AASB
Auditing and Assurance Standards Board

Audit Insights: Testing Journal Entries in Audits of Less Complex Entities (Part 3)

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This Auditing and Assurance Standards Board (AASB) staff publication is part 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 focuses on how to effectively perform journal entry testing. It builds on Parts 1 and 2, which explain why journal entry testing is needed and how to determine the completeness of the population for testing.

In practice, auditors of LCEs often struggle with two linked questions: Given limited time and resources, how do I focus my journal entry testing on riskier entries and, once selected, how do I determine if those entries are appropriate? This publication covers:

- what to consider when selecting journal entries for testing;
- how to test journal entries; and
- whether audit evidence obtained through other procedures counts toward journal entry testing.

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

Relevant Sections in the CPA Canada Handbook – Assurance

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

- Paragraphs 49(c-d), A141-A143, select journal entries.
- Paragraphs 49(c-d), A144-A145, timing of testing journal entries.
- Paragraphs 49(c-d), A146, examining underlying support for journal entries.

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.

Flowchart of journal entry testing

This flowchart depicts how journal entry testing is designed and performed in an audit engagement. This publication focuses on the red-shaded requirements in the bottom row.

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

What should I consider when selecting journal entries for testing?

First, remember that journal entry testing is an overall response to the financial statement level fraud risk of management override of controls. The **objective is not to test all journal entries but to focus on those more likely to indicate potential fraud**.

Standard entries used to record recurring entries such as periodic payroll journal entries will generally present a lower fraud risk and may not warrant testing. In contrast, **non standard entries** used to record non-recurring or unusual entries, particularly those adjusting revenue or other sensitive accounts, may indicate an increased risk. Revenue transactions are typically system generated and would not normally be adjusted through journal entries.

Relevant Sections in the CPA Canada Handbook – Assurance

- CAS 240.Appendix 1, examples of fraud risk factors.
- CAS 240.Appendix 4, additional considerations when selecting journal entries for testing.
- CAS 240.49(c), A144, testing journal entries made at the end of the reporting period.
- CAS 240.49(d), A145, testing journal entries made throughout the reporting period.
- CAS 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Canadian Auditing Standards*, requirements and guidance related to professional judgment and professional skepticism.

In determining which journal entries to test, consider the presence of fraud risk factors that indicate incentives, pressures, opportunities or attitudes that could motivate management to override controls (e.g., journal entries that inappropriately affect tax outcomes or debt covenant calculations).

Characteristics of fraudulent journal entries may include:

- **Timing** – entries that occur after the closing of a financial reporting period (month-end or year-end)
- **Nature** – entries affecting unusual accounts or unexpected combinations of accounts (e.g., debiting revenue and crediting cash) or entries without a clear business rationale
- **Amount** – large, round-figure entries or amounts just small enough to avoid thresholds based on a percentage of performance materiality
- **Source** – manual adjustments posted directly to the general ledger (as opposed to routine system-generated entries) or to financial statements
- **Description** – missing, vague or unusual descriptions
- **Documentation** – entries that have little or no explanatory support
- **Related party** – entries that involve owners, management or related entities
- **Who prepared the journal entry** – entries initiated by individuals who do not normally process journal entries

When determining which journal entries to test, consider entries recorded at period end and ones recorded throughout the period, based on the assessed fraud risks

Period end	Throughout the period
Fraudulent journal entries and other adjustments are often made at the end of a reporting period.	Material misstatements due to fraud can occur throughout the period and may involve extensive efforts to conceal how the fraud is accomplished (for example, through complex related party structures).

The selection and number of journal entries tested will depend on the entity's circumstances. **One size does not fit all**. Effective testing relies on an understanding of the entity, applying professional judgment and skepticism and documenting the rationale for the items selected. Although many firms provide templated selection criteria to identify journal entries that may exhibit the characteristics of fraud, these selection criteria may be treated as a starting point. Auditors may tailor the selection criteria to the entity's circumstances so that the items selected for testing are responsive to the assessed fraud risks.

Last, while the extent of testing may vary, it would be unusual for an auditor to conclude that no journal entries require testing. Testing journal entries is an overall response to the fraud risk of management override of controls present at every entity.

