

An Effective and Efficient Audit – Journal Entry Testing

ASK KSA Consulting Inc.

1

Overview of the Requirements

Canadian Auditing Standards

2

Journal Entry Testing

- Specific CAS requirements:
 - CAS 240
 - Addresses the risk of fraud and management override of controls
 - CAS 315
 - Identify controls that address the risk of material misstatement at the assertion level
 - CAS 330
 - Perform substantive procedures related to the financial statement closing process

3

CAS 240
The Auditor's Responsibilities
Related to Fraud

4

Responsibilities of the Auditor

- Not the responsibility of the auditor to find or detect fraud
- The auditor's responsibility is to address the risk of fraud
 - Specific requirement to test journal entries to address the risk of management override of controls

5

Responsibilities of the Auditor

CAS 240.3:

- The auditor is concerned with fraud that causes a material misstatement in the financial statements
- Two types of intentional misstatements are relevant to the auditor
 - Misstatements resulting from fraudulent financial reporting
 - Misstatements resulting from misappropriation of assets

6

Responsibilities of the Auditor

CAS 240.5:

- An auditor is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, **whether caused by fraud or error**
- There is an unavoidable risk that some material misstatements may not be detected

7

Fraud Definition

CAS 240.12:

The intentional act by one or individual among management, TCWG, employees or third parties involving the use of deception to obtain an unjust or illegal advantage

8

Fraud vs. Error

- **Fraud:** Acts that are performed by a cunning person and intended to mislead people about the truth and/or harm the intended person or organization. If caught, the perpetrator could end up in jail.
- **Error:** Acts that are made unknowingly made someone who might lack knowledge or not have appropriate oversight. If caught, actions can be taken to help prevent it from happening again.

9

Professional Skepticism

CAS 240.8:

- When obtaining reasonable assurance, the auditor is responsible for:
 - Maintaining professional skepticism
 - Considering potential for management override of controls
 - Recognizing certain audit procedures may not detect fraud

10

Professional Skepticism

CAS 200.13:

- Maintain an attitude of professional skepticism
 - Not withstanding past experience of honesty and integrity
- An attitude that includes:
 - A questioning mind
 - Being alert to conditions which may indicate possible misstatement due to error or fraud
 - A critical assessment of audit evidence

11

CAS 315
Identifying and Assessing the
Risks of Material Misstatement

12

Identifying and Assessing RMM

- Required to understand the entity and its components of internal control including control activities
 - Specific requirement to test journal entries as part of identifying and assessing the risk of material misstatement

13

Identifying and Assessing RMM

- Revised CAS 315
 - Effective for years beginning on or after December 15, 2021
- Extant CAS 315 includes the same requirements but clarified and strengthened in Revised CAS 315

14

Controls Over Journal Entries

315.26:

- The auditor shall obtain an understanding of the control activities component, through performing risk assessment procedures, by:
 - a) Identifying controls that address risks of material misstatement at the assertion level in the control activities component as follows:
 - i. Controls that address a risk that is determined to be a significant risk;
 - ii. **Controls over journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments;**
 - iii. Controls for which the auditor plans to test operating effectiveness in determining the nature, timing and extent of substantive testing, which shall include controls that address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence; and
 - iv. Other controls that the auditor considers are appropriate to enable the auditor to meet the objectives of paragraph 13 with respect to risks at the assertion level, based on the auditor's professional judgment

15

Controls Over Journal Entries

CAS 315.A160:

- Controls addressing the risks of material misstatement at the assertion level **required for all audits**

• General ledger  Financial Statement

- The extent to which other controls are identified varies

16

Controls Over Journal Entries

CAS 315.A160 example:

In an audit of a less complex entity, the entity's information system may not be complex and the auditor may not plan to rely on the operating effectiveness of controls.

17

CAS 330
The Auditor's Responses to
Assessed Risk

18

Auditor's Response to Assessed Risk

- Required to perform certain procedures as a response to the assessed risk of material misstatement
 - Specific requirement to test journal entries as a substantive procedure related to the financial statement closing process

19

Financial Statement Closing Process

CAS 330.20:

The auditor's substantive procedures shall include the following audit procedures related to the financial statement closing process:

- a) Agreeing or reconciling information in the financial statements with the underlying accounting records, including agreeing or reconciling information in disclosures, whether such information is obtained from within or outside of the general and subsidiary ledgers; and
- b) Examining material journal entries and other adjustments made during the course of preparing the financial statements.**

20

Summary

21

What?

