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GUIDANCE ON SMALLER ENTITY  
AUDIT DOCUMENTATION

The Auditing Practices  
Board

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- Standards and guidance for auditing;
- Standards and guidance for reviews of interim financial information performed by the auditor of the entity;
- Standards and guidance for the work of reporting accountants in connection with investment circulars; and
- Standards and guidance for auditors' and reporting accountants' integrity, objectivity and independence,

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# PRACTICE NOTE 26

## GUIDANCE ON SMALLER ENTITY AUDIT DOCUMENTATION

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## Introduction

1. This Practice Note provides guidance to auditors on the application of documentation requirements contained within International Standards on Auditing (ISAs) (UK and Ireland) to the audit of financial statements of smaller entities. It should be read in conjunction with the ISAs (UK and Ireland). It is not intended to be comprehensive guidance on the application of ISAs (UK and Ireland) to smaller audits.
2. The guidance in this Practice Note is directed to auditors of companies that are exempt from audit but choose nonetheless to have a voluntary audit and other smaller entities such as charities. However, a more detailed and rigorous approach may be necessary in small entities with complex operations.
3. The guidance may also be helpful to auditors of larger entities where:
  - ownership of the entity is concentrated in a small number of individuals (sometimes a single individual) who are actively involved in managing the business; and
  - the operations are uncomplicated with few sources of income and activities; and
  - business processes and accounting systems are simple; and
  - internal controls are relatively few and may be informal.
4. Initial feedback on the implementation of ISAs (UK and Ireland) during 2005 and 2006 suggests that increased documentation related to ISA (UK and Ireland) 315 is the primary area where additional cost has been incurred for audits of smaller entities. In particular, there is uncertainty about the extent of documentation required to evidence the auditor's understanding of the entity, especially with regard to internal control<sup>1</sup>.
5. To comply with ISAs (UK and Ireland), it is not necessary to document the entirety of the auditor's understanding of the entity and matters related to it. Key elements of the understanding documented by the auditor include those on which the auditor has based the assessment of the risks of misstatement. For smaller entities the audit documentation may be simple in form and relatively brief.

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1 ISA (UK and Ireland) 315 requires the auditor to document key elements of understanding obtained regarding:

- Relevant industry, regulatory and other external factors including the applicable financial reporting framework;
- The nature of the entity;
- The entity's selection and application of accounting policies;
- The entity's objectives and strategies;
- The means by which the entity's financial performance is measured and reviewed; and
- Each of the internal control components (the control environment, the entity's risk assessment process, the information system, control activities, and monitoring controls).

6. There are many different ways in which audit documentation can be prepared to meet the requirements of ISAs (UK and Ireland). The examples which are included in the Appendix to this document are illustrative of some of the possible ways in which compliance with the documentation requirements related to ISA (UK and Ireland) 315 and other planning aspects can be achieved. The illustrative examples are not mandatory.

### **Purposes of audit documentation**

7. ISA (UK and Ireland) 230 (Revised) requires that the auditor should prepare, on a timely basis, audit documentation that provides:
  - (a) A sufficient and appropriate record of the basis for the auditor's report; and
  - (b) Evidence that the audit was performed in accordance with ISAs (UK and Ireland) and applicable legal and regulatory requirements.
8. In relation to these objectives, ISA (UK and Ireland) 230 (Revised) explains that:
  - Preparing sufficient and appropriate audit documentation on a timely basis helps to enhance the quality of the audit and facilitates the effective review and evaluation of the audit evidence obtained and conclusions reached before the auditor's report is finalised. Documentation prepared at the time the work is performed is likely to be more accurate than documentation prepared subsequently.
  - Compliance with the requirements of ISA (UK and Ireland) 230 (Revised) together with the specific documentation requirements of other relevant ISAs (UK and Ireland) is ordinarily sufficient to achieve the objectives in paragraph 7.
9. In addition to the objectives in paragraph 7, audit documentation serves a number of purposes, including:
  - Assisting the audit team to plan and perform the audit;
  - Assisting members of the audit team responsible for supervision to direct and supervise the audit work, and to discharge their review responsibilities in accordance with ISA (UK and Ireland) 220, "Quality Control for Audits of Historical Financial Information;"
  - Enabling the audit team to be accountable for its work;
  - Retaining a record of matters of continuing significance to future audits;
  - Enabling an experienced auditor to conduct quality control reviews and inspections in accordance with International Standard on Quality Control (ISQC) (UK and Ireland) 1, "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements;" and

- Enabling an experienced auditor to conduct external inspections in accordance with applicable legal, regulatory or other requirements.
10. Complying with the documentation requirements of the ISAs (UK and Ireland) can also assist the auditor's consideration of the issues associated with significant matters arising during the audit. This often enhances the quality of the reasoning followed, the judgments made and the conclusions reached. In the UK and Ireland external monitoring of audits has consistently emphasised the need for high quality documentation of the rationale for the key audit judgments made in reaching the audit opinion.

### **Special considerations in the documentation of a smaller entity audit**

11. The nature and extent of audit documentation that is appropriate for an audit of a smaller entity is influenced by special considerations which arise from:
- the qualitative indicators of a simpler entity as set out in paragraph 3; and
  - the characteristics of a typical smaller entity audit team and the way in which they carry out the audit work, including:
    - the provision of accounting and related business advice;
    - relatively small team size;
    - the use of proprietary audit systems.
12. Notwithstanding these special considerations, an audit of the financial statements for a smaller entity will still comply with ISAs (UK and Ireland) and all audit documentation must be prepared in sufficient detail to enable an experienced auditor, having no previous connection with the audit, to understand:
- (a) The nature, timing, and extent of the audit procedures performed to comply with ISAs (UK and Ireland) and applicable legal and regulatory requirements;
  - (b) The results of the audit procedures and the audit evidence obtained; and
  - (c) Significant matters arising during the audit and the conclusions reached thereon.

### *Concentration of ownership and management*

13. The ownership of a smaller entity is often concentrated in a small number of individuals, one or more of whom are actively involved in managing the business on a day-to-day basis. In these circumstances the auditor's documentation of the entity's ownership and governance arrangements is likely to be relatively brief.
14. Particular consideration and documentation may be needed of matters, such as family and other close relationships that may impact the auditor's risk assessments in relation to related parties.

*Uncomplicated operations*

15. Smaller entities often have a limited range of products or services and operate from a limited number of locations, with the consequence that their processes and structures are uncomplicated. In these circumstances, the documentation of the auditor's understanding of such an entity's operations and of the relevant industry, regulatory and other external factors required under ISA (UK and Ireland) 315 is likely to be simple in form and relatively brief.
16. This understanding may be documented using, for example, free-form narrative notes or by completing a structured form. The notes may be maintained separately or incorporated in the documentation of the overall audit strategy required by ISA (UK and Ireland) 300.
17. The key elements which are documented by the auditor include those that impact the auditor's assessment of the risks of material misstatement in the financial statements.

*Simple accounting systems*

18. Most smaller entities have a relatively uncomplicated accounting process. They are likely to employ few, if any, personnel solely engaged in record-keeping and there will be limited opportunities for segregation of duties.
19. Bookkeeping procedures and accounting records are often simple and there are usually no documented descriptions of accounting policies or procedures. Smaller entities are likely to use an off the shelf accounting package in producing their accounts. Understanding of the accounting package in question, including that gained from other audits, can help the auditor to identify and focus on areas of risk that arise from the accounting system.
20. The audit documentation associated with the accounting system is likely to be relatively simple, focussing on how the main transaction cycles operate (including how a transaction originates and gets recorded) and highlighting the risks of material misstatement that arise from the nature of the systems in place<sup>2</sup>.

*Relatively small number and informal nature of controls*

21. In the audit of a smaller entity, the auditor may decide that most of the audit evidence will be obtained from substantive tests of detail. Notwithstanding this, as part of the process of assessing the risks of material misstatement, the auditor is required by ISA (UK and Ireland) 315 to obtain and document an understanding of the components of the entity's

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2 Auditors of UK companies will be conscious of their responsibilities under Section 498 of the Companies Act 2006 to carry out such investigations as will enable them to form an opinion as to whether adequate accounting records have been kept by the company.

internal control relevant to the audit (including, for example, the control environment, information systems relevant to financial reporting, and control activities).

