CHARTERED PROFESSIONAL ACCOUNTANTS CANADA

Implementation Tool for Auditors

CANADIAN AUDITING STANDARDS (CAS)

APRIL 2015

STANDARD DISCUSSED
CAS 240, The auditor's responsibilities relating to fraud in an audit of financial statements

Testing Journal Entries and Other Adjustments: Responding to the Risk of Management Override of Controls

The requirements to test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements apply to every audit, irrespective of your assessment of the risks of management override of controls. Although the level of risk of management override of controls will vary from entity to entity, the risk is nevertheless present in all entities. Due to the unpredictable way in which such an override could occur, it is a risk of material misstatement due to fraud and thus a significant risk which requires special audit considerations, one of which is to test journal entries and other adjustments.

This ***Implementation Tool for Auditors*** (**Tool**) will help you in designing an approach to testing journal entries and other adjustments as a response to risks of management override of controls. In this respect, the **Tool** focuses on how to comply with the requirements of CAS 240 paragraph 32(a): the "what" (requirements to be complied with by the auditor), the "why" (reason(s) for performing the requirements) and "how" (practical considerations for complying with the requirements).

This tool does not address the other procedures you are required to perform to respond to risks of management override of controls. Moreover, the tool does not address the requirement in CAS 330 paragraph 20(b) for the auditor to perform substantive procedures related to the financial statement closing process by examining material journal entries and other adjustments made during the course of preparing the financial statements. Journal entry testing may also be a source of testing for specific fraud risks other than management override.

CAS 240, The auditor's responsibilities relating to fraud in an audit of financial statements:

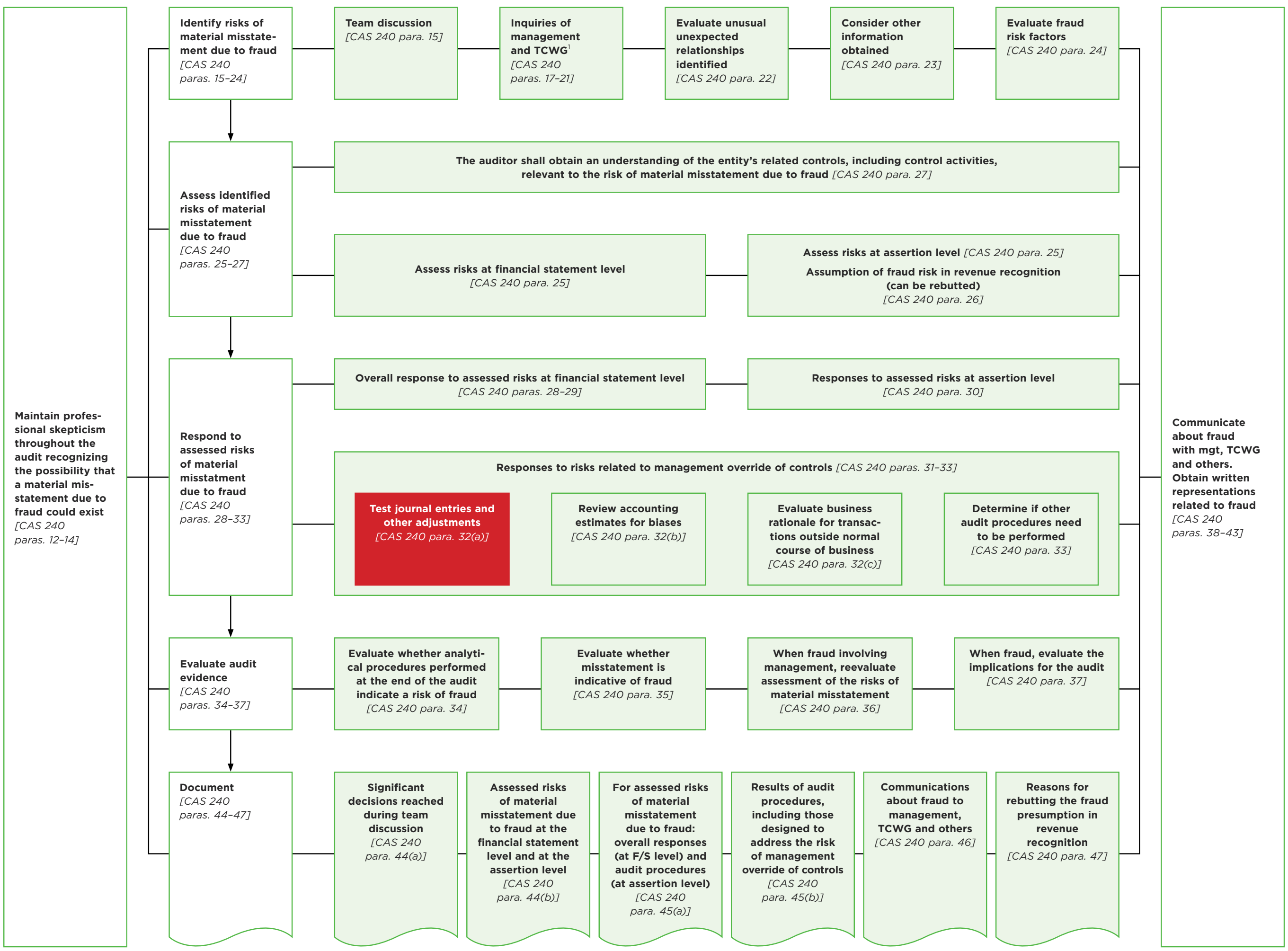
- focuses on your responsibility to obtain reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error
- states that when obtaining reasonable assurance, you are responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognizing the fact that audit procedures that are effective for detecting error may not be effective in detecting fraud
- defines fraud as an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage
- assists you in identifying and assessing the risks of material misstatement due to fraud and in designing procedures to detect such misstatement

You shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding your past experience of the honesty and integrity of the entity's management and those charged with governance. [CAS 240 paragraph 12]

CAS 240 requirements, including those applicable to responding to risks of management override of controls

Diagram 1 below summarizes the specific requirements in CAS 240 dealing with the auditor's responsibilities relating to fraud in an audit of financial statements. It highlights in red shading the specific requirements in paragraph 32(a) discussed in the **Tool** and shows how these specific requirements fit into the overall standard as well as their relation with other requirements. Although these requirements may appear to be a small component of responding to the risk of fraud in an audit, they have proven to be challenging for practitioners to apply.

Diagram 1



1 "TCWG" refers to Those Charged with Governance

Steps to test the appropriateness of journal entries and other adjustments as a response to risk of management override of controls

Diagram 2 illustrates an approach to testing journal entries and other adjustments as a response to risk of management override of controls. You will need to adapt your approach to the specific circumstances of your audit engagement.

This is a risk that requires special audit considerations, one of which is to test journal entries and other adjustments. CAS 240 paragraph 32 (a) requires you, **irrespective of your assessment of the risks of management override of controls**, to design and perform audit procedures to:

- Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements. In designing and performing audit procedures for such tests, the auditor shall:
  - make inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments
  - select journal entries and other adjustments made at the end of a reporting period, and
  - consider the need to test journal entries and other adjustments throughout the period

CAS 240, paragraph A41 reminds auditors that a material misstatement of financial statements due to fraud often involves the manipulation of the financial reporting process by recording inappropriate or unauthorized journal entries. This may occur throughout the year or at period end, or by management making adjustments to amounts reported in the financial statements that are not reflected in journal entries, such as through consolidating adjustments and reclassifications.