How do I test journal entries?

Testing the appropriateness of journal entries involves examining supporting documentation to determine the business rationale for recording them, including whether the recording of the journal entry reflects the substance of the transaction and comply with the applicable financial reporting framework.

Exercising **professional judgment** and **professional skepticism** is essential in evaluating whether the underlying support indicates the journal entry is appropriate. Remember that fraudulent journal entries may also have fraudulent supporting documentation. The existence of underlying support does not prove that a journal entry is appropriate. Fraudulent journal entries could be supported by incomplete, misleading or fraudulent documentation. You can always reinforce professional skepticism into the planning and performance of the audit by involving more experienced members of the engagement team in journal entry testing.

Let's consider a couple of examples of how journal entry testing may be performed in practice:

Journal entry	Fraud risk factor	How to test
Accrued expenses	Management may record manual accrued expenses at period end that belong in the following period to reduce current year's net income and tax liability.	• Identify all manual journal entries posted to accrued expense accounts at period end. • Determine if the debits and credits were recorded to the appropriate accounts. • Obtain and examine the underlying supporting documentation to determine if the transaction: ◦ has a clear business rationale; ◦ complies with the applicable financial reporting framework; ◦ is recorded in the appropriate period (cut-off) and at an appropriate amount (accuracy); and ◦ was prepared, reviewed or approved by an individual with appropriate authority.
Expense reclassification between grants	In a not-for-profit organization, the executive director may record manual entries to misallocate or misclassify expenses between grants to falsely show compliance with funding requirements and avoid returning unused amounts.	• Identify manual journal entries involving grant expense accounts. • Determine whether the debits and credits were recorded to the appropriate accounts. • Obtain and examine the underlying supporting documentation to determine if the transaction: ◦ has a clear business rationale; ◦ complies with the applicable financial reporting framework; ◦ occurred, is recorded at an appropriate amount (accuracy) and is classified to the correct grant per funding terms; and ◦ was prepared, reviewed or approved by an individual with appropriate authority.

In testing journal entries, it is important to document how the journal entries were selected and tested. CAS 230, *Audit Documentation*, requires the auditor to prepare audit documentation that allows an experienced auditor with no prior involvement to understand what was done, what evidence was obtained and how significant judgments and conclusions were reached.[1] Sufficient, appropriate audit documentation facilitates internal quality monitoring or external inspection.

[1] CAS 230, *Audit Documentation*, paragraph 8

Does audit evidence obtained through other procedures count toward journal entry testing?

Journal entry testing doesn't need to be performed in isolation or deferred until the end of the audit. In some circumstances, it may be appropriate to combine journal entry testing with other substantive procedures if they:

- address the same risk (i.e., management override of controls);
- provide evidence over the same relevant assertion(s); and
- fulfill the purpose of journal entry testing, including whether the journal entry is supportable, appropriate and consistent with the underlying transaction.

When these conditions are met, combining procedures may help reduce duplication and overall audit effort. However, to do so appropriately, it is important that the relevant journal entries to be tested **are identified during the risk assessment rather than retrospectively**. This ensures that the combined procedures are intentionally designed to respond to the fraud risk of management override of controls.

For example, an auditor may plan to perform tests of details to address the risk of material misstatement in a subset of expenses, such as management reimbursements, professional and consulting fees, marketing and promotion or other discretionary items that may be more susceptible to misstatement. When designing these procedures, if the auditor explicitly links the tests of details to the fraud risk of management override of controls, the procedures can be expanded to also assess whether the related journal entries were supportable, appropriate and consistent with the underlying transaction. In such circumstances, the audit evidence obtained from testing these expenses may also contribute toward journal entry testing.

Conclusion

Remember that journal entry testing isn't about volume.

By applying professional skepticism, focusing on the presence of fraud risk factors to identify journal entries for testing and determining the appropriateness of those entries, you can meet the requirements of CAS 240 while performing efficient and effective LCE audits.

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

Additional Resources

For further information, the following resources may be helpful:

- Audit Insights: Testing Journal Entries in Audits of Less Complex Entities (Part 1)
- Audit Insights: Testing Journal Entries in Audits of Less Complex Entities (Part 2)
- 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**