error in the population, the larger the sample size needs to be.

4. *The total error the engagement team is willing to accept (tolerable error).* The lower the total error that the auditor is willing to accept, the larger the sample size needs to be.

5. *The amount of error the engagement team expects to find in the population (expected error).* The greater the amount of error the engagement team expects to find in the population, the larger the sample size needs to be in order to make a reasonable estimate of the actual amount of error in the population. Factors relevant to the

engagement team's consideration of the expected error amount include the extent to which item values are determined subjectively, the results of risk assessment procedures, the results of tests of control, the results of audit procedures applied in prior periods, and the results of other substantive procedures.

6. *Stratification.* When there is a wide range (variability) in the monetary size of items in the population. It may be useful to group items of similar size into separate sub-populations or strata. This is referred to as stratification. When a population can be appropriately stratified the aggregate of the sample sizes from the strata generally will be less than the sample size that would have been required to attain a given level of sampling risk, had one sample been drawn from the whole population.

APPENDIX 22: LIST OF ISAs CONTAINING REQUIREMENTS FOR WRITTEN REPRESENTATIONS

This appendix identifies paragraphs in other ISAs that require subject matter specific written representations. The list is not a substitute for considering the requirements and related application and other explanatory material in ISAs.

- **ISA 240, "The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements" – paragraph 39**

  The auditor shall obtain written representations from management and, where appropriate, those charged with governance that:

  1. *They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud;*
  2. *They have disclosed to the auditor the results of management's assessment of the risk that the financial statements may be materially misstated as a result of fraud;*
  3. *They have disclosed to the auditor their knowledge of fraud or suspected fraud affecting the entity involving:*
     (a) Management;
     (b) Employees who have significant roles in internal control; or
     (c) Others where the fraud could have a material effect on the financial statements; and
  4. *They have disclosed to the auditor their knowledge of any allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.*

- **ISA 250, "Consideration of Laws and Regulations in an Audit of Financial Statements" – paragraph 16**

  The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements have been disclosed to the auditor.

- **ISA 450, "Evaluation of Misstatements Identified during the Audit" – paragraph 14**

  The auditor shall request a written representation from management and, where appropriate, those charged with governance whether they believe the effects of uncorrected misstatements are immaterial, individually and in aggregate, to the financial statements as a whole. A summary of such items shall be included in or attached to the written representation.

- **ISA 501, "Audit Evidence—Specific Considerations for Selected Items" – paragraph 12**

  The auditor shall request management and, where appropriate, those charged with governance to provide written representations that all known actual or possible litigation and claims whose effects should be considered when preparing the financial statements have been disclosed to the auditor and accounted for and disclosed in accordance with the applicable financial reporting framework.

- **ISA 540, "Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures" – paragraph 22**

  The auditor shall obtain written representations from management and, where appropriate, those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable.

- **ISA 550, "Related Parties" – paragraph 26**

  Where the applicable financial reporting framework establishes related party requirements, the auditor shall obtain written representations from management and, where appropriate, those charged with governance that: (Ref: Para. A48-A49)

  (a) They have disclosed to the auditor the identity of the entity's related parties and all the related party relationships and transactions of which they are aware; and
  (b) They have appropriately accounted for and disclosed such relationships and transactions in accordance with the requirements of the framework.

- **ISA 560, "Subsequent Events" – paragraph 9**

  The auditor shall request management and, where appropriate, those charged with governance, to provide a written representation in accordance with ISA 580 that all events occurring subsequent to the date of the financial statements and for which the applicable financial reporting framework requires adjustment or disclosure have been adjusted or disclosed.

- **ISA 570, "Going Concern" – paragraph 16(e)**

  Requesting written representations from management and, where appropriate, those charged with governance, regarding their plans for future action and the feasibility of these plans.

- **ISA 710, "Comparative Information—Corresponding Figures and Comparative Financial Statements" – paragraph 9**

As required by ISA 580, the auditor shall request written representations for all periods referred to in the auditor's opinion. The auditor shall also obtain a specific written representation regarding any restatement made to correct a material misstatement in prior period financial statements that affect the comparative information.

APPENDIX 23: ILLUSTRATIVE REPRESENTATION LETTER

The following illustrative letter includes written representations that are required by this and other ISAs. It is assumed in this illustration that the applicable financial reporting framework is International Financial Reporting Standards; the requirement of ISA 570 to obtain specific written representation is not relevant; and that there are no exceptions to the requested written representations. If there were exceptions, the representations would need to be modified to reflect the exceptions.