You are alerted to the fact that journal entry testing is broader than just looking at material journal entries and other material adjustments as required by paragraph 20(b) of CAS 330. Your procedures, under paragraph 32(a) of CAS 240, involve responding to the risks of material misstatement due to fraud arising from management override of controls. The nature, timing and extent of journal entry testing depend on the assessed risks of material misstatement due to fraud. Further, CAS 240 paragraph A43 states that, when identifying and selecting journal entries and other adjustments for testing, relevant matters include the characteristics of fraudulent journal entries or other adjustments, the nature and complexity of accounts and the journal entries or other adjustments processed outside the normal course of business. You will find in the **Tool** examples of these matters, which are referred to as "characteristics of potentially inappropriate journal entries." However, it is important to note that the testing required by paragraph 20(b) of CAS 330 does not necessarily address testing required by paragraph 32(a) of CAS 240.

Diagram 2

Steps to test the appropriateness of journal entries and other adjustments as a response to the risk of management override of controls

STEP 1

Understand the information system and business processes relevant to financial reporting, including controls surrounding:

- standard journal entries
- non-standard journal entries, and
- unusual transactions or adjustments

STEP 2

Make **inquiries** of individuals about inappropriate or unusual activity relating to the processing of journal entries and other adjustments.

STEP 3

Select the journal entries and other adjustments with characteristics of potentially inappropriate journal entries and other adjustments. Consider the need to test journal entries and other adjustments throughout the period.

STEP 4

Test the appropriateness of journal entries and other adjustments, as selected in Step 3.

STEP 5

Document results of journal entry and other adjustment testing.

Diagram 2—Step 1—Understand

"What"

[CAS 315 paragraph 18(f)]

The auditor shall **obtain an understanding** of the information system, including the related business processes, relevant to financial reporting, including the following areas:

> Controls surrounding journal entries, including non-standard journal entries used to record non-recurring, unusual transactions or adjustments.

"Why"

This understanding is used to help the auditor recognize inappropriate or unauthorized journal entries and other adjustments or unusual journal entry activities. Your understanding of the journal entries and other adjustments combined with your understanding of the fraud risk factors specific to the entity may be used to identify where there is the opportunity, and incentive for management to perpetrate fraud through manipulation of accounting records, inappropriate journal entries or other adjustments. You may also consider whether there are attitudes/rationalization in the entity, such as a poor tone at the top that may increase the risk of employees perpetrating a fraud within the entity.

Fraud risk factors may, for example, include incentives or pressures for individuals to misrepresent the results or financial position of the entity:

- for personal gain (e.g., salary, promotion, bonuses)
- to meet targets (n.b., consideration may also be given to non-GAAP measures, which may be important to analysts and investors; amounts may be reclassified within the financial statements in order to improve key performance indicators)
- to meet debt covenants, and
- to satisfy the requirements of third parties

[This step in conjunction with inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments (Step 2) will provide the basis for identifying the population of journal entries and other adjustments to be tested (Step 3).]

"How"

Even when you do not intend to place reliance on internal controls because you have taken a "substantive approach", at a minimum, you must evaluate the design of the entity's relevant controls over journal entries and other adjustments that are intended to address fraud risks and determine whether those controls have been implemented. Procedures to obtain audit evidence about the design and implementation of relevant controls may include:

- inquiring of entity personnel (inquiry alone is not considered sufficient appropriate audit evidence)
- observing the application of specific controls
- inspecting documents and reports
- tracing transactions through the information system relevant to financial reporting (walk-through)

Diagram 2—Step 1—Understand

"How" (continued)

You may consider the following elements for your understanding:

- What accounting software is the entity using (off-the-shelf or custom)?
- Does the entity have in-house information technology (IT) expertise?
- What are the types of journal entries (standard, non-standard, post-closing and other adjustments)?
- How are entries generated (i.e., electronically or manually)?
- Who has access to source code?
- Is there segregation of duties between IT and accounting personnel?
- Who can/is authorized to record journal entries and other adjustments?
- Who can/is authorized to approve journal entries and other adjustments?
- What is the nature, timing and extent of reviews required for journal entries and other adjustments?
- What is the required nature, extent and timing of documentation of reviews?
- Are there situations where management has asked IT to provide access to record a journal entry that is normally limited to only authorized personnel?
- When are journal entries and other adjustments typically processed (e.g., during the day, at night, weekend)?

