

Principles of Auditing: An Introduction to International Standards on Auditing

Chapter 6 – Main Audit Concepts and Planning the Audit (ISA 300, 315, 320)

Rick Hayes, Hans Gortemaker
and Philip Wallage



Planning defined

International Standards on Auditing (ISA) 300, 'Planning an Audit of Financial Statements', states, 'the objective of the auditor is to plan the audit so that it will be performed in an effective manner... The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.'

Planning – Phase II of the audit process model – Objective

Objective	Determine the amount and type of evidence and review required to give the auditor assurance that there is no material misstatement of the financial statements.
------------------	---

Illustration 6.1 Audit Process Model

Planning – Phase II of the audit process – Procedures

Procedures

- 1 Perform audit procedures to understand the entity and its environment, including the entity's internal control
- 2 Assess the risks of material misstatements of the financial statements
- 3 Determine materiality
- 4 Prepare the planning memorandum and audit programme containing the auditor's response to the identified risks

Illustration 6.1 Audit Process Model (Continued)

Understanding the entity and its environment *ISAs on audit risk*

- ISA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment
- ISA 330 The Auditor's Responses to Assessed Risks
- ISA 500 Audit Evidence.

Procedures to assess risks (ISA 315.6)

- Inquiries of management
- Analytical procedures
- Observation and inspection

Inquires of management and personnel

Objectives? (profit, investment, product) Expectations? (customers, suppliers, product, shareholders, banks, government) Reports? (SEC, public, government)



Business operations?
(market, locations);
Investments

Analytical procedures

These may help the auditor in identifying unusual transactions or positions. Analytical procedures usually involve a comparison of company results to that of the industry. There are publications of major industry ratios and trends that might be helpful to the auditor doing analytical procedures (see Chapter 7 'Internal Control and Control Risk').

Inspection and observation

Observe core activities, read management reports, internal control manuals

View facilities (inventory, fixed assets, cleanliness, employee work habits, internal control, segregation of duties)

Audit team discussion

ISA 315 requires a team-wide discussion of the susceptibility of the entity's financial statements to material misstatement.



ISA 315 distinguishes the following relevant aspects in the understanding of the entity and its environment

- Industry, regulation, financial reporting framework
- Nature of the entity including:
 - Business operations
 - Types of investments
 - Capital structure and financing
 - Ownership and governance structures
- Accounting policies
- Objectives and strategies
- Measurement and review of financial performance.