What should be considered?

- Manipulation in the financial reporting process
- Can occur:
 - Throughout the year
 - At period end
 - Through adjustments

22

Why?

Why is this important?

- Management is in a unique position to perpetrate fraud
- Risk is present in all entities
- Journal entry testing addresses the risk of management override of controls

23

How?

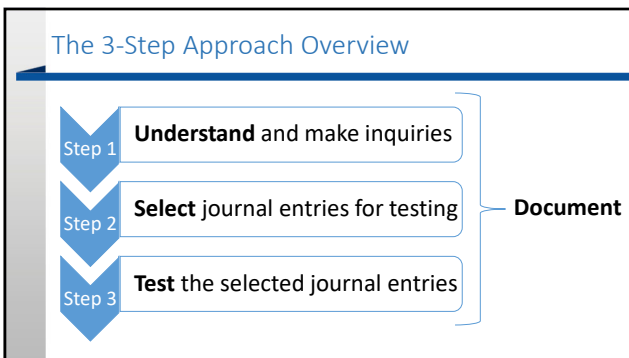
How to test journal entries?

- Design and perform audit procedures to test appropriateness
- In designing and performing audit procedures:
 - Make inquiries
 - Select journal entries made at the end of a reporting period
 - Consider need to test journal entries made throughout the period

24

3-Step Approach
Introduction

25



26

Step 1
Understand and Make Inquiries

27

Step 1: Objective

- Understand the controls surrounding journal entries
- Corroborate and supplement understanding to assist in recognizing inappropriate or unauthorized journal entries

28

Step 1: Purpose

- Addresses requirement to understand:
 - Control activities related to journal entries
 - Financial reporting closing process
- Helps to recognize:
 - Inappropriate or unauthorized journal entries
 - Other adjustments
 - Unusual journal entry activities

29

Step 1: Considerations

- Link understanding to:
 - Understanding the entity
 - Discussion of fraud risks
 - Design and implementation of financial reporting process
- Confirm understanding through inquiries however . . .

30

Step 1: Considerations

- Considerations for understanding:
 - What accounting software is used?
 - What are the types of journal entries made?
 - How are entries generated?
 - Who is authorized to record journal entries?
 - Who is authorized to approve journal entries?
 - When are journal entries typically processed?
 - What support is required?

31

Step 1: Considerations

- Considerations for inquiry:
 - What types journal entries are normally processed?
 - What other types were processed during the year?
 - Any without supporting documentation?
 - Who usually processes journal entries? Did others process journal entries that do not typically do so?

32

Step 1: Practical Application

- Start with obtaining an understanding of:
 - Standard journal entries
 - Non-standard journal entries
- Include others involved with the financial reporting process

33

Step 1: Practical Application

- Procedures may include:
 - Inquiry
 - Observing the application of specific controls
 - Inspecting documents and reports
 - Tracing transactions through the information system

34

Step 1: Practical Application

- Who records the JE? Who approves them?
- What are normal journal entries for your clients?
- What is considered an unusual JE?

35

Step 2

Select

36

Step 2: Objective

- Determine criteria
- Select the proper journal entries for testing

37

Step 2: Purpose

- Meets the requirement to test journal entries made during the financial reporting closing process
- Addresses the risk of fraud as journal entries selected for testing
 - Focus on the unusual, inappropriate or other journal entries made during the period

38

Step 2: Considerations

- Before selection:
 - Assess the completeness of the population
 - Determine the end of the reporting period
 - Selection criteria for other adjustments and journal entries
 - Materiality

39

Step 2: Considerations

- Matters of relevance in selecting journal entries outlined in CAS 240.A44:
 - Identification and assessment of the risks of material misstatement
 - Controls over journal entries and other adjustments
 - Entity's financial reporting process
 - Characteristics of fraudulent journal entries
 - Nature and complexity of accounts
 - Journal entries processed outside the normal course of business
 - Professional judgement

40

Step 2: Practical Application

- Tailor to
- Link back to understanding obtained in Step 1
- Obtaining list of the journal entries
 - At the end of the reporting period
 - Made throughout the period
- Assess completeness
- Determine criteria
- Document

