AASB
Auditing and Assurance Standards Board

# Audit Insights: Testing Journal Entries in Audits of Less Complex Entities (Part 1)

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This Auditing and Assurance Standards Board (AASB) staff publication is the first of a series of non-authoritative guidance developed for auditors in smaller practices who perform audits of less complex entities (LCEs). It is intended to assist in applying certain requirements in Canadian Auditing Standards (CASs) to audits of non-listed entities, including smaller owner-managed entities and smaller not-for-profit organizations. These types of entities may require a financial statement audit for statutory or other purposes, such as meeting loan covenants, obtaining government funding, raising private capital or responding to third-party audit requests.

## Introduction

This publication explains why journal entry testing is needed. It also provides guidance on how to design journal entry testing for LCEs to respond to the risk of fraud arising from management override of controls.

Auditors of LCEs often respond to risks of material misstatement at the assertion level by performing substantive procedures (i.e., tests of details or substantive analytical procedures), sometimes referred to in practice as "taking a substantive approach." These auditors may ask whether journal entry testing is necessary when they have already tested many transactions substantively. The publication covers:

- what constitutes a journal entry and other adjustment;
- why journal entry testing is required when a predominantly substantive approach has been taken; and
- why an appropriate risk assessment under CAS 315 is fundamental to designing effective journal entry testing.

### Relevant Sections in the CPA Canada Handbook – Assurance

CAS 240, *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

- Paragraphs 35, A99-A101, obtaining an understanding of the information systems and communication component of internal control, including the journal entry process.
- Paragraphs 36, A102-A107, obtaining an understanding of control activities, including controls over journal entries designed to prevent or detect fraud.
- Paragraphs 48-49, A136-A147, overall responses to test the appropriateness of journal entries.
- Appendix 1, fraud risk factors.
- Appendix 4, additional considerations when selecting journal entries for testing.

CAS 315, *Identifying and Assessing the Risks of Material Misstatement*

- Paragraph 25, obtaining an understanding of the information systems and communication component of internal control.
- Paragraphs 26(a)(ii), (d), A151, A160-A161, obtaining an understanding of control activities, including identifying controls over journal entries and evaluating their design effectiveness and determining implementation.

CAS 330, *The Auditor's Responses to Assessed Risks*

- Para. 5, overall responses to financial statement-level risks.

**Disclaimer:** This Audit Insight is non-authoritative and supplements, but does not replace, detailed knowledge of the CASs. A practitioner may use this publication to help understand certain requirements in the CASs when planning and performing an audit.

This AASB staff publication was written with input from the Audits of Less Complex Entities Working Group. The Working Group acts in an advisory capacity to the AASB and assists in addressing matters related to audits of LCEs, focusing on supporting practitioners in small and medium-sized practices and sole practitioners.

## What is a journal entry and other adjustment?

A journal entry is a formal record of a financial transaction that the entity makes in its accounting system or a change it makes directly to the financial statements (e.g., in a year-end closing spreadsheet, it is often called an "other adjustment").

Journal entry types include:

- **standard entries** used to record recurring transactions (e.g., monthly depreciation, sales, purchases and cash disbursement); and
- **non-standard entries** used to record non-recurring, unusual transactions or adjustments (e.g., year-end accruals, corrections or adjustments made directly in the general ledger).

The process for recording or making journal entries may be **automated** through the entity's systems or involve **manual** preparation and posting.

### Relevant Sections in the CPA Canada Handbook – Assurance

- CAS 240, paragraphs A136, A137, A140 and Appendix 4.
- CAS 240, paragraph 39(b), fraud risks are significant risks.

The following are examples of journal entries that may be recorded at an entity:

- monthly depreciation
- recurring sales summaries
- year-end accruals
- consolidation adjustments and reclassifications
- entries made directly to the financial statements, such as eliminating adjustments for transactions, unrealized profits and intra-group account balances at the group level
- manual adjustments, or other "top-sided" adjustments that are made directly to the amounts reported in the financial statements

For this publication, "journal entries" includes journal entries and other adjustments.