Information obtained, including discussion among the engagement team, may also be useful in identifying fraud risk factors that affect your assessment of the risks of material misstatement of the financial statements. You need to consider whether there are any particular risk factors that increase the risk of management override of controls. This may help you to recognize specific classes of journal entries and other adjustments for testing.

If you have tested the operating effectiveness of controls over recording journal entries and other adjustments and concluded that the relevant controls are operating effectively, you may be able to reduce the extent of your substantive testing of those entries and adjustments. It is important to note that journal entries or other adjustments processed outside the normal course of business may not be subject to the same level of internal control as those journal entries used on a recurring basis to record transactions such as monthly sales, purchases and cash disbursements. Any modification in substantive testing of those entries and adjustments (due to the existence of effective internal control over recording journal entries and other adjustments) needs to be carefully considered since journal entry testing forms part of the audit response to the risk of fraud due to management override of controls.

Diagram 2—Step 2—Inquiries

"What"

[CAS 240 paragraph 32(a)(i)]

CAS 240 paragraph 32(a)(i) requires you to **make inquiries** of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments.

"Why"

These inquiries are intended to corroborate and supplement your understanding obtained in **Step 1** to assist in recognizing inappropriate or unauthorized journal entries and other adjustments or unusual journal entry activities and to identify where there is the opportunity and/or incentive for management to perpetrate fraud through manipulation of accounting records, inappropriate journal entries or other adjustments.

For example, you may learn from an employee of an unusual change in the way transactions have been processed or that he or she has been asked to process a journal entry to amend accounting estimates without adequate explanation and documentation. You may also learn about periods where unusual activities took place during the year indicating an increased risk of management override of controls.

"How"

You need to consider not only discussions with management, but also with other individuals involved in the financial reporting process. Professional judgement is required to determine that you have selected the relevant and appropriate individuals to whom you should make your inquiries.

You may consider asking open-ended questions of those directly involved with the financial reporting process, such as:

- What types of journal entries and other adjustments do you normally record or process?
- What other types of journal entries and other adjustments did you record or process during the year?
- What journal entries and other adjustments did you record or process without supporting documents?
- Who covered your journal entry and other adjustment responsibilities during your vacation?
- Tell me about situations in which:
  - you were asked to provide your login information;
  - you are aware of any colleagues recording or processing unusual entries; or
  - individuals, who normally do not process journal entries and other adjustments, recorded or processed them this year.
- For those involved with the financial reporting process, but not directly involved with processing journal entries, you may consider asking open-ended questions in regard to whether there is anything unusual contained in the reports or other outputs from the financial reporting process over the period of the audit.

Diagram 2—Step 3—Select Journal Entries/Other Adjustments

"What"

[CAS 240 paragraphs 32(a)(ii) and (iii)]

Select the journal entries and other adjustments made at the end of a reporting period and consider the need to test journal entries and other adjustments throughout the period.

"Why"

There may often be a higher risk of management manipulating financial results through the use of journal entries and other adjustments at the period end because, for example, there may be motivations to meet identified targets. However, financial statement fraud may be perpetrated through use of inappropriate journal entries at any time during the period under audit.

Therefore, you are required to consider the need to test journal entries and other adjustments throughout the period. In doing this, you may take into account the information obtained in **step 1 and step 2** that may increase the risk of inappropriate journal entries and other adjustments being recorded throughout the period such as:

- the lack of structured financial statement close and reporting processes, and
- the existence of significant financial targets or other incentives that may have to be met or assessed at other times than the year end

"How"

You need to use professional judgment in selecting journal entries and other adjustments for testing.

An important starting point is to identify the population of journal entries and other adjustments to reduce the possibility that the auditor omits journal entries and other adjustments from being selected for testing. The method of assessing completeness of the population of journal entries and other adjustments will depend, in part, on the entity's information system. This completeness assessment is performed prior to selecting journal entries and other adjustments for testing. The method could involve using Computer Assisted Audit Techniques (CAATs). There are commercial CAATs available that can be used on accounting software such as SimplyAccounting, AccPac, Quick Books and GreatPlains.

