Appendix 4

(Ref: Para. A100, A104 and A143)

Additional Considerations that May Inform the Auditor When Selecting Journal Entries and Other Adjustments for Testing

The following considerations are of relevance when selecting journal entries and other adjustments for testing:

- Understanding of the entity's information system and communication relevant to the preparation of the financial report[93] (see also paragraph 35 of this ASA) – obtaining this required understanding provides the auditor with knowledge about:
  - The entity's policies and procedures regarding (including the individuals within the entity responsible for) how transactions are initiated, recorded, processed, corrected as necessary, incorporated in the general ledger, and reported in the financial report.
  - The types of journal entries (whether standard or non-standard) incorporated in the general ledger and, in turn, reported in the financial report, including other adjustments made directly to the financial report.
  - The process of how journal entries and other adjustments are recorded or made (whether automated or manual) as well as the supporting documentation required, based on the entity's policies and procedures.
  - The entity's financial report closing process.
- Understanding of the entity's controls designed to prevent or detect fraud over journal entries[94] (see also paragraph 36 of this ASA) – for many entities, routine processing of transactions involves a combination of manual and automated controls. Similarly, the processing of journal entries and other adjustments may involve both manual and automated controls across one or multiple IT systems. Where IT is used in the financial reporting process, journal entries and other adjustments may exist only in electronic form.
  - The types of controls designed to prevent or detect fraud over journal entries may include authorisations and approvals, reconciliations, verifications (such as edit and validation checks or automated calculations), segregation of duties, and physical or logical controls.
  - The requirement in paragraph 36 covers controls over journal entries that address a risk(s) of material misstatement due to fraud at the assertion level, and that could be susceptible to unauthorised or inappropriate intervention or manipulation. These controls include:
    - ♦ Controls over non-standard journal entries — where the journal entries are automated or manual and are used to record non-recurring, unusual transactions or adjustments.
    - ♦ Controls over standard journal entries — where the journal entries are automated or manual and are susceptible to unauthorised or inappropriate intervention or manipulation.
- The effectiveness of controls that have been implemented over journal entries and other adjustments— effective controls over the preparation and posting of journal entries and other

[93] See ASA 315, paragraph 25.
[94] See ASA 315, paragraph 26.

adjustments may reduce the extent of substantive testing necessary, provided that the auditor has tested the operating effectiveness of the controls.

- The identification and assessment of the risks of material misstatement due to fraud — the evaluation of information obtained from the risk assessment procedures and related activities, including the consideration of information obtained from other sources, could indicate the presence of fraud risk factors. Such fraud risk factors, particularly events or conditions that indicate incentives and pressures for management to override controls, opportunities for management override, and attitudes or rationalisations that enable management to justify override of controls, may assist the auditor to identify specific classes of journal entries and other adjustments for testing. These may include journal entries and other adjustments susceptible to unauthorised or inappropriate intervention or manipulation resulting from:
  - Pressures or incentives to meet or exceed performance measures used, internally and externally (e.g., auto-reversing journal entries made at year-end).
  - Pressures or incentives to minimise or avoid taxes (e.g., inappropriate journal entries to record premature or delayed revenue or expense recognition).
  - Pressures to comply with debt repayment or other debt covenant requirements (e.g., inappropriately offsetting assets and liabilities in the balance sheet by directly making adjustments to the financial report to achieve a debt covenant on the entity's debt-to-equity ratio, even when the conditions for a right of setoff are not met).
  - Opportunities, arising from the inappropriate segregation of duties, for any individual in the entity to conceal or perpetrate fraud in the normal course of that individual's duties (e.g., journal entries and other adjustments relating to transactions affecting assets, where the individual is responsible for (a) the custody of assets, or (b) the authorisation or approval of the related transactions affecting those assets, and (c) the recording or reporting of related transactions).
  - Opportunities arising from deficiencies in internal control (e.g., journal entries and other adjustments related to purchase payments to unauthorised suppliers or made by terminated or transferred employees).
  - Opportunities arising from privileged access granted to individuals involved in the financial report closing process (e.g., journal entries and other adjustments made by individuals with administrative or powerful users' access).
  - Opportunities arising from calculations based on end-user computing tools that support accounting estimates susceptible to misstatement due to management bias or fraud (e.g., journal entries and other adjustments based on calculations of impairment of goodwill and other intangible assets using spreadsheet software).
- The characteristics of fraudulent journal entries and other adjustments — inappropriate journal entries or other adjustments often have unique identifying characteristics. Such characteristics may include entries:
  - Made to unrelated, unusual, or seldom-used accounts.
  - Made by individuals who typically do not make journal entries.
  - Recorded at the end of the period or as post-closing entries that have little or no explanation or description.
  - Made either before or during the preparation of the financial report that do not have account numbers.
  - Containing round numbers or consistent ending numbers.

The auditor may use recent information, such as data on actual perpetrated frauds or reports regarding trends in occupational fraud, to inform the auditor as to characteristics of fraudulent journal entries.

- The nature and complexity of the accounts — inappropriate journal entries or adjustments may be applied to accounts that:
  - Contain transactions that are complex or unusual in nature.
  - Contain significant estimates and period-end adjustments.
  - Have been prone to misstatements in the past.
  - Have not been reconciled on a timely basis or contain unreconciled differences.
  - Contain intercompany transactions or transaction with related parties.
  - Are otherwise associated with an identified risk of material misstatement due to fraud.
- Journal entries and other adjustments processed outside the normal course of business – non-standard journal entries may not be subject to the same nature and extent of controls as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases, and cash disbursements