(Entity Letterhead)

(To Auditor) (Date)

This representation letter is provided in connection with your audit of the financial statements of ABC Company for the year ended December 31, 20XX11 for the purpose of expressing an opinion as to whether the financial statements are presented fairly, in all material respects, (or *give a true and fair view*) in accordance with International Financial Reporting Standards.

We confirm that (*, to the best of our knowledge and belief, having made such inquiries as we considered necessary for the purpose of appropriately informing ourselves*):

Financial Statements

- We have fulfilled our responsibilities, as set out in the terms of the audit engagement dated [insert date], for the preparation of the financial statements in accordance with International Financial Reporting Standards; in particular the financial statements are fairly presented (or give a true and fair view) in accordance therewith.

- Significant assumptions used by us in making accounting estimates, including those measured at fair value, are reasonable.

- Related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the requirements of International Financial Reporting Standards.

- All events subsequent to the date of the financial statements and for which
- International Financial Reporting Standards require adjustment or disclosure have been adjusted or disclosed.

- The effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements as a whole. A list of the uncorrected misstatements is attached to the representation letter.

Information Provided

- We have provided you with:

  - Access to all information of which we are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;

  - o Additional information that you have requested from us for the purpose of the audit; and
  - o Unrestricted access to persons within the entity from whom you determined it necessary to obtain audit evidence.

- All transactions have been recorded in the accounting records and are reflected in the financial statements.

- We have disclosed to you the results of our assessment of the risk that the financial statements may be materially misstated as a result of fraud.

- We have disclosed to you all information in relation to fraud or suspected fraud that we are aware of and that affects the entity and involves:

  - o Management;
  - o Employees who have significant roles in internal control; or
  - o Others where the fraud could have a material effect on the financial statements.

- We have disclosed to you all information in relation to allegations of fraud, or suspected fraud, affecting the entity's financial statements communicated by employees, former employees, analysts, regulators or others.

- We have disclosed to you all known instances of non-compliance or suspected non-compliance with laws and regulations whose effects should be considered when preparing financial statements.

- We have disclosed to you the identity of the entity's related parties and all the related party relationships and transactions of which we are aware.

____

Management Management

APPENDIX 24: LETTER OF SUPPORT

(Date)
The Directors
(Company Name) Ltd
P.O. Box (Postcode) Kampala.

Dear Sir,

RE: LETTER OF SUPPORT IN RESPECT OF__________________________LTD

We are aware that the Balance Sheet of ___________________________ Limited *reflects* a net liability position as at 31 December 1805 amounting to Shs ________________,and an excess of current liabilities over current assets of Shs. _______________.
We nonetheless believe that the going concern basis is appropriate in preparing the financial, statements for the year ended and we hereby give a formal undertaking to provide the Company with the necessary financial support to enable it to meet its liabilities as they fall due, for at least 12 months from the date the above financial statements are approved by the Board of Directors.

Yours faithfully

For: _________________Limited

cc (The Auditors)
P.O Box (Postcode) Kampala.

APPENDIX 25: AUDIT REPORT EXAMPLES

1. Unmodified Opinion

REPORT OF THE INDEPENDENT AUDITORS

TO THE MEMBERS OF________________________LIMITED

We have audited the accompanying financial statements of_________ Limited which comprise the balance sheet as at *(Date of balance sheet)* and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

Directors' responsibility for the Financial Statements

The directors are responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards and the Ugandan Companies Act. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error, and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an independent opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance that the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depended on our professional judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we considered the internal control relevant to the company's preparation and fair presentation of the financial statements in order to design audit procedures that were appropriate in the circumstances, but not for the purpose of expressing an opinion on the company's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

Opinion

In our opinion, proper books of account have been kept, and the financial statements, which are in agreement therewith, give a true and fair view of the state of financial affairs of the company as at (date of balance sheet) and of its financial performance and cash flows for the year then ended in accordance with international Financial Reporting Standards and the Ugandan Companies Act.

Report on Legal and Other Regulatory Requirements

The Companies Act requires that in carrying out our audit, we consider and report to you on the following matters.

We confirm that:

- We have obtained all the information and explanation which to the best of our knowledge and belief were necessary for the purposes of our audit.
- In our opinion proper books of accounts have been kept, so far as appears for our examination of those books.
- The balance sheet and income statement are in agreement with the books of accounts.