41

Step 2: Practical Application

- Materiality
 - Consider
 - Other factors

42

Step 2: Assess Completeness

- Various approaches:
 - "Off the shelf" system-generated report
 - Identify first and last journal entry
 - Perform a roll forward
 - CAATs
 - Use of IT specialist

43

Step 2: End of the Reporting Period

- What constitutes the "end of the reporting" period?
 - Consider entries made before and after year end

44

Step 2: Journal Entries Throughout the Period

- Base selection criteria on understanding gained in Step 1
 - Standard JEs
 - Non-standard JEs
 - Unusual JEs
- Tailor

45

Step 2: Journal Entries Throughout the Period

- Characteristics:
 - Made to unrelated or unusual accounts
 - Made to seldom-used accounts
 - Made by individuals who typically do not post journal entries
 - Recorded and approved by the same person
 - Not approved
 - Made to related party accounts

46

Step 2: Journal Entries Throughout the Period

- Characteristics:
 - Outside normal course of business
 - Containing round numbers or consistent ending numbers
 - Recorded at an unusual time
 - Applied to accounts that:
 - Contain transactions that are complex or unusual
 - Contain significant estimates
 - Have been prone to misstatements
 - Have not been reconciled

47

Step 2: Practical Application

- Document selection criteria
- Incorporate unpredictability procedures

48

Step 3

Test the Appropriateness

49

Step 3: Objective

- Test the journal entries selected in Step 2 to determine appropriateness of journal entries

50

Step 3: Purpose

- Determine whether journal entries are:
 - Properly approved
 - Adequately supported
 - Properly recorded
 - Appropriately reflect underlying events and transactions

51

Step 3: Considerations

- Audit evidence obtained includes:
 - Discussion with management
 - Additional audit procedures
 - Source documents

52

Step 3: Considerations

- Are you provided source documents?
- Are documents missing?
- Do the documents appear to have been altered?
- Were the journal entries approved?
- Is the rationale appropriate?
- Do you need to trace to underlying information?

53

Step 3: Practical Application

- Determine procedures to be performed
- What constitutes a deviation?
- Conclude

54

Step 3: Practical Application

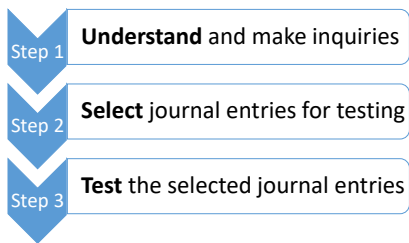
- Appropriate audit evidence may include:
 - Journal entry number
 - Debit? Credit?
 - Business rationale?
 - Date made?
 - By who?
 - Approved?
 - Supporting documentation?

55

Document

56

Document



57

Document

- Overall considerations:
 - Re-performance standard
 - Nature and extent of inquiries
 - Audit evidence obtained
 - Method:
 - PEG
 - Memo
 - Firm template

58

Scenario

- Practical Application Company Ltd.
 - Not-for-profit organization
 - Uses QuickBooks
 - Executive director – Diane Kroehl
 - Monthly reporting to the Board
 - Journal entries are by bookkeeper and approved by Diane

59

Document: Step 1

- Specific considerations:
 - Who did you talk to and date of discussions
 - Nature and extent of inquiries made
 - Responses
 - Characteristics of typical/standard journal entries
 - Findings
 - Evaluation of the design and the implementation

60

Document: Step 1

Client Name: Practical Application Company Ltd.

Year end: December 31, 20x0

Objective: To determine whether material misstatements (fraud or error) have occurred from the use of inappropriate, fictitious or unauthorized journal entries and to meet the requirements of CAS 240.33 (a).

Date of inquiries made: February 29, 20x1

With whom: Diane Kroehl (Executive Director)

61

Document: Practical Application – Step 1

Procedure	Response
Accounting software used to process journal entries.	QuickBooks. As this is a standard off the shelf program, no changes can be made to underlying reports.

62

Document: Practical Application – Step 1

Procedure	Response
Understand and document what constitutes the end of the reporting period.	Management keeps the books open for two month past year end and dates all year end adjusting journal entries as of December 31, 20x0.