22. Size and economic considerations in smaller entities often reduce the opportunity for formal control activities, although some basic control activities are likely to exist for the main transaction cycles such as revenues, purchases and employment costs. Management's direct control over key decisions and the ability to intervene personally at any time to ensure an appropriate response to changing circumstances, are often important features of the management of any entrepreneurial venture. For example, management's sole authority for granting credit to customers and approving significant purchases can provide strong control over those important account balances and transactions, lessening or removing the need for more detailed control activities. Furthermore, management often has a personal interest in safeguarding the assets of the entity, measuring its performance and controlling its activities, and so they will apply their own controls and develop their own key indicators of performance.
23. However, the dominant position of management in a smaller entity may be abused and can result in the override of controls and inaccurate accounting records. Furthermore, personal and business objectives can be inextricably linked in the mind of the owner-manager, which increases audit risk. For example, personal tax planning considerations might be important and could provide management with the motivation to bias the financial statements.
24. The extent and nature of management's involvement in internal control in a smaller entity is likely to be a key aspect in the documentation of the auditor's understanding of the entity and assessment of risk, including for example:
  - The evaluation of the control environment, including consideration of the attitude and motives of management based on prior year experience and the observation of management's actions during the audit.
  - Specific control activities relevant to the audit. These are likely to be limited but may include management's direct involvement in, and/or supervision of, controls that mitigate risks of material misstatement.
  - The key indicators used by management for evaluating financial performance.

*Nature of the professional relationship between smaller entities and their auditors*

25. Management of a smaller entity often need professional advice and assistance on a wide range of accounting and related financial and business issues which are not available 'in-house' and it is common for the audit firm to provide non-audit services, including accounting and taxation services. These services can enable the auditor to obtain useful information about the entity and about its objectives and strategies and the management style and ethos, as well as helping to keep the understanding of the entity up to date and so plan the audit efficiently.

26. In circumstances where the audit firm provides non-audit services, the auditor bears in mind the need to maintain objectivity when forming and expressing an opinion on the financial statements. When forming an opinion, but before issuing the report on the financial statements, the audit engagement partner reaches and documents an overall conclusion<sup>3</sup> that any threats to objectivity and independence have been properly addressed in accordance with APB Ethical Standards including, where appropriate, ES – Provisions Available for Small Entities<sup>4</sup>.
27. The documentation considerations associated with providing non-audit services include the following:
- To achieve completeness of ‘audit documentation’, information, gained as a result of the provision of other services, which is used as audit evidence needs to be incorporated or cross-referenced into the audit documentation.
  - The auditor’s assessment of his or her objectivity and independence is documented, including a description of the threats identified and the safeguards applied to eliminate or reduce the threats to an acceptable level<sup>5</sup>.
  - The respective responsibilities of the directors (or equivalent) and the auditor are documented in an engagement letter. This is particularly important where the audit firm is involved in the preparation of the financial statements.

*Relatively small audit team size*

28. Audits of smaller entities may be conducted by small audit ‘teams’, possibly involving the audit engagement partner working with one audit assistant (or without any audit assistants).
29. In all circumstances, to meet the requirements of ISA (UK and Ireland) 230 (Revised), the audit documentation must, as a minimum, be sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the audit approach adopted, the audit evidence obtained, and the significant matters arising during the audit and the conclusions reached thereon.
30. However, as the size of the engagement team increases, or where more inexperienced team members are introduced, more detailed documentation may assist the team in obtaining an appropriate understanding of the entity. There may also be more reviews

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3 As required by paragraphs 43 and 54 of ES 1.

4 ES – Provisions Available for Small Entities provides alternative provisions for auditors of Small Entities (size criteria for Small Entities are set out in paragraph 4) to apply in respect of certain threats arising from economic dependence and the provision of non-audit services and allows the option of exemptions from certain requirements in ES 1 to 5.

5 As required by ES 1, paragraph 54, and ES 5, paragraph 37

performed in compliance with quality control policies and procedures, although the format of documentation for these reviews is not affected by the audit team size.

*Use of proprietary audit systems*

31. Where the auditor of a smaller entity operates in a small practice, it is likely that use will be made of an audit methodology and/or audit software provided by an external supplier (proprietary systems). Proprietary systems are usually comprehensive and are designed to deal with a wide variety of client situations. To be used efficiently and effectively, the auditor needs to think carefully about how the system should be applied to each individual client entity.
32. Documentation of the understanding of the entity including its controls is usually embedded into proprietary systems by use of optional check lists or 'white space' techniques. A risk exists that less experienced staff might think that it is compulsory to comply with all elements of these systems, without tailoring the approach to the needs of the particular entity, and thereby prepare excessive, and often irrelevant and costly audit documentation. Proper training and supervision of junior staff and communication within the engagement team can help to overcome this risk.
33. Even where a proprietary system is used, a free-form planning memorandum can be a good way of documenting the auditor's understanding of the business and the basis for the risk assessments made. Such a memorandum can then easily be updated from one year to the next.

**Audit Documentation Requirements in ISAs (UK and Ireland)**

34. In addition to ISA (UK and Ireland) 230 (Revised), several other ISAs (UK and Ireland) set out further specific audit requirements and guidance in relation to audit documentation. The Appendix to ISA (UK and Ireland) 230 (Revised) lists the main paragraphs that contain such specific requirements and guidance.
35. Taking these requirements and guidance into account, the content of the file(s) for an individual audit engagement includes the key matters to document summarised in the table below to the extent they apply in the context of the engagement. Where matters are not applicable, there is no need to include any references to them in the audit working papers.

Subject Matter	ISA/ISQC (UK and Ireland) main paragraphs setting out requirements and, in [ ], guidance	Key matters to document <sup>6</sup>
<b>General</b>		
– Departures, if any, from basic principles or essential procedures	ISA (UK and Ireland) 230 (Revised) “Audit Documentation”  <b>21, [22]</b>	How the alternative procedures performed achieve the objective of the audit and, unless otherwise clear, the reasons for the departure. <sup>7</sup>
– Audit procedures performed	ISA (UK and Ireland) 230 (Revised)  <b>9</b>	Sufficient detail to enable an experienced auditor, having no previous connection with the audit, to understand:  (a) The nature, timing, and extent of the audit procedures performed to comply with ISAs (UK and Ireland) and applicable legal and regulatory requirements;  (b) The results of the audit procedures and the audit evidence obtained; and  (c) Significant matters arising during the audit and the conclusions reached thereon.
– Consideration of ethical requirements and, in particular, independence	ISA (UK and Ireland) 220 “Quality Control for Audits of Historical Financial Information”  <b>12, [11, 13]</b>	Conclusions on auditor independence (both actual and perceived) and any relevant discussions within the firm that support these conclusions. Including actions taken where threats to independence exist that safeguards may not be able to eliminate or reduce to an acceptable level.

<sup>6</sup> These matters are presented in the form of a summary combining both the bold text requirements and the supporting guidance that set out matters which the auditor documents. The footnotes include further guidance relating to matters such as the nature and form of documentation. It is necessary to refer to the relevant ISA/ISQC (UK and Ireland) paragraphs for the full detail of the specific documentation requirements and guidance. UK and Ireland “pluses” in the standards are highlighted by shading.

<sup>7</sup> The ISA (UK and Ireland) indicates that this documentation requirement does not apply to basic principles and essential procedures that are not relevant in the circumstances, e.g. those relating to internal audit where there is no such function (paragraph 22).

Subject Matter	ISA/ISQC (UK and Ireland) main paragraphs setting out requirements and, in [ ], guidance	Key matters to document <sup>6</sup>
		Any issues identified with respect to compliance with ethical requirements and how they were resolved, including identified threats and safeguards applied.
<b>Engagement acceptance and continuation</b>		
– Acceptance and continuance	ISQC (UK and Ireland) 1 “Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements” <b>28</b> ISA (UK and Ireland) 220 “Quality Control for Audits of Historical Financial Information” <b>14, [16]</b>	The quality control procedures performed regarding the acceptance/continuance of the engagement, conclusions reached from those procedures and how issues, if any, were resolved.
– Terms of the engagement	ISA (UK and Ireland) 210 “Terms of Audit Engagements” <b>5-1, [2, 5, Appendix 2]</b>	The terms of the engagement, including the auditor’s acceptance of the appointment, the objective and scope of the audit, the extent of the auditor’s responsibilities to the client and the form of any reports. <sup>8</sup>  In the UK and Ireland, there is a requirement that the auditor should ensure that the engagement letter documents and confirms the auditor’s acceptance of the appointment, and includes a summary of the responsibilities of those charged with governance and of the auditor, the scope of the engagement and the form of any reports.