Certified Public Accountants
Kampala
(Date)

2. Limitation on Scope - Qualified Opinion

REPORT OF THE INDEPENDENT AUDITORS

TO THE MEMBERS OF____________________ LIMITED

We have audited the accompanying financial statements of____________ Limited, which comprise the balance sheet as at *(Date of balance sheet*) and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Directors' responsibility for the Financial Statements

The directors are responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards and the Ugandan Companies Act. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error, and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an independent opinion on these financial statements based on our audit. Except as discussed in the following paragraph, we conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance that the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depended on our professional judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we considered the internal control relevant to the company's preparation and fair presentation of the financial statements in order to design audit procedures that were appropriate in the circumstances, but not for the purpose of expressing an opinion on the company's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

Basis of Qualified Opinion

We were not appointed as auditors of the company until after December 31, 20X1 and thus did not observe the counting of physical inventories at the beginning and end of the year. Owing to the nature of the Company's records, we were unable to satisfy ourselves by alternative means concerning the inventory quantities held at December 31, 20X0 and 20X1 which are stated in the balance sheet at xxx and xxx, respectively.

Opinion

In our opinion, except for the effect of such adjustments, if any, as might have been necessary had we been able to satisfy ourselves as to physical inventory quantities, proper books of account have been kept, and the financial statements, which are in agreement therewith, give a true and fair view of the state of financial affairs of the company as at *(date of balance* sheet) and of its financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards and the Uganda Companies Act

Report on Legal and Other Regulatory Requirements

The Companies Act requires that in carrying out our audit, we consider and report to you on the following matters.

We confirm that:

- We have obtained all the information and explanation which to the best of our knowledge and belief were necessary for the purposes of our audit.
- In our opinion proper books of accounts have been kept, so far as appears for our examination of those books.
- The balance sheet and income statement are in agreement with the books of accounts.

Certified Public Accountants
Kampala
(Date)

3. Limitation on Scope - Disclaimer of Opinion

REPORT OF THE INDEPENDENT AUDITORS

TO THE MEMBERS OF___________________LIMITED

We have audited the accompanying financial statements of ____________Limited, which comprise the balance sheet as at *(Date* of *balance* sheet) statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Directors' responsibility for the Financial Statements

The directors are responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards and the Ugandan Companies Act. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error, and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on conducting the audit in accordance with International Standards on Auditing. Because of the matter described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis of Disclaimer of Opinion

We were not appointed as auditors of the company until after December 31, 20X1 and thus did not observe the counting of physical inventories at the beginning and end of the year. We were unable to satisfy ourselves by alternative means concerning the inventory quantities held at December 31, 20X0 and 20X1 which are stated in the balance sheet at xxx and xxx, respectively. In addition, the introduction of a new computerized accounts receivable system in September 20X1 resulted in numerous errors in accounts receivable. As of the date of our audit report, management was still in the process of rectifying the system deficiencies and correcting the errors. We were unable to confirm or verify by alternative means accounts receivable included in the balance sheet at a total amount of xxx as at December 31, 20X1. As a result of these matters, we were unable to determine whether any adjustments might have been found necessary in respect of recorded or unrecorded inventories and accounts receivable, and the elements making up the income statement, statement of changes in equity and cash flow statement.

Opinion

Because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on the financial statements

Report on Legal and Other Regulatory Requirements

The Companies Act requires that in carrying out our audit, we consider and report to you on the following matters.

We confirm that:

- We have obtained all the information and explanation which to the best of our knowledge and belief were necessary for the purposes of our audit.
- In our opinion proper books of accounts have been kept, so far as appears for our examination of those books.
- The balance sheet and income statement are in agreement with the books of accounts.