63

Document: Practical Application – Step 1

Procedure	Response
Understand and document information system and business processes relevant to financial reporting closing process.	See documentation included on working paper 560 related to the design and implementation of controls related to financial reporting.

64

Document: Practical Application – Step 1

Procedure	Response
Understand and document management's policies and procedures regarding authorization and control over journal entries including: <ul style="list-style-type: none"> • Standard journal entries • Non-standard journal entries • Unusual transactions or adjustments • Other adjustments 	Journal entries are typically made by the bookkeeper. Documentation is required for all general journal entries. Diane approves the journal entries at the month end (Bookkeeper prints them off and provides list). Standard JEs include entries at period-end mainly related to prepaids, long-term debt payments and amortization. Funding from the government is also recorded via journal entry. Finally standard JEs also include reversing entries and post-closing entries. Inspected JE #555 related to prepaids; JE #789 related to amortization; JE #1054 related to debt repayment; and JE #212 related to funding. Non-standard JEs are made related to correction of payments, this happens on a fairly regular basis due to unexpected discounts. Inspected JE #831 related to correction.

65

Document: Practical Application – Step 1

Procedure	Response
Inquire about any usual or large entries made or unusual activity relating to the processing of routine JEs and other adjustments.	Based on discussions with Diane as noted above, there were no unusual or large entries made during the year. There was no unusual activity related to the processing of JEs.

66

Document: Practical Application – Step 1

Procedure	Response
Consider impact of any fraud risk factors identified.	No additional risk factors noted.

67

Document: Practical Application – Step 1

Procedure	Response
Conclude on design and implementation of controls relevant to journal entries.	Design: Controls have been designed effectively. Implementation: Controls are in place and are working.

68

Document: Step 2

- Specific considerations:
 - Procedures used to assess completeness of population
 - What constitutes the end of the reporting period
 - Selection criteria for other adjustments

69

Document: Practical Application – Step 2

Procedure	Response
Obtain list of all JE made during the year.	Obtained list of all JEs from QuickBooks JE Report.

70

Document: Practical Application – Step 2

Procedure	Response
Assess completeness.	Generated directly from system therefore complete.

71

Document: Practical Application – Step 2

Procedure	Response
Select journal entries made at the period end for testing.	Selected all journal entries made dated December 31, 20x0 and greater than performance materiality. See journal entries selected for testing in table below.

72

Document: Practical Application – Step 2

Procedure	Response
Based on the risk assessment, select journal entries made throughout the entire period for testing.	Selected journal entries for testing that were not classified as standard journal entries (as documented in Step 1 above, greater than performance materiality and those made to suspense accounts. See journal entries selected for testing in table below.

73

Document: Step 3

- Specific considerations:
 - Details of journal entries selected
 - Procedures performed
 - Findings about inappropriate or unusual activities relating to journal entries
 - Conclusions reached

74

Document: Practical Application – Step 3

- Testing documentation – Example 1:

JE Number	Traced to supporting documentation	JE Approved and Presented to the Board	Confirmed business reason for JE	Other documentation as required	Exceptions
123	Y	Y	Y	Y	
367	Y	Y	Y	Y	
459	Y	Y	Y	Y	
1059	Y	N	Y	Y	1
2687	Y	Y	Y	Y	
2999	Y	Y	Y	Y	
3579	Y	Y	Y	Y	
4121	Y	Y	Y	Y	

Audit Codes:

1. No approval noted for this journal entry. Based on discussion with client, this entry was posted while the ED was away on vacation. It was approved by the Board as part of the month end reporting process.

75

Document: Practical Application – Step 3

- Testing documentation – Example 2:

JE Number	Description	Date	Account	Amount	Documentation Examined	Entry Appropriate?	Indicative of Fraud or Management Override of Controls?
123	Record investment made.	August 12, 2000	1051	\$40,000	Investment statement	Y	N
367							
459							
1059							
2687							
2999							
3579							
4121							

76

Document: Practical Application

- Conclude:
 - Evaluate the results
 - Based on professional judgement

The audit evidence obtained is sufficient and appropriate to reduce the risk of material misstatement to an acceptably low level.

77

Document: Practical Application

- Communicate to TCWG:
 - Significant deficiencies
 - Exceptions or deviations

78

Bringing it all Together

79

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80

80

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81

81