8 There is no specific requirement for an engagement letter, but the ISA (UK and Ireland) makes clear that one is in the interest of both client and auditor, and one is mandated by some professional accountancy bodies. Examples of matters that may be covered in an engagement letter are given in ISA (UK and Ireland) 210.

Subject Matter	ISA/ISQC (UK and Ireland) main paragraphs setting out requirements and, in [ ], guidance	Key matters to document <sup>6</sup>
		Appendix 2 to ISA (UK and Ireland) 210 (Revised) sets out illustrative wording to describe the responsibilities of the directors and the auditor and the scope of the audit, for a limited (non-listed) company client for an audit conducted in accordance with ISAs (UK and Ireland).
<b>Planning the audit</b>		
– Overall audit strategy	ISA (UK and Ireland) 300 “Planning an Audit of Financial Statements” <b>22</b> , [10, 12, 23, 25, 26]	The key decisions considered necessary to properly plan the audit and to communicate significant matters to the engagement team (e.g. regarding the overall scope, timing and conduct of the audit). <sup>9</sup>  Any significant changes made during the audit, the reasons therefore, and the auditor’s response to the events, conditions, or results of audit procedures that resulted in such changes.
– Audit plan, including procedures to respond to assessed risks	ISA (UK and Ireland) 300 <b>22</b> , [14, 15, 24, 25, 26]	The planned nature, timing and extent of risk assessment procedures, and further audit procedures at the assertion level for each material class of transaction, account balance, and disclosure in response to the assessed risks. <sup>10</sup>

9 The guidance in the ISA (UK and Ireland) indicates that a brief memorandum prepared at the completion of the previous audit, based on a review of the working papers and highlighting issues identified in the audit just completed, updated and changed in the current period based on discussions with the owner-manager, can serve as the basis for planning the current audit engagement (paragraph 12).

10 The guidance in the ISA (UK and Ireland) indicates that the auditor may use standard audit programs or audit completion checklists appropriately tailored to reflect the particular engagement circumstances (paragraph 24).

Subject Matter	ISA/ISQC (UK and Ireland) main paragraphs setting out requirements and, in [ ], guidance	Key matters to document <sup>6</sup>
		Any significant changes made during the audit, the reasons therefore, and the auditor's response to the events, conditions, or results of audit procedures that resulted in such changes.
<ul style="list-style-type: none"> <li>- Understanding of the entity and its environment</li> </ul>	<p>ISA (UK and Ireland) 315 "Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement" <b>122</b>, [20, 43, 123]</p>	<p>Key elements of the understanding obtained regarding:</p> <ul style="list-style-type: none"> <li>(a) Industry, regulatory, and other external factors, including the applicable financial reporting framework.</li> <li>(b) Nature of the entity, including the entity's selection and application of accounting policies.</li> <li>(c) Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements.</li> <li>(d) Measurement and review of the entity's financial performance.<sup>11</sup></li> <li>(e) Internal control, including: <ul style="list-style-type: none"> <li>- The control environment.</li> <li>- The entity's risk assessment process.</li> <li>- The information system, including the related business processes, relevant to financial reporting, and communication.</li> <li>- Control activities.</li> <li>- Monitoring of controls.</li> </ul> </li> </ul> <p>to assess the risks of material misstatement of the financial statements.</p>

<sup>11</sup> Smaller entities often do not have formal processes to measure and review financial performance. However, enquiries of management may reveal that they rely on certain key indicators for evaluating financial performance, for example, sales per day or week end bank balances.

Subject Matter	ISA/ISQC (UK and Ireland) main paragraphs setting out requirements and, in [ ], guidance	Key matters to document <sup>6</sup>
		<p>The sources of information from which the understanding was obtained.</p> <p>The risk assessment procedures.<sup>12</sup></p>
<p>– Use of a service Organisation</p>	<p>ISA (UK and Ireland) 402 “Audit Considerations Relating to Entities Using Service Organisations”</p> <p><b>5-3, [5-4, 9-13]</b></p>	<p>The contractual terms which apply to relevant activities undertaken by the service organization and the way that the entity monitors those activities so as to ensure that it meets its fiduciary and other legal responsibilities.<sup>13</sup></p> <p>For each relevant activity involving maintenance of material elements of the entity’s accounting records by a service organisation – an understanding as to the way that the accounting records are maintained, including the way in which those charged with governance ensure that the entity’s accounting records meet any relevant legal obligations.</p>
<p>– Assessment of the risks of material misstatement and, in particular, those risks related to fraud<sup>14</sup></p>	<p>ISA (UK and Ireland) 315</p> <p><b>122, [123]</b></p> <p>ISA (UK and Ireland) 240 “The Auditor’s Responsibility to Consider Fraud in an</p>	<p>The discussion among the engagement team regarding the susceptibility of the entity’s financial statements to material misstatement due to error or fraud, and the significant decisions reached.<sup>15</sup></p> <p>The identified and assessed risks of material misstatements, due to error</p>

12 The guidance in the ISA (UK and Ireland) indicates that the manner in which these matters are documented is for the auditor to determine using professional judgment. In particular, the results of the risk assessment may be documented separately, or may be documented as part of the auditor’s documentation of further procedures (see below re paragraph 73 of ISA (UK and Ireland) 330). Examples of common techniques, used alone or in combination include narrative descriptions, questionnaires, check lists and flow charts (paragraph 123).

13 Paragraph 5-4 of the ISA (UK and Ireland) gives examples of matters the auditor may consider.

14 ISA (UK and Ireland) 240 expands on the standards and guidance in ISAs (UK and Ireland) 315 and 330. Presenting ISA (UK and Ireland) 240 separately, rather than embodying its content in ISAs (UK and Ireland) 315 and 330 emphasises the importance of the auditor’s responsibility to consider fraud in an audit of financial statements. To comply with the requirements of ISA (UK and Ireland) 240, matters related to fraud need to be identifiable as such.

15 This requirement would not apply where the audit is performed by a single individual.

Subject Matter	ISA/ISQC (UK and Ireland) main paragraphs setting out requirements and, in [ ], guidance	Key matters to document <sup>6</sup>
	Audit of Financial Statements” <b>107, 110</b> [60, 111]	or fraud, at the financial statement level and at the assertion level for classes of transactions, account balances and disclosure, including: <ul style="list-style-type: none"> <li>• Significant risks identified, and the related controls evaluated.</li> <li>• The risks identified, and the related controls evaluated, where it is not possible or practicable to reduce the risks of material misstatement at the assertion level to an acceptably low level with audit evidence obtained only from substantive procedures.</li> </ul> If the auditor has concluded that there is not a significant risk due to fraud related to revenue recognition, the reasons for that conclusion.
<b>Procedures performed in response to assessed risks</b>		
– Overall responses and specific procedures <sup>10</sup>	ISA (UK and Ireland) 330 “The Auditor’s Procedures in Response to Assessed Risks” <b>73, [73b]</b> ISA (UK and Ireland) 240 <b>108, [111]</b>	The overall responses to the assessed risks of material misstatements due to error or fraud at the financial statement level.  The nature, timing and extent of audit procedures, and the linkage of those procedures with the assessed risks of material misstatement due to error or fraud at the assertion level.
		If the auditor plans to use audit evidence about the operating effectiveness of controls obtained in prior audits, the auditor should document the conclusions reached with regard to relying on such controls that were tested in a prior audit.

Subject Matter	ISA/ISQC (UK and Ireland) main paragraphs setting out requirements and, in [ ], guidance	Key matters to document <sup>6</sup>
– Identifying characteristics of the specific matters or items being tested	ISA (UK and Ireland) 230 (Revised) <b>12</b> , [13]	In documenting the nature, timing and extent of audit procedures performed – the identifying characteristics of the specific items or matters being tested. <sup>16</sup>
– Results	ISA (UK and Ireland) 330 “The Auditor’s Procedures in Response to Assessed Risks” <b>73</b> , [73b] ISA (UK and Ireland) 240 <b>108</b> , [111]	Results and conclusions of audit procedures performed, including where applicable those designed to address the risk of management override of controls.
– Agreement of financial statements to accounting records	ISA (UK and Ireland) 330 “The Auditor’s Procedures in Response to Assessed Risks” <b>73a</b> , [73b]	Demonstration that the financial statements agree or reconcile with the underlying accounting records.
– External confirmations	ISA (UK and Ireland) 505 “External Confirmations” [33]	Oral confirmations, if any, of responses received (e.g. where a response was received in electronic format and the auditor wishes to validate the source). <sup>17</sup>
– Discussion of significant matters with management or others	ISA (UK and Ireland) 230 (Revised) <b>16</b> , [17]	The significant matters discussed and when and with whom the discussions took place. <sup>18</sup>

16 Identifying characteristics will vary with the nature of the audit procedure and the item or matter being tested. Paragraph 13 of the ISA (UK and Ireland) gives examples.