Understanding the entity and its environment

Strategic audit

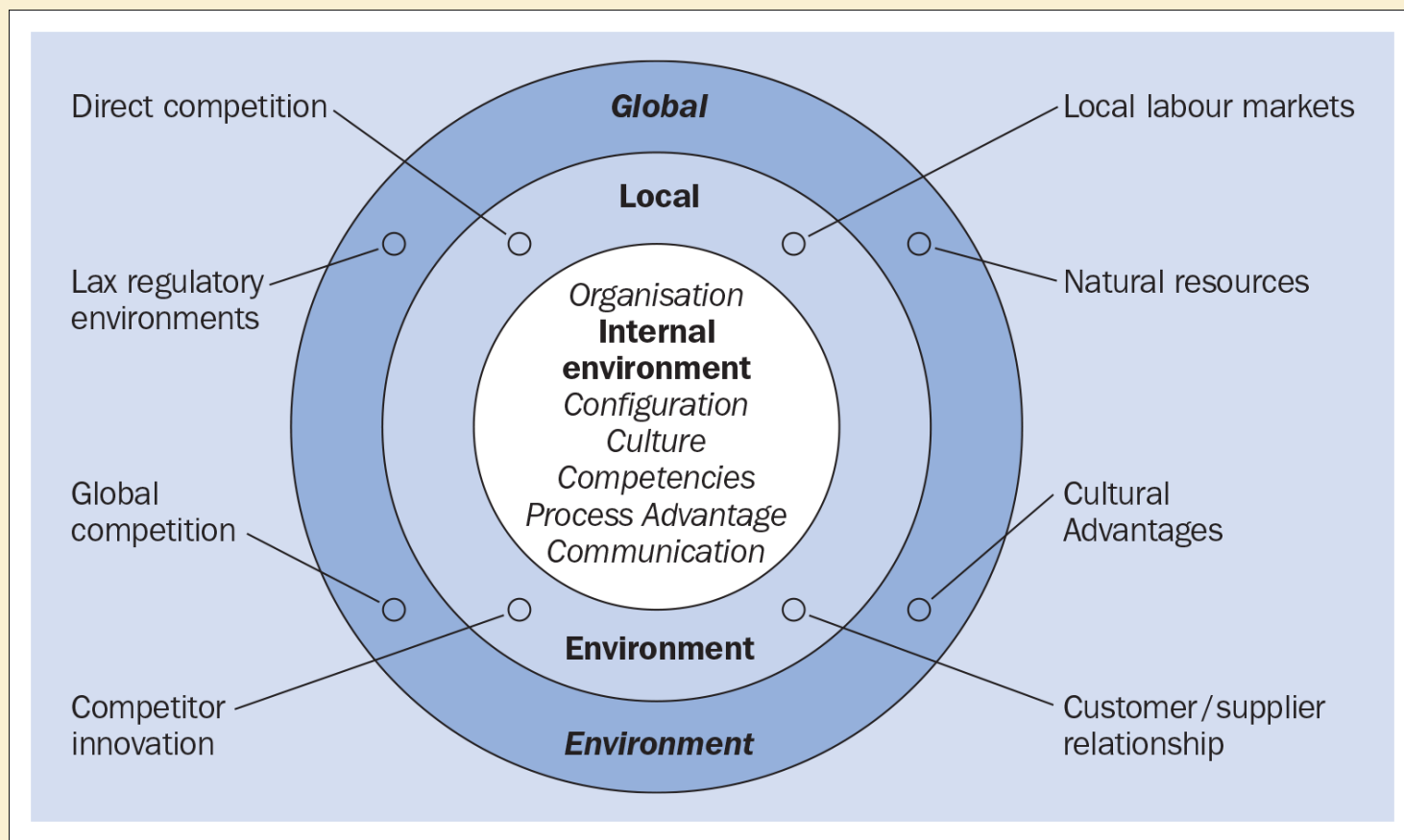


Illustration 6.2 Global Systems Perspective on Client Business Risk

Nature of the entity

- Business operations
- Investments
- Financial accounting policies.

Business operations

Information acquired about *business operations* may include:

- Nature of revenue sources
- Products and services
- Market
- Location of company facilities
- Employment
- Key suppliers and customers.

Investments

Important transactions for which information should be gathered include:

- Acquisitions, mergers and disposals of business divisions
- Use of derivative financial instruments
- Type of major investments by the company
- Capital investment activities
- Investment in non-consolidated entities such as joint ventures, *special purpose entities* and partnerships.

Financial accounting policies

- Company accounting policies
- Judgemental accounting valuations
- Presentation and disclosure
- Fair value accounting
- Accounting for unusual or complex transactions.

Investigate company's legal position

- Corporate charter and bylaws
- Minutes of the board of directors and stockholders meetings
- Contracts.

The entity's objectives, strategies and related business risks

- The auditor will also consider the entity's objectives and strategies, and the related business risks that may affect the financial statements.
- Significant conditions, events, circumstances or actions that could adversely affect the entity's ability to achieve its objectives and execute its strategies create business risks.

Auditors may use a strategy-oriented framework, which involves the following steps:

1. Understand the client's strategic advantage.
2. Understand the risks that threaten the client's business objectives.
3. Understand the key processes and related competencies to realise strategic advantage.
4. Measure and benchmark process performance.
5. Document the understanding of the client's ability to create value and generate future cash flows using a client business model, process analysis, **key performance indicators** and a business risk profile.
6. Use the comprehensive business knowledge decision frame to develop expectations about key **assertions** embodied in the overall financial statements.
7. Compare reported financial results to expectations and design additional audit test work to address any gaps between expectations.

Measurement and review of the financial performance

The following are internally-generated information used by management for analysing financial performance that an auditor might consider before performing analytical procedures during the planning phase:

- Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics
- Employee performance measures and incentive compensation policies
- Use of forecasts, budgets variance analysis, segment information and divisional, departmental or other level performance reports
- Comparisons of an entity's performance with that of competitors
- Period-on-period financial performance (revenue growth, profitability, leverage)

Illustration 6.8 Measurement and Review of the Entity's Financial Performance

Analytical procedures

- The auditor ordinarily applies analytical procedures at the planning stage to assist in understanding the business and in identifying areas of potential risk.
- Analytical procedures in planning the audit use information that is both financial and non-financial (e.g. the relationship between sales and square footage of selling space or volume of goods sold).