Certified Public Accountants
Kampala
(Date)

4. Disagreement with Management - Qualified Opinion

REPORT OF THE INDEPENDENT AUDITORS

TO THE MEMBERS OF-________________LIMITED

We have audited the accompanying financial statements of_________ Limited, which comprise the balance sheet as at *(Date of balance sheet)* and income statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Directors' responsibility for the Financial Statements

The directors are responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards and the Ugandan Companies Act. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error, and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an independent opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance that the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depended on our professional judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we considered the internal control relevant to the company's preparation and fair presentation of the financial statements in order to design audit procedures that were appropriate in the circumstances, but not for the purpose of expressing an opinion on the company's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

Basis of Qualified Opinion

As discussed in Note___________ to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, is not in accordance with International Financial Reporting Standards. The provision for the year ended *(Date of balance sheet)* should be Shs. based on the reducing balance method using annual rates of 12.5% on plant and machinery and 19% for motor vehicles. Accordingly, property plant and equipment should be reduced by accumulated depreciation of Shs. ________the loss for the year increased by Shs. ________and shareholders' funds should decreased by Shs _________

Opinion

In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, proper books of account have been kept, and the financial statements, which are in agreement therewith, give a true and fair view of the state of financial affairs of the company as at *(date of balance* sheet) and of its financial performance and cash flows for the year then ended in accordance with Imitational Financial Reporting Standards and the Uganda Companies Act.

Report on Legal and Other Regulatory Requirements

The Companies Act requires that in carrying out our audit, we consider and report to you on the following matters.

We confirm that:

- We have obtained all the information and explanation which to the best of our knowledge and belief were necessary for the purposes of our audit.
- In our opinion proper books of accounts have been kept, so far as appears for our examination of those books.
- The balance sheet and income statement are in agreement with the books of accounts.

Certified Public Accountants
Kampala
(Date)

5. Emphasis of Matter

REPORT OF THE INDEPENDENT AUDITORS

TO THE MEMBERS OF___________________________LIMITED

We have audited the accompanying financial statements of_____________ Limited,
Which comprise the balance sheet as at *(Date of balance sheet)* statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Directors' responsibility for the Financial Statements

The directors are responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards and the Ugandan Companies Act. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error, and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an independent opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance that the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depended on our professional judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we considered the internal control relevant to the company's preparation and fair presentation of the financial statements in order to design audit procedures that were appropriate in the circumstances, but not for the purpose of expressing an opinion on the company's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

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

Opinion

In our opinion, proper books of account have been kept, and the financial statements, which are in agreement therewith, give a true and fair view of the state of financial affairs of the company as at (date of balance sheet) and of its financial performance and cash flows for the year then ended in accordance with international Financial Reporting Standards and the Ugandan Companies Act.

Emphasis of Matter

Without qualifying our opinion, we draw attention to Note - to the financial statements which indicate the existence of a material uncertainty which may cast significant doubt about the Company's ability to continue as a going concern. The financial statement s have been prepared on a going concern basis on the assumption that continued financial support will be made available to the company by its bankers and shareholders.

Report on Legal and Other Regulatory Requirements

The Companies Act requires that in carrying out our audit, we consider and report to you on the following matters.

We confirm that:

- We have obtained all the information and explanation which to the best of our knowledge and belief were necessary for the purposes of our audit.
- In our opinion proper books of accounts have been kept, so far as appears for our examination of those books.
- The balance sheet and income statement are in agreement with the books of accounts.

Certified Public Accountants
Kampala
(Date)

6. Adverse Opinion

REPORT OF THE INDEPENDENT AUDITORS

TO THE MEMBERS OF__________________LIMITED

We have audited the accompanying financial statements of ___________Limited, which comprise the balance sheet as at *(Date* of *balance* sheet) statement of changes in equity and cash flow statement for the year then ended, and a summary of ,(- significant accounting policies and other explanatory notes.

Directors' responsibility for the Financial Statements

The directors are responsible for the preparation and fair presentation of the financial statements in accordance with International Financial Reporting Standards and the Ugandan Companies Act. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error, and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Except as discussed in the following paragraph, we conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance that the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depended on our professional judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, we considered the internal control relevant to the company's preparation and fair presentation of the financial statements in order to design audit procedures that were appropriate in the circumstances, but not for the purpose of expressing an opinion on the company's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

Basis of Adverse Opinion

As explained in Note X, the company has not consolidated the financial statements of subsidiary XYZ Company it acquired during 20X1 because it has not yet been able to ascertain the fair values of certain of the subsidiary’s material assets and liabilities at the acquisition date. This investment is therefore accounted for on a cost basis. Under International Financial Reporting Standards, the subsidiary should have been consolidated because it is controlled by the company. Had XYZ been consolidated, many elements in the accompanying financial statements would have been materially affected. The effects on the consolidated financial statements of the failure to consolidate have not been determined.