17 The guidance in the ISA (UK and Ireland) states that if the information in the oral confirmations is significant, the auditor requests the parties involved to submit written confirmation of the specific information directly to the auditor (paragraph 33).

18 The guidance in the ISA (UK and Ireland) indicates that the documentation may include records, such as agreed minutes, prepared by the entity. Others with whom the auditor may discuss significant matters include those charged with governance, other personnel within the entity, and external parties, such as persons providing professional advice to the entity (paragraph 17).

Subject Matter	ISA/ISQC (UK and Ireland) main paragraphs setting out requirements and, in [ ], guidance	Key matters to document <sup>6</sup>
– Information that contradicts or is inconsistent with the auditor’s final conclusion regarding a significant matter.	ISA (UK and Ireland) 230 (Revised) <b>18</b> , [19]	How the auditor addressed the contradiction or inconsistency in forming the final conclusion. <sup>19</sup>
– Consultation on difficult or contentious matters	ISA (UK and Ireland) 220 <b>30</b> , [31, 33]	Nature, scope and conclusions; in sufficient detail to enable an understanding of the issue; and the results of the consultation, including any decisions taken, the basis for those decisions and how they were implemented.
– Differences of opinion between members of the engagement team and/or others consulted	ISQC (UK and Ireland) 1 <b>57</b>	The conclusions reached and the implementation of them.
– Non compliance, if any, with laws and regulations	ISA (UK and Ireland) 250 “Consideration of Laws and Regulations in an Audit of Financial Statements” Section A: <b>28</b> [Section B: 46]	The findings, including copies of records and documents, and minutes of discussions with management about them, if appropriate.  Where matters may be reportable to a regulator: the facts and the basis for the auditor’s decision (whether to report or not), such that the reasons for that decision may be clearly demonstrated should the need to do so arise in future.
– Concerns, if any, about going concern	ISA (UK and Ireland) 570 “Going Concern” <b>30-1</b>	The extent of the auditor’s concern.

19 The guidance in the ISA (UK and Ireland) indicates that the auditor does not need to retain documentation that is incorrect or superseded (paragraph 19).

Subject Matter	ISA/ISQC (UK and Ireland) main paragraphs setting out requirements and, in [ ], guidance	Key matters to document <sup>6</sup>
– Management representations	ISA (UK and Ireland) 580 “Management Representations” [10]	A summary of oral discussions with management or written representations from management.
– Communications, if any, about fraud.	ISA (UK and Ireland) 240 <b>109</b> , [111]	Communications about fraud with management, those charged with governance, regulators and others.
– Communications with those charged with governance	ISA (UK and Ireland) 260 “Communication of Audit Matters With Those Charged With Governance” [16]	Matters of governance interest that are communicated orally and any responses to those matters. <sup>20 21</sup>
– Directors’ report	ISA (UK and Ireland) 720 “The auditor’s statutory reporting responsibility in relation to directors’ reports” <b>Section B: 12</b>	Results of procedures performed to assess whether the information in the directors’ report is consistent with the financial statements, including details of any material inconsistencies and how they were resolved.  The conclusion reached as to whether the information in the directors’ report is consistent with the financial statements.
<b>Review of the audit</b>		
– Engagement Quality Control Review <sup>22</sup>	ISQC (UK and Ireland) 1 <b>73</b>	Confirmation that: (a) The procedures required by the firm’s policies on engagement quality control review have been performed.

20 The guidance in the ISA (UK and Ireland) indicates that this documentation may take the form of a copy of the minutes of the auditor’s discussion with those charged with governance (paragraph 16).

21 Whilst not addressed by the ISA (UK and Ireland) it is reasonable to presume that the auditor will keep copies of written communications addressing audit matters of governance interest.

22 Engagement quality control reviews are not required for all audits. Further requirements on the nature and scope of these reviews are set out in paragraphs 60 to 73 of ISQC (UK and Ireland) 1 and paragraphs 36 to 40 of ISA (UK and Ireland) 220.

Subject Matter	ISA/ISQC (UK and Ireland) main paragraphs setting out requirements and, in [ ], guidance	Key matters to document <sup>6</sup>
		(b) The engagement quality control review has been completed before the report is issued. (c) The reviewer is not aware of any unresolved matters that would cause the reviewer to believe that the significant judgments the engagement team made and the conclusions they reached were not appropriate.
– Identification of preparer and reviewer	ISA (UK and Ireland) 220 [25, 27] ISA (UK and Ireland) 230 (Revised) 23, [24]	Who performed the audit work and the date it was completed.  Who reviewed the audit work and the date and extent of the review. <sup>23</sup>
<b>The auditor's report</b>		
	ISA (UK and Ireland) 700 "The Auditor's Report on Financial Statements"	Whilst not addressed by ISA (UK and Ireland) 700, it is reasonable to presume that the auditor will keep a copy of the auditor's report.

*Assembly of the Final Audit File*

36. ISA (UK and Ireland) 230 (Revised) and ISQC (UK and Ireland) 1 also set out specific requirements and guidance in relation to the assembly of the final audit file and the confidentiality, safe custody, integrity, accessibility and retrievability and retention of engagement documentation.

37. With respect to individual engagements, ISA (UK and Ireland) 230 (Revised) requires that:

- The auditor should complete the assembly of the final audit file on a timely basis after the date of the auditor's report (paragraph 25).

<sup>23</sup> The guidance in ISA (UK and Ireland) 230 indicates that the requirement to document who reviewed the audit work performed does not imply a need for each specific working paper to include evidence of review. The audit documentation, however, evidences who reviewed specified elements of the audit work performed and when (paragraph 24).

- After the assembly of the final audit file has been completed, the auditor should not delete or discard audit documentation before the end of its retention period (paragraph 28).
- When the auditor finds it necessary to modify existing audit documentation or add new audit documentation after the assembly of the final audit file has been completed, the auditor should, regardless of the nature of the modifications or additions, document:
  - (a) When and by whom they were made, and (where applicable) reviewed;
  - (b) The specific reasons for making them; and
  - (c) Their effect, if any, on the auditor's conclusions (paragraph 30).

*Changes to Documentation after the Date of the Auditor's Report*

38. ISA (UK and Ireland) 230 (Revised) recognises that in exceptional circumstances it may be necessary to change audit documentation after the date of the auditor's report. For example when the auditor subsequently discovers facts that existed at the date of the auditor's report that, had the auditor been aware of them at the time, might have affected the auditor's report.
39. When such exceptional circumstances arise, requiring the auditor to perform new or additional audit procedures or leading the auditor to reach new conclusions, the auditor is required to document:
- (a) The circumstances encountered;
  - (b) The new or additional audit procedures performed, audit evidence obtained, and conclusions reached; and
  - (c) When and by whom the resulting changes to audit documentation were made, and (where applicable) reviewed (paragraph 31).

**Appendix – Illustrative examples of audit documentation**

This appendix includes a number of illustrative examples of audit documentation. The examples focus on aspects of ISAs (UK and Ireland) 315, 330 and 240. These represent the areas where most ‘new’ requirements were added as a result of the introduction of ISAs (UK and Ireland) in 2004 and initial feedback on the implementation of ISAs (UK and Ireland) suggests that this is the primary area where increased documentation has resulted in additional cost for audits of smaller entities.

Much of the information documented under the requirements of these ISAs (UK and Ireland) can be kept as ‘permanent’ information and reviewed and updated as necessary in subsequent years. Therefore, the documentation costs are likely to be highest in the first year of an audit following ISAs (UK and Ireland).

There are a number of different ways in which audit documentation requirements can be fulfilled. The following examples illustrate this by demonstrating more than one technique in a number of areas for the audit of one company, in some cases focussing on one particular sales cycle. They do not represent a comprehensive set of audit working papers and do not necessarily identify all the risks associated with a business of the nature described. They are not intended to set a minimum standard of documentation and other approaches can be used in practice with adaptations to the circumstances of the audit. For example, it would be possible to prepare one planning document that encompasses all the individual examples illustrated.