Based on the evidence, assess risk

To assess the misstatement risks, the auditor performs four tasks.

1. Identify risks by developing an understanding of the company environment, including relevant controls that relate to the risks.
2. Relate the identified risks to what could go wrong in management's assertions about completeness, existence, valuation, occurrence and measurement of transactions or assertions about rights, obligations, presentation and disclosure.
3. Determine whether the risks are of a magnitude that could result in a material misstatement of the financial statements.
4. Consider the likelihood that the risks will result in a material misstatement of the financial statements and their impact on classes of transactions, account balances and disclosures.

Business risk

Business risks result from significant conditions, events, circumstances or actions that could adversely affect the entity's ability to achieve its objectives and execute its strategies.

- Operations in regions that are economically unstable.
- Operations exposed to volatile markets.
- High degree of complex regulation.
- Going concern and liquidity issues including loss of significant customers.
- Constraints on the availability of capital and credit.
- Changes in the industry in which the entity operates.

Audit risk

- Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. It includes:
- Risks of material misstatement
 - Inherent risk
 - Control risk
- Detection risk
 - Illustration 6.11 shows a symbolic graphic used by AICPA to illustrate how audit risk works.

Risk of material misstatement – Inherent risk

Inherent risk is the susceptibility of an account balance or class of transactions to misstatements that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.

Risk of material misstatement – Control risk

Control risk is the risk that a misstatement that could occur in an account balance or class of transactions and that could be material – individually or when aggregated with misstatements in other balances or classes – will not be prevented or detected and corrected on a timely basis by accounting and internal control systems.

Detection risk

Detection risk is the risk that an auditor's substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material, individually or when aggregated with misstatements in other balances or classes.

Audit Risk = F(IR, CR, DR)

The following table shows how the acceptable level of detection risk may vary based on assessments of inherent and control risks, based on the Appendix to International Standard on Auditing 400.

		Auditor's assessment of control		
		High	Medium	Low
Auditor's assessment of inherent risk	High	Lowest	Lower	Medium
	Medium	Lower	Medium	Higher
	Low	Medium	Higher	Highest

The darker shaded areas in this table relate to detection risk.

There is an inverse relationship between detection risk and the combined level of inherent and control risks. For example, when inherent and control risks are high, acceptable levels of detection risk need to be low to reduce audit risk to an acceptably low level. On the other hand, when inherent and control risks are low, an auditor can accept a higher detection risk and still reduce audit risk to an acceptably low level.