## Am I required to test journal entries when I have mostly taken a substantive approach in responding to assertion level risks?

Yes. Even when the auditor has obtained evidence over recorded transactions by performing substantive audit procedures in responding to assertion level risks, CAS 240 requires auditors to test journal entries in *all* audits. The requirement to test journal entries is an **overall response** to the risk of fraud at the financial statement level related to the management override of controls. This risk is present for every entity and **is treated as a significant risk**.

Management is in a unique position to perpetrate fraud because of its ability to manipulate accounting records and prepare fraudulent financial statements by overriding controls that otherwise appear to be operating effectively. For entities with few people in management or governance roles, it may be difficult to implement proper segregation of duties. For example, these entities may not be able to assign different people the responsibilities of authorizing transactions, recording transactions and maintaining custody of assets. Where other fraud risk factors are present, this ability to manipulate records can heighten the risk of management override of controls.

Fraud can also be perpetrated by intentionally:

- recording journal entries that should not be recorded;
- making adjustments to hide certain activities (e.g., misappropriating cash or other assets); or
- making adjustments to purposely misstate financial amounts due to incentives or pressures (e.g., to meet the terms of grants or loan covenants, to minimize taxable income, etc.).

Management might also adjust the amounts reported in the financial statements that are not done through a traditional journal entry, like a manual reclassification between expense accounts.

These entries can occur throughout the year or at the end of the reporting period.

## Flowchart of journal entry testing

This flowchart depicts how journal entry testing is designed and performed in an audit engagement. It serves as a reminder that effective testing is the result of an appropriate risk assessment. This publication focuses on the first row of requirements shaded in red.

**Perform risk assessment procedures and identify fraud risks**

- **Perform risk assessment procedures** related to journal entries (CAS 240.35/CAS 315.25, CAS 240.36/CAS 315.26(a)(ii), CAS 315.26(d))
- **Identify journal entries that are susceptible** to unauthorized or inappropriate **intervention or manipulation** (CAS 240.A99)
- **Identify fraud risk factors** (CAS 240.38)
- **Identify and assess risks of material misstatement due to fraud**. Determine if it exists at the financial statement level or assertion level (CAS 240.29/CAS 315.28)

Always treat the risk of management override of controls as a fraud risk at the financial statement level (CAS 240.40(a)). Also, determine whether this risk affects the assessment of risks at the assertion level (CAS 240.40(b)).

Journal entry testing is an overall audit response to the risk of management override of controls (CAS 240.47).

**Test the appropriateness of journal entries recorded in the general ledger made in preparation of the financial statements (CAS 240.48)**

- Make inquiries (CAS 240.49(a))
- Obtain evidence about the completeness of the population (CAS 240.49(b))
- Select journal entries at period end (CAS 240.49(c))
- Determine the need to test throughout the period (CAS 240.49(d))
- Test that selected entries are authorized and approved and supporting documentation is appropriate

## Why is risk assessment (CAS 315) key to designing and performing effective journal entry testing?

Before designing journal entry testing, it is important to reflect on the appropriateness of the risk assessment. CAS 315 requires the auditor to perform risk assessment procedures to identify and assess the risks of material misstatement due to error or fraud. CAS 240 adds a fraud lens to the risk assessment. It helps the auditor evaluate if the:

- results of the risk assessment procedures indicate that fraud risk factors are present; and
- risks of material misstatement due to fraud exist at the financial statement level or at the assertion level for classes of transactions, account balances and disclosures.

For example, even in an LCE, the absence of appropriate review and approval controls over journal entries may increase the risks of material misstatement due to fraud.

### Fraud Risk Factors

Appendix 1 of CAS 240 provides examples of fraud risk factors to consider in your risk assessments.

Some of the fraud risk factors listed may not be relevant to smaller, non-listed entities; however, your risk assessment cannot result in a conclusion that no testing needs to be done.

Instead, appropriate risk assessment helps narrow the focus for your journal entry testing.