<b>Area of documentation</b>	<b>Illustrative approach</b>	<b>Page</b>
Understanding the entity	Example 1 – Free-form notes	21
	Example 2 – Based on a checklist	25
Audit team planning meeting	Example 3 – Excerpt from meeting using a pre-set agenda	30
Controls documentation	Example 4 – Free-form notes	33
	Example 5 – Based on a checklist and systems diagrams	38
Risk assessment	Example 6 - Based on risks	42
	Example 7 - Based on assertions	44

**Example documentation: for illustrative purposes only**

## **Example 1 – Free-form notes of Understanding the entity**

*(Documentation requirement at ISA (UK and Ireland) 315 paragraph 122(b))*

### *Nature of the entity*

Bulls Restaurant and Hotel Limited is a company that owns and operates a restaurant and hotel property in Manchester city centre. This property comprises a three storey building (wine bar on the ground floor, restaurant on the first floor and ballroom on the top floor) and an adjoining luxury hotel property of 10 en-suite rooms and 2 large family suites.

The company qualifies as a small company:

- Turnover is £2.5million.
- Balance sheet total is £1million.
- There are 25 permanent employees and a pool of approximately 15 casual staff who are used when special events are held.

The directors have chosen to have a voluntary audit for a number of reasons. However, if the property is reflected at its current value (about £3million) in the accounts, the audit exemption will not be available. Additionally, a non-executive (chartered accountant) director has suggested it would be valuable from a control viewpoint and in order that future expansion might be eased.

Revenue is generated from two sources – Food and Beverage (the wine bar, restaurant and function room) (70%) and Room revenue from the hotel (30%).

A local brewer supplies all alcohol and soft drinks – long established relationship.

The hotel business is reliant on travel agent and internet related bookings.

### *Industry factors*

Regeneration of Manchester city centre brought in a large number of competitors a few years ago. Occupancy rates of 80% and average room rate were maintained during this time but this resulted in a squeeze on margins as costs of supply increased.

Customers are now demanding a higher quality dining experience. Bulls is set up to provide this, but past experience is keeping clientele away. The client base may change in the future as a result of the following two factors:

**Example documentation: for illustrative purposes only**

- Unlike other local bars and restaurants, Bulls do not plan to apply for a change in their licence in order to be able to open later (currently 11pm in the wine bar, 12midnight in the restaurant and 1am in the function suite);
- The forthcoming changes relating to a ban on smoking in public places may change the nature of the client base attracted to the wine bar on the ground floor which is the public face of the business.

The business is subject to seasonal variation. This is most pronounced during December, when Christmas events increase turnover by over 100% and casual staff are employed for a large proportion of the time during this month.

*Regulatory factors*

- Environmental health inspections continue to be thorough and turn up areas for improvement.
- National minimum wage legislation is relevant.
- Tax treatment of gratuity payments was under dispute, but now agreed by HMRC.
- Health and Safety at work and fire safety legislation is relevant – there are a number of hazardous environments, especially in kitchen areas.
- A premises licence is held for the sale and supply of alcohol and provision of entertainment.

*Ownership and governance*

Single company owned by two family shareholders with a number of other minority shareholders. The directors are as follows:

			Shareholding
Executive directors:	Fred Bull	Brother	40%
	Jo Giles	Sister	40%
Non-executive directors:	Mark Quinn	Qualified lawyer	5%
	Lisa Swann	Qualified accountant	5%
	Terry Bull	Father	10%

The executive directors are in a dominant position, but past experience indicates that the active involvement of non-executive directors prevents an abuse of their position.

**Example documentation: for illustrative purposes only***Related parties*

A number of large functions have been held at the hotel for family and friends of the directors in the past. These have typically been invoiced at reduced rates compared to other customers, but have not been material and payments have been received promptly. There has therefore been no requirement for disclosure under FRSSE.

Terry Bull runs a local meat distribution company – Melville Foods. Much of the fresh meat used in the restaurant and for functions are supplied by this company, representing approximately 20% of the food costs of the company.

*Investments*

No major investments, except for freehold property, which is continually refurbished in order to maintain its value.

*Organisational structure and financing*

Company originally set up with share finance and bank loans (now repaid). The company has an overdraft facility of £50,000. This facility is fully utilised once or twice during the year, but it typically runs at £25,000. Annual meetings are held with a bank representative at which time the overdraft and any other loan facilities required for the forthcoming year are agreed.

*Accounting policies*

The company follows the FRSSE. In the past the property has been valued at cost. The directors have confirmed that they will revalue the property this year, after which they will need to keep this valuation up to date.

*Objectives and strategies and related business risks*

Management want to raise the standard of the restaurant and gain higher quality ratings in hotel and restaurant listings. Directors are researching the possibility of a second (rural) location: they propose to fund such expansion largely through bank finance.

*Measurement and review of financial performance*

Management review monthly management accounts prepared by a part time bookkeeper, that include a comparison with budgets which are prepared by the directors. KPIs include occupancy, average room rate, covers served, turnover and rooms, food and beverage gross profit margins. Following a squeeze on margins in the late 1990s these have been steady for a number of years.

Originally prepared by Sarah Cole Date June 20XX

**Example documentation: for illustrative purposes only**

Sources of information referred to:

- Discussion with Fred Bull and Jo Giles
- Share register
- Review of 20XW financial statements
- Management accounts for 20XX
- Review of debtor and creditor listings
- Company website

*Risk assessment procedures performed in 20XY*

Continuing relevance of the information above confirmed by discussion on 18<sup>th</sup> January with Fred Bull and Stacey Burrows, the bookkeeper.

Updated for 20XY audit by Sarah Cole Date January 20XU

***Impact on the audit – risks of material mis-statement relevant to audit for the year ended 31 January 20XY***

***At the Financial Statement Level***

1. *No pervasive risks of material misstatement have been identified. The assessment of risk at the financial statement level is “low”.*

***At the Assertion Level***

2. *Family company means related party transactions likely to occur, but may not be classified as such. (R102)*
3. *Possible unrecorded liabilities resulting from fines and other liabilities arising from reviews by EHOs and HMRC – in the past few years there has been a potential liability relating to the tax treatment of gratuity payments. (R101)*
4. *The directors have confirmed that they will revalue the property this year for the first time. They have arranged for a valuation to be carried out by HBE Valuers. This will be a material change in accounting policy. **This constitutes a significant risk.** (R103)*

**Example documentation: for illustrative purposes only**

## Example 2 – Understanding the entity based on a checklist

(Documentation requirement at ISA (UK and Ireland) 315 paragraph 122(b))

Objective:	To obtain an understanding of the entity and its environment sufficient to identify and assess the risks of material misstatement of the financial statements
Method:	Review notes from prior year audit, make enquiries of management, review recent industry press and management accounts.
Information sources:	Share register, management accounts for 20XX, debtor and creditor listings, company website

Factors to consider	Notes	Ref
<b>Industry, regulatory and other external factors</b>		
<b>Industry conditions</b>		
<ul style="list-style-type: none"> <li>➤ Market and competition</li> <li>➤ Cyclical/seasonal activity</li> <li>➤ Product technology</li> <li>➤ Energy supply and cost</li> </ul>	<p>The company owns and operates a restaurant and hotel. Regeneration in Manchester brought in a large number of competitors and it is still a competitive market. Occupancy rates of 80% and average room rates have been maintained, but margins are tight.</p> <p>Customers are demanding a higher quality dining experience. Bulls is set up to provide this but a poor reputation in the past is keeping people away.</p> <p>The business is subject to seasonal variation. This is most pronounced during December when Christmas events increase turnover by over 100% and casual staff are employed for a large part of the month.</p>	