Illustration 6.12 Interrelationship of the Components of Audit Risk

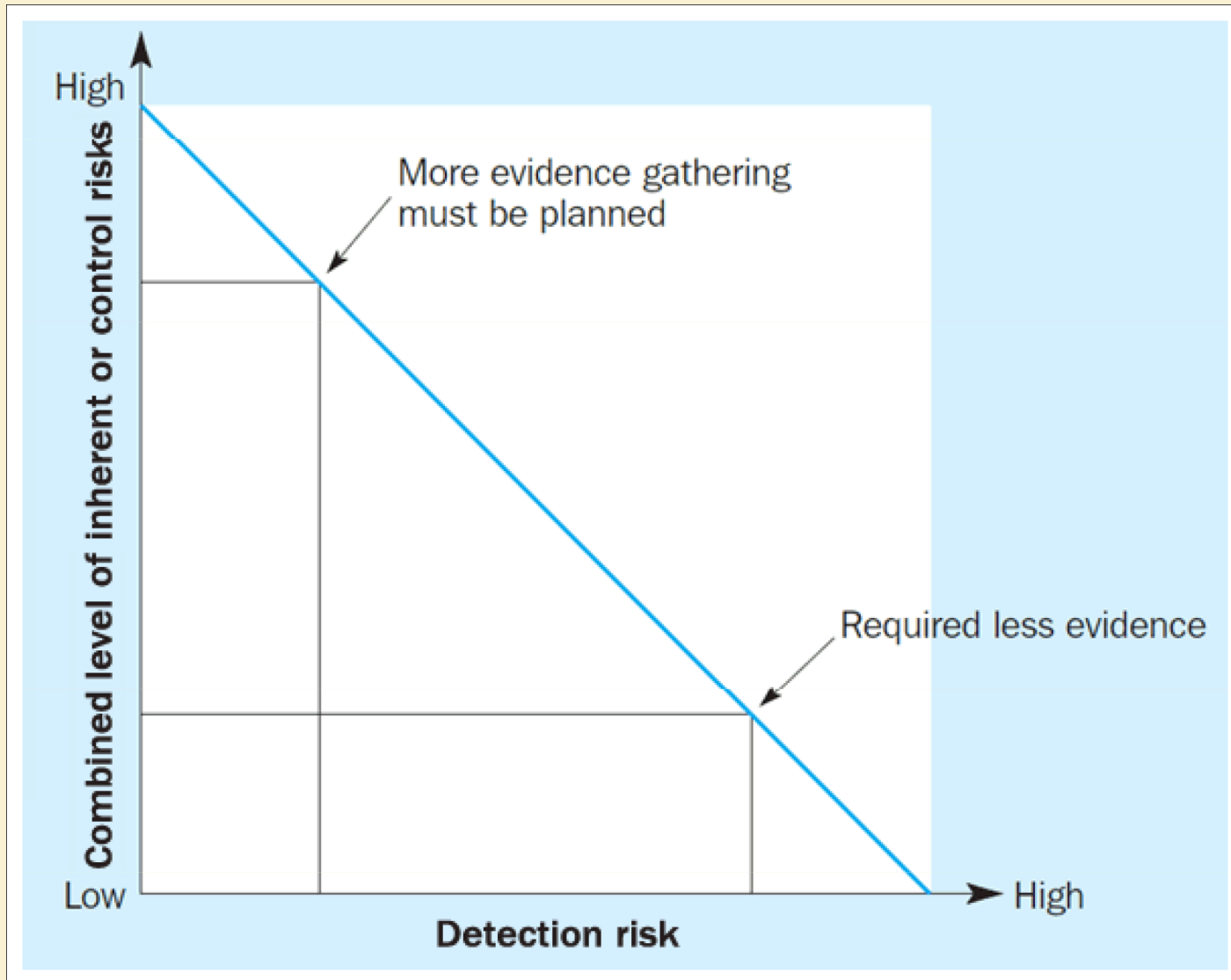


Illustration 6.13 Relationship between Inherent, Control and Detection Risk

Significant risk

- Significant risks generally relate to judgemental matters and significant non-routine transactions.
- Risks of material misstatement may be greater for significant judgemental matters requiring accounting estimates or revenue recognition and for assumptions about the effects of future events (e.g. fair value) than for ordinary transactions.

In determining what a significant risk is the auditor considers a number of matters, including the following:

- ✓ Whether the risk is a risk of fraud.
- ✓ The likelihood of the occurrence of the risk.
- ✓ Whether the risk is related to recent significant economic, accounting or other developments and, therefore, requires specific attention.
- ✓ The complexity of transactions that may give rise to the risk.
- ✓ Whether the risk involves significant transactions with related parties.
- ✓ The degree of subjectivity in the measurement of financial information related to the risk.
- ✓ Whether the risk involves significant transactions that are outside the normal course of business for the entity, or that otherwise appear to be unusual given the auditor's understanding of the entity and its environment.

Materiality

‘Misstatements or omissions are material if they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements’

Materiality is influenced by size, nature and circumstances

Materiality (Continued)

- Judgements about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both.
- Judgements about matters that are material to users of the financial statements are based on a consideration of the common financial information needs of users as a group. The possible effect of misstatements on specific individual users, whose needs may vary widely, is not considered.

Materiality size, nature, circumstances

Size of the item: The most common application of materiality has to do with the size of the item considered.

Nature of the item: The nature of an item is a qualitative characteristic.

Circumstances: The materiality of an error depends upon the circumstances of its occurrence.

Materiality

Low materiality level

There are additional costs for an auditor to audit with a lower materiality.

- The lower the materiality, the more costly is the audit.
- If any error of whatever small size needs to be found in the audit, the auditor would spend significantly more time than when a certain level of imprecision (higher materiality level) is considered acceptable.

Rules of thumb in setting materiality levels

In practice every accounting firm has its own set of guidelines or 'rules of thumb' materiality related to a financial statement base such as net income, total revenues, etc.

Rules of thumb commonly used in practice include:

5 to 10 per cent of net income before taxes;

5 to 10 per cent of current assets;

5 to 10 per cent of current liabilities;

0.5 to 2 per cent of total assets;

0.5 to 2 per cent of total revenues;

1 to 5 per cent of total equity.

Fraud and irregularities

The audit standards define **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.’