Examples of procedures that could be performed to assess completeness:

- Use CAAT tools to conduct quantitative analytic procedures (for example, identify the population of all journal entries from the first and last journal entry numbers for the period and perform numerical sequence testing to identify missing or duplicate entries).
- Perform a roll forward:
  - Obtain the general ledger for the period, agree opening balances to prior year closing balances, sort activity by account, roll forward selected general ledger accounts for the period and agree with ending trial balance.
  - Reconcile the ending trial balance from the roll-forward with the financial statements to provide evidence that all journal entries and other adjustments, including post-closing entries, are reflected in the financial statements.
- Use of an IT specialist, for example, to evaluate the entity's process used to extract journal entries for the period, or to independently extract journal entries from the system.

Diagram 2—Step 3—Select Journal Entries/Other Adjustments

"How" (continued)

If testing only journal entries made at the end of the reporting period, you need to consider how to assess the completeness of the relevant population.

To address the requirement to select the journal entries and other adjustments made at the end of the reporting period, you need to apply professional judgment in determining what constitutes the "end of the reporting period" in your specific circumstances. Generally, this will encompass not just the last day of the year and will take into consideration entries recorded before and after period-end depending on the nature of the transactions and your understanding of management's reporting processes. It may include the period during which you have identified, through your understanding obtained in **Step 1** and **Step 2**, that management has the incentive and the opportunity to perpetrate fraud.

Based on your understanding and inquiries performed in **Step 1** and **Step 2** you should have enough information to identify client-specific characteristics of potentially inappropriate journal entries and other adjustments. For example, characteristics of potentially inappropriate journal entries and other adjustments may include journal entries or other adjustments:

- made to unrelated, unusual (e.g., unusual combinations of debits and credits), or seldom-used accounts
- made by individuals who typically do not make journal entries and other adjustments
- 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 statements but that do not have account numbers
- containing round numbers or consistent ending numbers
- recorded and approved by the same person, or not approved
- recorded at an unusual time for the entity
- outside of the normal course of business
- dated outside of the regular recording period, for example, beyond the number of days included in the client's standard closing process, or
- 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 inter-company transactions or
  - are otherwise associated with an identified risk of material misstatement due to fraud (e.g., assumption of fraud risk in revenue recognition)

Diagram 2—Step 3—Select Journal Entries/Other Adjustments

"How" (continued)

Potentially inappropriate journal entries and other adjustments should be considered for testing even though they do not contain large dollar values because there is a risk of management override of controls and frauds being committed by processing a high volume of low dollar value entries. The magnitude of a journal entry or other adjustments may not necessarily be a characteristic of a potentially inappropriate journal entry and other adjustments. All journal entries and other adjustments should be considered for testing regardless of their size because there is a risk of management override of controls and fraud.

The characteristics that result in an increased risk of material misstatement due to fraud will vary from entity to entity. For example, if the entity's accounting staff regularly works on evenings and weekends, this may not be considered an unusual time for recording journal entries and other adjustments; therefore, this may not be a characteristic of potentially inappropriate journal entries or other adjustments. If management regularly makes accruals with round numbers you may not consider this as a characteristic of potentially inappropriate journal entries.

The method of selecting the journal entries and other adjustments reflecting the defined client-specific characteristics of potentially inappropriate journal entries and other adjustments will depend on the entity's information system. The method of selection could be manual or using CAATs.

Make sure the characteristics you have defined are specific to the entity you are auditing and appropriate for the circumstances so you are not capturing standard recurring entries (previously determined to have no characteristics of fraud) through the selection process.

Effective controls over the preparation and recording of journal entries and other adjustments may reduce the extent of substantive testing necessary, provided that you have tested the operating effectiveness of the controls.