**Example documentation: for illustrative purposes only**

Factors to consider	Notes	Ref
<b>Regulatory environment</b>		
<ul style="list-style-type: none"> <li>➤ Accounting principles and industry specific practices</li> <li>➤ Legislation and regulation</li> <li>➤ Taxation</li> <li>➤ Government policies</li> <li>➤ Environmental requirements</li> </ul>	<p>Environmental health inspections continue to be thorough and highlight areas for improvement.</p> <p>National minimum wage, fire safety and health and safety legislation are relevant.</p> <p>Tax treatment of gratuity payments was under dispute but is now agreed by HMRC.</p> <p>Premises licence held.</p>	R101
<b>Other factors affecting the business</b>		
<ul style="list-style-type: none"> <li>➤ General level of economic activity</li> <li>➤ Interest rates</li> <li>➤ Inflation</li> </ul>	<p>The company has maintained performance during the current year and draft accounts show a small profit for the year.</p>	
<b>Nature of the entity</b>		
<b>Business operations</b>		
<ul style="list-style-type: none"> <li>➤ Nature of revenue sources</li> <li>➤ Products, services and markets</li> <li>➤ Conduct of operations</li> <li>➤ Alliances, joint ventures and outsourcing activities</li> <li>➤ Involvement in e-commerce</li> <li>➤ Geographic dispersion</li> <li>➤ Industry segmentation</li> <li>➤ Key customers</li> <li>➤ Important suppliers</li> <li>➤ Employment</li> <li>➤ Research and development activities</li> <li>➤ Related parties</li> </ul>	<p>Revenue is generated from two sources – the wine bar, restaurant and function room (70%) and rooms in the hotel (30%). A high proportion of these are cash transactions.</p> <p>A local brewer supplies all alcohol and soft drinks and this is a long established relationship. The hotel business is reliant on travel agent and internet related bookings.</p> <p>This is a family company so related party transactions are likely to occur but may not be classified as such. One non-executive director runs Melville Foods</p>	R102

**Example documentation: for illustrative purposes only**

Factors to consider	Notes	Ref
	which supplies meat to Bulls, representing approximately 20% of the food costs of the company.	
<b>Investments</b>		
<ul style="list-style-type: none"> <li>➤ Acquisitions/mergers/disposals</li> <li>➤ Securities and loans</li> <li>➤ Capital investment activities</li> <li>➤ Investments in non-consolidated entities</li> </ul>	No major investments other than the freehold property which is continually refurbished to maintain value.	
<b>Financing</b>		
<ul style="list-style-type: none"> <li>➤ Group structure</li> <li>➤ Debt structure</li> <li>➤ Leasing</li> <li>➤ Beneficial owners</li> <li>➤ Related parties</li> <li>➤ Use of derivative financial instruments</li> </ul>	<p>80% of the issued share capital is held by the executive directors (F Bull and J Giles) who are brother and sister. Three non executive directors each own 5-10% share capital and are effective in preventing management abusing their position. The company was originally set up with share finance and bank loans (now repaid) and now has an overdraft facility of £50K. The facility is fully utilised a couple of times a year but typically runs at £25K.</p>	

**Example documentation: for illustrative purposes only**

Factors to consider	Notes	Ref
<b>Financial Reporting</b>		
<ul style="list-style-type: none"> <li>➤ Accounting principles and industry specific practices</li> <li>➤ Revenue recognition practices</li> <li>➤ Fair value accounting</li> <li>➤ Inventories</li> <li>➤ Foreign currency</li> <li>➤ Industry specific categories</li> <li>➤ Unusual or complex transactions</li> <li>➤ Financial statement presentation and disclosure</li> </ul>	<p>The company follows the FRSSE. In the past the property has been valued at cost. The directors have confirmed that they will revalue it for the first time this year – after which it must be kept up to date.</p>	<p>R103</p>
<b>Objective and strategies and related business risks</b>		
<p>How does the client address industry, regulatory and other external factors:</p> <ul style="list-style-type: none"> <li>➤ Industry developments</li> <li>➤ New products and services</li> <li>➤ Expansion of the business</li> <li>➤ New accounting requirements</li> <li>➤ Regulatory requirements</li> <li>➤ Current and prospective financing requirements</li> <li>➤ Use of IT</li> </ul> <p>What effect will implementing this strategy have on the entity?</p>	<p>The management wish to raise the standard of the restaurant and gain higher quality ratings in hotel and restaurant listings. The board are researching the possibility of a second rural location.</p>	

**Example documentation: for illustrative purposes only**

Factors to consider	Notes	Ref
<b>Measurement and review of the entity's financial performance</b>		
<ul style="list-style-type: none"> <li>➤ Key ratios and operating statistics</li> <li>➤ Key performance indicators</li> <li>➤ Employee performance measures and incentives</li> <li>➤ Trends</li> <li>➤ Use of forecasts, budgets and variance analysis</li> <li>➤ Analyst and credit rating reports</li> <li>➤ Competitor analysis</li> <li>➤ Period on period financial performance</li> </ul>	<p>Management review monthly accounts prepared by a part time bookkeeper which include comparison with budgets. KPIs include occupancy, average room rate, turnover and gross profit margin. These have been steady for a number of years.</p>	

**Risks of material mis-statement arising from Understanding the Entity**

*No pervasive risks of material misstatement have been identified. The assessment of risk at the financial statement level is "low"*

*R101 – Possible unrecorded liabilities resulting from fines and other liabilities arising from reviews by EHOs and HMRC – in the past few years there has been a potential liability relating to the tax treatment of gratuity payments.*

*R102 – Family company means related party transactions likely to occur, but may not be classified as such.*

*R103 – The revaluation of property for the first time will be a material change in accounting policy. **This constitutes a significant risk.***



**Example documentation: for illustrative purposes only**

- (d) While management are in a dominant position, two directors' signatures are required on all cheques and non-executive directors are actively involved in the business.
- (e) Purchases from and sales to related parties (directors and Melville Foods) could be made not at arms length (R102)
- (f) Fred Bull has complained about the amount of corporation tax and VAT the company is paying and has asked whether there are ways it could be reduced. He indicated, however, that he would not want the company to mislead HMRC deliberately and risk penalties. (R106)

**2. Team response to the assessed risks of material misstatement due to fraud including any additional work required**

- (a) Addressed in audit work on sales completeness
- (b) Confirm control consciousness of management by observation during the audit
- (c) Ensure that split of responsibilities is maintained by observation and walkthrough tests
- (d) Review Board meeting minutes to confirm attendance of non-executive directors.
- (e) Review invoicing for functions held for directors (unlikely to be material) and review invoices from Melville Foods
- (f) Remain alert for mis-accounting particularly in relation to matters affecting tax, e.g. expenditure v capital.

**B. Susceptibility of the financial statements to material misstatements due to error**

The term 'error' refers to an unintentional misstatement in the financial statements, including the omission of an amount or a disclosure, such as:

- A mistake in gathering or processing data from which financial statements are prepared.
- An incorrect accounting estimate arising from oversight or misinterpretation of facts; or
- A mistake in the application of accounting principles relating to measurement, recognition, classification, presentation or disclosure.

**Example documentation: for illustrative purposes only**

**1. Notes of team discussion on consideration of any known external and internal factors that may result in error**

- (a) Large number of small transactions so generally if errors arise should be small.
- (b) Some manual processes e.g. transfer of till rolls to spreadsheet which could result in error but if material should be identified by sales review. (R201)
- (c) Lack of preparation of debtors listing could lead to errors arising due to bad debts not being identified. (R202)

**2. Team response to the assessed risks of material misstatement due to error together with additional testing required**

Generally susceptibility to error is low, subject to items b) and c) identified above.

- (b) Unlikely to result in material misstatement: ensure that bank reconciliation control is operating effectively.
- (c) Request directors to compile a year end debtors listing and match invoices to cash received after year end.

**OVERALL CONCLUSION**

**(subject to points carried forward in the final notes)**

Generally susceptibility to fraud and error is low. Specific risks of material misstatement and responses are noted above. There is a limited risk of material misstatement at the financial statement level as there are few external users of the financial statements, the business is well-controlled and there are not many related parties.

Signed: P Cox

Date: 10 April 20X4

**Example documentation: for illustrative purposes only**

## **Example 4 – Free-form notes of controls documentation**

*(Documentation requirement at ISA (UK and Ireland) 315 paragraph 122(b))*

### ***Control environment***

Non-executive directors (including a professional accountant and lawyer) are personal friends or family of the two main directors, but are not involved in the business on a day-to-day basis. Directors' meetings are held on a bi-monthly basis, where management accounts are reviewed and business operational matters are discussed. A high level of reliance is placed on the part-time bookkeeper and the restaurant manager, who have been with the company for a number of years, and no significant problems with their work have been encountered in previous audits. The bookkeeper is a member of the Institute of Certified Bookkeepers.

Management's attitude to internal control is a very positive one. The two executive directors make a point of reviewing the records of the previous day's sales with key staff and holding regular staff meetings to emphasise the importance of maintaining both quality and control.