Inherent limitations with misstatements resulting from fraud

- The risk of not detecting fraud is higher than the risk of not detecting error because fraud may involve sophisticated and carefully organised schemes designed to conceal it (such as forgery, deliberate failure to record transactions).
- Collusion may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false.
- Because management is frequently in a position to manipulate accounting records or override controls, the risk of the auditor not detecting management fraud is greater than for employee fraud.

Two types of intentional misstatements

- 1. Fraudulent financial reporting** involves intentional misstatements including omissions of amounts or disclosures in financial statements to deceive financial statement users.
- 2. Misappropriation of assets** involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts.

Necessary for fraud to occur

- Perceived pressure
 - A situation where someone believes that they have a need to commit a fraud.
- Perceived opportunity
 - A situation where someone believes they have a favourable or promising combination of circumstances to commit an undetectable fraud.
- Rationalisation
 - To devise a self-satisfying but incorrect reasons for one's behaviour.

Fraud triangle – Three elements are common to every fraud

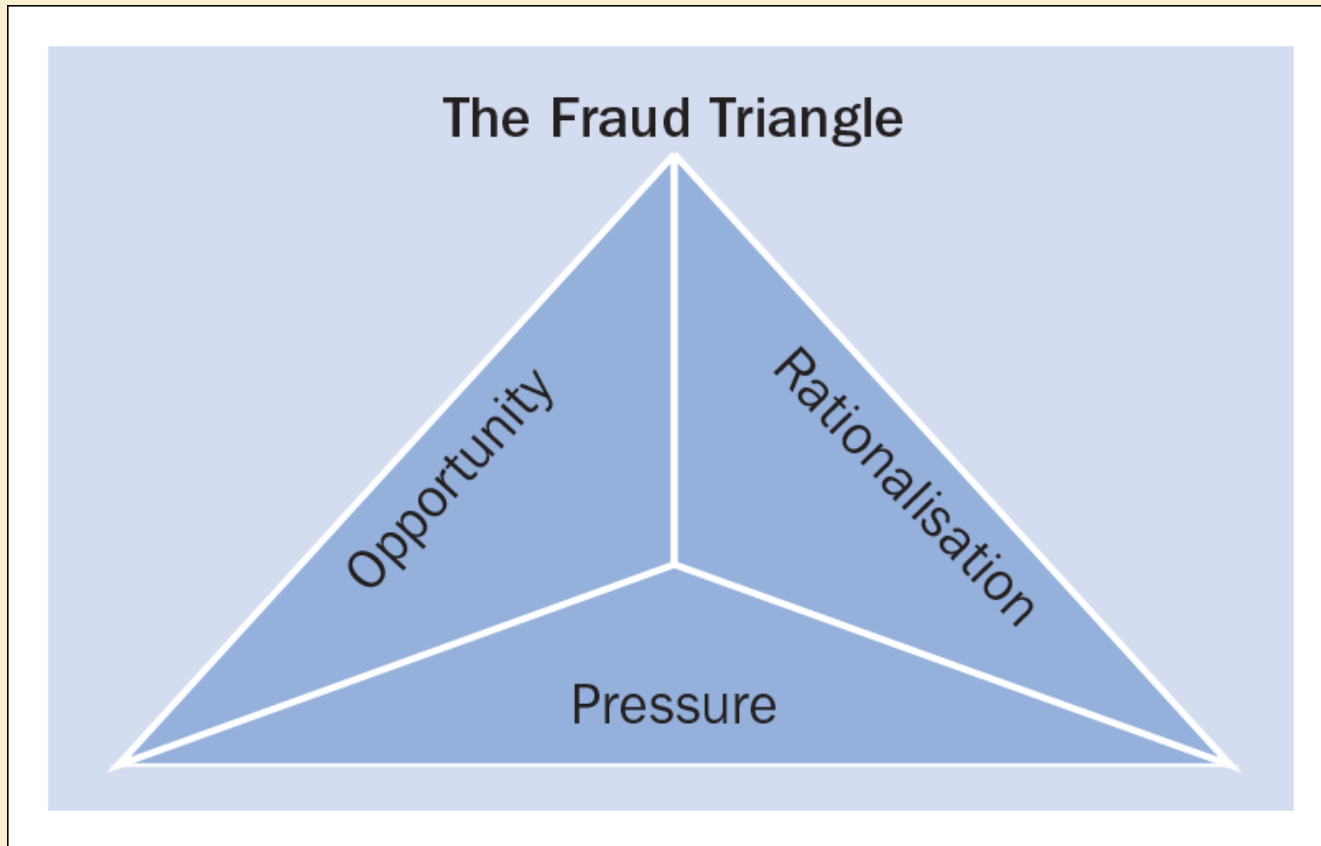


Illustration 6.15 The Fraud Triangle

Discussion with engagement team and risk assessment procedures

ISA 315 requires a discussion among the engagement team members which places particular emphasis on how and where the entity's financial statements may be susceptible to material misstatement due to fraud, including how fraud might occur, setting aside beliefs that management and those charged with governance are honest and have integrity.

Risk assessment procedures that may indicate fraud include inquiries of management regarding:

- Management's assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments.
- Management's process for identifying and responding to the risks of fraud, including any specific risks of fraud that has been brought to management's attention, and classes of transactions, account balances or disclosures for which a risk of fraud is likely to exist.

Risk assessment procedures that may indicate fraud include inquiries of management regarding: (Continued)

- Any management communication to those charged with governance regarding the risks of fraud in the entity; and, to employees regarding management views on business practices and ethical behaviour.
- Whether management has knowledge of any actual, suspected or alleged fraud affecting the entity.

The auditor must 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; review journal entries or any adjustments made at the end of a reporting period; and test journal entries throughout the audit period.
- Review accounting estimates for biases and evaluate whether they represent a risk of material misstatement due to fraud.
- Review significant transactions that are outside the normal course of business for the entity.

Reporting the fraud

- If the auditor has identified a fraud, it is her duty to communicate these matters to management. The auditor will report to those charred with governance any identified or suspected fraud involving management or employees who have significant roles in internal control.
- If the auditor has identified or suspects a fraud, she must determine whether there is a responsibility to report it to third parties outside the entity (such as government regulators).