You may also wish to incorporate an element of unpredictability in the selection of journal entries for testing from year to year.

Diagram 2—Step 4—Test

"What"

[CAS 240 paragraph 32(a)]

Test the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.

"Why"

Test whether potentially inappropriate journal entries are appropriate.

"How"

Test the journal entries and other adjustments with the identified client-specific characteristics of potentially inappropriate journal entries selected in **Step 3**.

When reviewing the description of the journal entries and other adjustments, it is important to go to the source documents. Discussion with management, without obtaining corroborating evidence, is not a sufficient audit response to address the risk of management override of controls. You are looking at the evidence supporting these entries and adjustments to determine whether they are properly approved, adequately supported, properly recorded, and whether they appropriately reflect the underlying events and transactions, taking into consideration the characteristics of potentially inappropriate journal entries that lead to the entries being selected. For example:

- Are documents supporting the journal entries or other adjustments missing?
- Do the supporting documents appear to have been altered?
- Were the journal entries and other adjustments approved by the appropriate person?
- Are you denied access to records or to employees or others from whom audit evidence might be sought?
- Are there valid business purposes for the journal entries and other adjustments?
- Why are you provided only with photocopied documents when documents in original form should exist?

Diagram 2—Step 5—Document

“What”

[CAS 240 paragraph 45(b)]

Paragraph 45(b) of CAS 240 requires you to include in the **audit documentation** the results of the audit procedures, including those designed to address the risk of management override of controls.

“Why”

Your audit file must demonstrate, sufficiently to meet “the experienced auditor test” (as defined in paragraph 8 of CAS 230), your evaluation of the appropriateness of journal entries recorded in the general ledger and other adjustments made in the preparation of the financial statements.

“How”

In documenting your approach to journal entry testing [**Steps 1 to 4**] and the results of the audit procedures you may consider summarizing (in, for example, a memorandum to audit file):

- The nature and extent of inquires made, the individuals to whom inquiries were made, the individuals who are involved in the financial reporting process, and key aspects of the responses to the inquires made
- Your findings about inappropriate or unusual activity relating to the recording of journal entries and other adjustments
- Your evaluation of the design and the implementation of controls surrounding the journal entries and other adjustments relevant to your audit
- The procedures used to assess the completeness of the population of journal entries and other adjustments subject to testing
- The journal entries and other adjustments that were selected for testing and the basis for selecting them
- The procedures performed to test the journal entries and other adjustments
- Your conclusions

Do not forget to document your consideration of the need to test journal entries and other adjustments throughout the period, i.e., at other than the end of a reporting period.

Related Resources on fraud in an audit of financial statements

Visit the CPA Canada website where you will find resources on related topics:

- Audit & Assurance Alert CAS 540 — Challenges in Complying with the Requirements when Auditing Accounting Estimates;
- Implementation Tool for Auditors — Auditing Accounting Estimates Under CASs: What, Why and How?;
- Implementation Tool for Auditors — Communications Between the Auditor and Those Charged with Governance: What, When and How?; and
- Auditing and Assurance Staff Bulletin — Understanding Internal Control Relevant to the Audit — The Function of a Walk-through.

About this Publication

CPA Canada undertakes initiatives to support practitioners and their clients in the implementation of standards. As part of these initiatives, CPA Canada created the Advisory Group on Implementation of Canadian Auditing Standards to provide advice on the identification of issues related to the implementation of Canadian Auditing Standards (CASs) and on the development of non-authoritative implementation guidance related to these issues.

CPA Canada staff prepared this publication based on the advice of the advisory group. It provides non-authoritative guidance and has not been adopted, endorsed, approved or otherwise acted upon by the Auditing and Assurance Standards Board.

Auditors are expected to use professional judgment in determining whether the material in this publication is both appropriate and relevant to the circumstances of their particular audit engagements. This publication is based on the CASs as updated in September 2014.

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Comments on this Implementation Tool for Auditors, or suggestions for future publications should be sent to:

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