### ***Risk assessment process***

No formal process in place. Executive directors have an understanding of the key risks to the business:

- |                     |  |
|---------------------|--|
| Reputational risks: | <ul style="list-style-type: none"> <li>○ Possible failure of health and safety systems, resulting in poor reputation and possible fines or requirements for capital investment (R101)</li> <li>○ Loss of customers resulting from poor reviews or experience of 'loutish behaviour' (R301)</li> </ul>                              |
| Financial risks:    | <ul style="list-style-type: none"> <li>○ Losses due to stock shrinkage (R105)</li> <li>○ High level of cash transactions leading to potential loss through misappropriation (R104)</li> <li>○ Poor cash flow management (R302)</li> <li>○ Credit facilities given to corporate clients who are not credit-worthy (R303)</li> </ul> |

**Example documentation: for illustrative purposes only**

***Information system***

Food and beverage transactions are recorded on EPOS terminals in situ. Room revenue is generated from a separate hotel computer system. All revenues are totalled daily and input manually to the ACT accounting system. All systems have been in place for a number of years. ACT has been experienced on a number of other small clients in the firm.

***Monitoring controls***

Formal monitoring controls consist of:

- The executive directors review the monthly stock-take information and follow up any shrinkage with bar staff.
- The bank reconciliation is reviewed by one of the non-executive directors, who is a qualified accountant.

Originally prepared by Sarah Cole Date June 20XX

Continuing relevance of the information above confirmed by discussion with Fred Bull and Stacey Burrows, the bookkeeper. These monitoring controls have been found by previous audits to have operated effectively in prior years. They will be tested again this year.

Internal control notes updated

for 20XY audit by Sarah Cole Date January 20XY

***Impact on the audit – risks of material mis-statement relevant to audit for the year ended 31 January 20XY***

A high volume of cash transactions (combined with manual transfers of information from till rolls to a spreadsheet summary and then to the accounting system) increases the risks of inaccuracies in the sales cycles for all sources of revenue.

**Example documentation: for illustrative purposes only**

*Information system and control activities – extract from notes relevant to sales cycle*

This is an extract of information from the permanent audit file, which is relevant only to liquor sales in the wine bar, restaurant and function room.

### ***Liquor sales***

#### ***Sources of income***

*Wine bar (40%), restaurant (35%), function room (25%)*

#### ***Methods of recording orders***

*Alcoholic and soft drinks are all served from the bar areas in the wine bar, restaurant and function room. In the wine bar and function room these are dealt either:*

- On a cash basis, where details of the drinks served are input to the EPOS system terminal and payment is made by the customer at the time of serving.*
- On credit, where a tab is opened on the EPOS terminal and either a credit card is retained behind the bar for use in settling the account when the guests are leaving or an invoice is made up on the following day from the details recorded.*

*In the restaurant, the orders are input to a waiter's terminal by waiting staff and paid for by the guest at the end of the meal. Drinks are served from the bar area in accordance with what has been input to the system.*

#### ***Method of ensuring all sales are recorded***

*At the end of each day (or shift), all EPOS terminal till rolls are printed. Beverage sales totals are input from the till rolls to a summary spreadsheet maintained by the restaurant manager, together with an analysis of credit card and cash takings and amounts to be invoiced.*

*Invoices are made up for credit sales in the function room by the restaurant manager or one of the directors, using the information recorded by the EPOS terminal. These are handwritten and are taken from a pad with pre-printed serial numbers.*

**Example documentation: for illustrative purposes only**

***Accounting records and method of use***

Information on sales totals is taken from the spreadsheet maintained by the restaurant manager and input directly to the ACT accounting system on a weekly basis by the bookkeeper.

At the end of each month an independent stocktake is carried out on all bar stocks (excluding hotel mini-bar stock). Closing stock values are input to the general ledger and gross profit margins monitored by the directors. Any variations in stock shrinkage from the norm are followed up with bar staff.

The bookkeeper reconciles the cash and credit card receipts with cash banked and receipts recorded on the bank statements. She also maintains a file of all unpaid invoices from the function room and where cash is received in the post, this is matched to these invoices. The file is reviewed on an ad hoc basis by one of the executive directors and clients are chased for payment where appropriate.

***Impact on the audit – risks of material mis-statement***

R104 There is a fraud risk arising from the possible misappropriation of cash when cash sales are not input to an EPOS terminal. ***This is a significant risk.*** In relation to this the independent monthly stocktake provides a mitigating control by highlighting stock shrinkages that are outside the norm (follow up of shrinkages has led to staff being dismissed in the past). ***This control will be tested.***

R201 A high volume of cash transactions (combined with manual transfers of information from till rolls to a spreadsheet summary and then to the accounting system) increases the risks of inaccuracies in the sales cycle.

R202 No debtors listing is maintained and follow up of unpaid invoices is done on an ad hoc basis. This leads to a risk that bad debts are not provided for – past experience suggests a reluctance to accept that particular debts are 'bad'. Christmas and New Year

**Example documentation: for illustrative purposes only**

*functions are material and some debtors relating to this period are still outstanding two months after the year end.*

*R203 Deposit invoices raised in advance of a function may be treated as sales at the time of invoicing rather than the date of the function, creating a possible cut-off error.*

Originally prepared by Sarah Cole Date June 20XX

Continuing relevance of the information above confirmed by discussion with Fred Bull and Stacey Burrows, the bookkeeper.

Updated for 20XY audit by Sarah Cole Date January 20XY

**Example documentation: for illustrative purposes only**

**Example 5 – Controls documentation based on a checklist and systems diagrams**

*(Documentation requirement at ISA (UK and Ireland) 315 paragraph 122(b))*

**Objective:** To obtain an understanding of internal control sufficient to identify and assess the risks of material misstatement of the financial statements

**Method:** Review notes from prior year audit, make enquiries of management and perform walk through tests on transaction cycles.

Factors to consider	Notes	Ref
<b>Control environment</b>		
<ul style="list-style-type: none"> <li>➤ Communication and enforcement of integrity and ethical values</li> <li>➤ Commitment to competence</li> <li>➤ Participation by those charged with governance</li> <li>➤ Management’s philosophy and operating style</li> <li>➤ Organisational structure</li> <li>➤ Assignment of authority and responsibility</li> <li>➤ Human resource policies and practices</li> </ul>	<p>Management’s attitude to internal controls is a very positive one. Executive directors make a point of reviewing the records of the previous day’s sales with key staff and holding regular staff meetings to emphasise the importance of maintaining both quality and control.</p> <p>Non executive directors are personal friends or family of the two main directors, but are not involved in the business on a day to day basis.</p> <p>Directors’ meetings are held every two months where management accounts are reviewed and business operational matters are discussed.</p> <p>A high level of reliance is placed on the part time bookkeeper and the restaurant manager (both have been with the co. for a number of years and no significant problems encountered in previous audits)</p> <p>The bookkeeper is a member of the Institute of Certified Bookkeepers.</p>	

Factors to consider	Notes	Ref
<b>Entity's risk assessment process</b>		
<ul style="list-style-type: none"> <li>➤ Changes in operating environment</li> <li>➤ New personnel</li> <li>➤ New or revamped information systems</li> <li>➤ Rapid growth</li> <li>➤ New technology</li> <li>➤ New business models, products or activities</li> <li>➤ Corporate restructurings</li> <li>➤ Expanded foreign operations</li> <li>➤ New accounting pronouncements</li> </ul>	<p>No formal process is in place. Executive directors have an understanding of the key risks to the business:</p> <ul style="list-style-type: none"> <li>• reputational risk (due to the failure of I&amp;ES systems &amp; loss of customers from poor reviews)</li> <li>• financial risks (due to stock shrinkage, misappropriation of cash, poor cash flow management and bad debts).</li> </ul>	
<b>Information system</b>		
<ul style="list-style-type: none"> <li>➤ Infrastructure and software</li> <li>➤ Document individual transaction cycles</li> <li>➤ Individual roles and responsibilities</li> <li>➤ Financial and accounting manuals</li> </ul>	<p>Food and beverage transactions recorded on EPOS terminals in situ. Room revenue is generated from a separate hotel computer system. Sales totals are taken from each system daily and input manually to the ACT accounting system. ACT accounting system is used by bookkeeper to prepare trial balance information.</p>	R201
<b>Control activities</b>		
<ul style="list-style-type: none"> <li>➤ Performance reviews</li> <li>➤ Information processing</li> <li>➤ Physical controls</li> <li>➤ Segregation of duties</li> </ul>	<p>See systems documentation on transaction cycles in Profit and Loss section:</p> <ul style="list-style-type: none"> <li>• Sales, Purchases, Payroll</li> </ul> <p>Segregation of duties in place over sales with responsibilities split between restaurant manager, receptionist and bookkeeper.</p>	P20-23