### Designing journal entry testing

Paragraph A139 of CAS 240 explains that in planning the audit, you should draw on the experience and insights of the audit partner and other engagement team members. They may be able to help you design journal entry testing with the appropriate resources and determine the nature, timing and extent of the direction, supervision and review.

To inform the risk assessment, CAS 315 requires the auditor to understand every component of the entity's system of internal controls. Two of those components have specific understandings related to journal entries:

- **The entity's information system and communications** that are relevant to the preparation of financial statements.[1] When applying the fraud lens under CAS 240, this understanding includes how journal entries are initiated, processed, recorded and corrected as necessary.[2]
- **The entity's control activities**, which include controls that address risks of material misstatement at the assertion level, whether due to fraud or error, that are:
  - controls over journal entries; and
  - general information technology (IT) controls that address risks arising from the use of IT applications when processing journal entries.[3]

When applying the fraud lens under CAS 240, this understanding includes evaluating if the identified controls over journal entries are designed effectively to prevent or detect fraud and determining if they are implemented.[4]

Understanding controls over journal entries assists the auditor to design and perform journal entry testing by helping them:

- determine the population of journal entries to be tested; and
- identify which types of journal entries within the population are most susceptible to unauthorized or inappropriate intervention or manipulation.

1 CAS 315, paragraph 25

2 CAS 240, paragraphs 35, A99

3 CAS 315, paragraphs 26(a)(ii) and 26(b-c)

4 CAS 240, paragraphs 36, A104

## What are some examples of controls over journal entries?

Controls over journal entries address the authorization, appropriateness and accuracy of the journal entries to reduce the risk that management can record inappropriate entries or override the processing of entries. Controls over journal entries may include:

| Control | Description |
|---|---|
| **Segregation of duties** | Different individuals prepare, approve and post journal entries. |
| **Authorization and approval** | An appropriate level of management authorizes, reviews and approves journal entries before posting. |
| **Reconciliation** | Journal entries and related account balances are periodically reconciled to independent sources (e.g., subledgers, supporting schedules or trial balance totals), with differences investigated and resolved before finalization. |
| **Verification** | Journal entries are subject to system-based or manual verification checks (e.g., required fields, valid account codes, balanced debits and credits and automated calculations) to ensure entries are complete, accurate and appropriate before posting. |
| **Supporting documentation** | Journal entries are prepared with clear explanations and sufficient supporting documentation to support the rationale and authorization and approval of the entry. |
| **Restricted access to posting** | Only authorized personnel can create or post journal entries. |
| **System audit trails and monitoring** | Systems maintain logs of who created, modified and approved entries, with periodic review of non-standard journal entries. |
| **Close period** | Postings are restricted to closed periods. |

If the relevant controls over the preparation and posting of journal entries are not designed effectively or implemented (e.g., there is a lack of segregation of duties), the auditor cannot test and rely on the operating effectiveness of those controls and would instead perform substantive testing to test the appropriateness of journal entries.

## Conclusion

Remember that journal entry testing begins with an appropriate risk assessment under CAS 315 to identify and assess fraud risks specific to the entity and to understand how those risks could lead to material misstatement, particularly through journal entries. CAS 240 complements that assessment by requiring procedures, like journal entry testing, that respond to the risk of management override of controls. This risk exists at the financial statement level and is present in every audit engagement, regardless of the entity's size or complexity.

*What are your thoughts? Do you have any other questions on journal entry testing? Let us know by submitting an issue.*

*Read our next Audit Insights on journal entry testing, which will discuss obtaining evidence about the completeness of the population of journal entries.*

## Additional Resources

For further information, the following resources may be helpful:

- Audit Insights: Testing Journal Entries in Audits of Less Complex Entities (Part 2)
- Audit Insights: Testing Journal Entries in Audits of Less Complex Entities (Part 3)
- IAASB Non-authoritative Guidance: The Fraud Lens – Interactions between ISA 240 and Other ISAs (May 2022)

## Questions?

Have a question or comment?

Contact us: **info@aasbcanada.ca**