Opinion

Because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on the financial statements

Report on Legal and Other Regulatory Requirements

The Companies Act requires that in carrying out our audit, we consider and report to you on the following matters.

We confirm that:

- We have obtained all the information and explanation which to the best of our knowledge and belief were necessary for the purposes of our audit.
- In our opinion proper books of accounts have been kept, so far as appears for our examination of those books.
- The balance sheet and income statement are in agreement with the books of accounts.

Certified Public Accountants
Kampala
(Date)

APPENDIX 26: MANAGEMENT LETTER

The main purpose of a management letter is to provide helpful and constructive comments to the client on inherent weakness in the control systems and also provide advice to the entity on how to run the entity more effectively. The scope of the management letter, the legal and professional responsibilities and the reliance and the distribution of the letter should be covered in the engagement letter.

1. Issues that can be Covered

Management letters can in particular be used to highlight:

- Deficiencies in the accounting systems and records.
- Deficiencies in the design or implementation of internal control (Required by ISA 315).
- Areas where efficiency and profitability could be improved.
- Inappropriate accounting policies and practices.
- Non-compliance with legislation or financial reporting standards.
- Difficult areas for verification, due to the client's procedures or lack of audit trail.
- Other matters affecting the conduct of the audit.
- Points outstanding from previous management letters.

2. Preparation of Management Letters

Planning stage

At the planning stage, the following should be discussed with the entity:

- The best way of reporting audit findings.
- Procedures for discussing the form and content of the management letter.
- A timetable for issue and response.
- The distribution of the management letter.

Preparation of the draft letter

- During the audit, points for inclusion in the management letter should be noted as they arise.
- The analysis of risk will often highlight points to be included.
- A management letter should only include material points. The entity's comments should be obtained before the management letter is finalised. This is a key stage, and the engagement team should:
  - Address its comments to appropriate personnel.
  - Discuss observations in a factual manner.
  - Enquire whether there are any additional relevant facts.
  - Listen carefully to responses, which may yield extra information.
  - Consider the impact on all entity personnel.
  - Enquire what actions will be taken to correct deficiencies.
  - Find out whether previous management letter points have been implemented, and if not, why not.
  - Revise as appropriate and consider the economic viability of suggestions made

Final Letter

The final letter should normally be sent to the company chairman or the managing director with a copy to the chair of the Audit Committee where one exists, with a covering note requesting the letter be tabled at a board meeting.

- The contents of the covering letter are covered in Form 02.02 in Part E of the Manual.
- The bulk of the letter should be arranged so as to be of most benefit to the entity. For larger clients, it may be useful to adopt a tiered structure, highlighting the most significant points for the Board's attention. The letter may also be used to emphasise points raised previously but not resolved. Whatever the format chosen, the engagement letter should make clear:
    - The auditor's observations.
    - The implications and risks.
    - The auditor's recommendations.
    - The management comments received on the draft letter.

The approach should be modified wherever there is a statutory duty to report on any shortcomings in systems.

Management's response

- A reply should be requested to all of the points raised, indicating the action management intends to take as a result of the comments made in the report. It should be made clear that at least an acknowledgement is expected and the directors' discussion of the report should be recorded in the board minutes.

Timing

- Management letters should often be drafted after an interim audit (if one was performed) or as soon as possible after the audit field work has been completed. Recommendations will be perceived as more valuable if reported on a timely basis.
- Other factors to consider when deciding timing include:
    - Specific industry requirements.
    - The risk of loss to the client.
    - Seriousness of weaknesses.
    - The possibility of avoiding an increase in audit time through prompt client action. In such cases it may be necessary to report critical issues as they arise pending the issue of a draft management letter.

Filing

- The original draft management letter (with any client comments) and the final management letter should be placed on the current audit file. A copy of the final letter may also be placed in the client file or the permanent audit file.

3. Third parties

Any report to management should be regarded as confidential. Occasionally however management may provide third parties (such as banks or regulators) with copies of the report. It needs to be clarified with the client whether this will be so.

4. Groups

If the firm audits all the companies in a group, the firm should obtain permission from the management of subsidiaries to disclose the contents of their management letters to the parent company.

If the firm audits a parent company but not some of the subsidiaries, the firm should - obtain the reports made by other auditors of group companies. The firm's request to management should be made through the parent company, and the firm should obtain - agreement from both the management of subsidiaries and their auditors before disclosing management letters from other auditors to the parent company.