Factors to consider	Notes	Ref
<b>Monitoring of controls</b>		
<ul style="list-style-type: none"> <li>➤ Ongoing activities</li> <li>➤ Separate evaluations</li> <li>➤ Internal audit</li> <li>➤ Use of external information</li> </ul>	<p>Executive directors review monthly stock takes and follow up any shrinkage with bar staff.</p> <p>The bank reconciliation is reviewed by one of the non executive directors – a qualified accountant.</p> <p>These monitoring controls have been found by previous audits to have operated effectively in prior years. They will be tested again this year.</p>	

**Risks of material mis-statement arising from Components of internal control**

*R201 – A high volume of transactions (combined with manual transfers of information from till rolls to a spreadsheet summary and then to the accounting system) increases the risks of inaccuracies in the sales cycle.*

*Arising from systems documentation of beverage sales at P20:*

*R104 – There is a fraud risk arising from the possible misappropriation of cash when cash sales are not input to an EPOS terminal. **This is a significant risk.** In relation to this the independent monthly stocktake provides a mitigating control by highlighting stock shrinkages that are outside the norm (follow up of shrinkages has led to staff being dismissed in the past). **This control will be tested.***

Example documentation: for illustrative purposes only

Ref: P20

Beverage sales cycle – systems documentation

Transaction initiation and processing	Responsibility	Frequency	Controls in place over assertions	Risk
<pre> graph TD     A[Details of F&amp;B input to EPOS. Master price list held in system and applied to each item automatically.] --&gt; B[Payment made by customer and input to EPOS.]     B --&gt; C[Sales totals taken from till rolls and input invoices and input to spreadsheet.]     C --&gt; D[Spreadsheet information used to update ACT.]     E[Function room invoices prepared for credit sales from customer and notes on pricing kept in function diary.] -.-&gt; C             </pre>	Bar and restaurant staff	As F&B are ordered	C – No detailed control in place. Directors review daily sales totals and follow up where lower than expected. O, A, L – Customer would complain if not served with F&B ordered or charged more than expected.	
	Bar and restaurant staff	When F&B ordered or customer leaves	C – Executive directors review gross margins and monthly stock take and follow up any shrinkages with bar staff. O, A – total for cash taken is reconciled to total charges at the end of each shift and followed up by restaurant manager	R104- Misappropriation of cash at point of sale
	Restaurant manager	At end of each shift	C, F – Manager logs till roll from each terminal and checks Z-totals. Directors review daily sales totals and follow up where lower than expected. Function room invoices pre-numbered O, A – Bank reconciliation performed monthly, reviewed by non executive director	R201 – Manual posting errors
	Bookkeeper	Weekly	C, O, A – Bank reconciliation performed monthly, reviewed by non executive director	

Key to assertions: O = Occurrence, C = Completeness, A = Accuracy, F = Cutoff, L = Classification

**Example documentation: for illustrative purposes only**

**Example 6 – Risk assessment based on risks**

(Documentation requirements at ISA (UK and Ireland) 315 paragraph 122(c) and (d), ISA (UK and Ireland) 240 paragraph 107(b) and 108(a), ISA (UK and Ireland) 330 paragraph 73)

Beverage sales and debtors cycle SALES and TRADE DEBTORS – SUMMARY OF RISKS OF MATERIAL MISSTATEMENT and AUDIT RESPONSE						
Risk of material misstatement identified	Significant risk?	Mitigating internal controls	Likelihood of risk resulting in material misstatement	Assertions impacted	Audit procedures	Audit program reference
R104 – Misappropriation of cash at point of sale	✓ (this is a fraud risk)	Independent monthly stocktake to identify abnormal stock shrinkages	High	<b>Sales:</b> Completeness <b>Debtors:</b> Completeness	Review records of monthly stocktakes. Ascertain follow up taken where margins out of line with expectation	
R201 – Manual posting errors from till rolls and invoices to ACT via spreadsheet		Monthly bank reconciliation will identify cash received but no sale posted	Med	<b>Sales:</b> Completeness, Accuracy, Classification <b>Debtors:</b> Valuation	Review monthly bank reconciliations and ensure outstanding items clear during following month.  For sample of dates, check sales totals from till rolls and invoices to spreadsheets and accounting system	

**Example documentation: for illustrative purposes only**

Risk of material misstatement identified	Significant risk?	Mitigating internal controls	Likelihood of risk resulting in material misstatement	Assertions impacted	Audit procedures <i>These procedures are specific to this example only. They are not exhaustive and will not necessarily be useful in relation to similar risks in other circumstances.</i>	Audit program reference
R202 – Bad debts not provided for or written off			Med	<b>Debtors:</b> Valuation	From client debtor listing match invoices to cash received after year end or include in discussion of bad debts	
R203 – Sales not recorded or recorded in wrong period			Med	<b>Sales:</b> Completeness, Cutoff <b>Debtors:</b> Completeness	Check sample of function diary entries back to invoices to confirm sales recorded Check sample of invoices back to function diary to confirm sales recorded in the correct period	

Example documentation: for illustrative purposes only

### Example 7 – Risk assessment based on assertions

(Documentation requirements at ISA (UK and Ireland) 315 paragraph 122(c) and (d), ISA (UK and Ireland) 240 paragraph 107(b) and 108(a), ISA (UK and Ireland) 330 paragraph 73)

**Beverage sales and debtors cycle**  
**SALES and TRADE DEBTORS – RISK ASSESSMENT and AUDIT APPROACH SUMMARY**

<p><b>As a result of the issues considered during the planning, note here the risks of material misstatement associated with the audit of this section:</b></p> <p>R104 Due to the nature of the business there is a fraud risk of cash pilferage. Cash sales might not be input to EPOS at the point of sale and cash relating to these unrecorded sales stolen by bar and restaurant staff. This is a significant risk.</p> <p>R201 Manual transfer of amounts from invoices, till rolls and spreadsheets could create errors.</p> <p>R202 No debtors listing is maintained by the client with follow up of unpaid invoices not done systematically and bad debts not provided for.</p> <p>R203 Sales recorded in wrong period.</p>	
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Assertion (and risk of material misstatement)	Risk factors	Control in operation	Tests of control (programme reference)	Substantive procedures (programme reference)
<b>Sales</b>				
Occurrence (Low)	None			
Completeness (High)	R104 – ie. liquor sales	Monthly independent stocktake and review by directors will pick up significant amounts of pilferage	Review records of monthly stocktakes. Ascertain follow up taken where margins out of the with expectation. (TC 5)	Check sample of function diary entries back to invoices to confirm sales recorded
	R201	Monthly bank reconciliation will identify cash received but no sale posted	Review monthly bank reconciliations and ensure outstanding items clear during following month. (TC 6)	For sample of dates, check sales totals from till rolls and invoices to spreadsheets and accounting system (S14)

**Example documentation: for illustrative purposes only**

Assertion (and risk of material misstatement)	Risk factors	Control in operation	Tests of control (programme reference)	Substantive procedures (programme reference)
Accuracy (Medium)	R201	See above – monthly bank reconciliation	See above – review monthly bank reconciliations	See above – test postings for a sample of dates
Cut off (Medium)	R203	Pre-numbered function room invoices		Check sample of invoices back to function diary to confirm sales recorded in the correct period (ST 7)
Classification (Low)	R201	See above – monthly bank reconciliation	See above – review monthly bank reconciliations	See above – test postings for a sample of dates
<b>Debtors</b>				
Existence (Low)	None			
Rights and obligations (Low)	None			
Completeness (High)	R104, R201, R203	See above – independent stocktake and gross profit review, monthly bank reconciliation and pre-numbered invoices	See above – review records of monthly stocktakes and review monthly bank reconciliations	See above – test postings for a sample of dates and check sample of invoices back to function diary
Valuation and allocation (High)	R201	See above – monthly bank reconciliation	See above – review monthly bank reconciliations	See above – test postings for a sample of dates
	R202	None		From client debtor listing match invoices to cash received after year end or include in discussion of bad debts (DT5)



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