 - The auditor's legal responsibilities may override the duty of confidentiality in some circumstances.

Auditor's expert

An **auditor's expert** is an individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence.

When using an expert's work the auditor must:

- Determine expert's
 - Competence (professional certifications)
 - Capabilities
 - Objectivity.
- The auditor shall agree, in writing when appropriate, with the auditor's expert:
 - The nature, scope and objectives of that expert's work.
 - The respective roles and responsibilities of the auditor and that expert.
 - The nature, timing and extent of communication.
 - The need for the auditor's expert to observe confidentiality.

Using the work of the auditee's internal auditors

- **The internal audit function** is an appraisal activity established or provided as a service to the entity. Its functions include, amongst other things, examining, evaluating and monitoring the adequacy and effectiveness of internal control.
- **Internal auditors** are those individuals who perform the activities of the internal audit function.

If internal auditor's work is used in the audit

If the external auditor uses specific work of the internal auditors, the external auditor must include in the audit documentation the conclusions reached regarding the evaluation of the adequacy of the work of the internal auditors and the audit procedures performed by the external auditor on that work.

Auditee use of a service organisation

A **service organisation** is a third-party organisation (or segment of a third-party organisation) that provides services to user entities that are part of those entities' information systems relevant to financial reporting.

The auditor must obtain an understanding of the controls of the service organisation from one or more of the following procedures:

- Obtaining a type 1 or type 2 report
- Contacting the service organisation
- Visiting the service organisation and performing procedures
- Or using another auditor to perform procedures that will provide the necessary controls information at the service organisation.

Type 1 and 2 internal control reports

The **Type 1 report** is a report on the description and design of controls at a service organisation encompassing:

- a. A description by management of the service organisation, service organisation's system, control objectives and related controls.
- b. A report by the service auditor conveying her opinion of the service organisation's system.

The **Type 2 report**, called ‘report on the description, design and operating effectiveness of controls at a service organisation’ encompasses:

- a. Management’s description of the service organisation, service organisation’s system, control objectives and related controls, and, in some cases, their operating effectiveness throughout a specified period.
- b. A report by the service auditor conveying her opinion on the description of the service organisation’s system, control objectives and related controls, the suitability of the design of the controls to achieve the specified control objectives and the operating effectiveness of the controls.
- c. A description of the service auditor’s tests of the controls and the results thereof.

Discussions with those charged with governance

The auditor may seek the views of those charged with governance about the appropriate person(s) in the entity's governance structure with whom to communicate, the allocation of responsibilities between those charged with governance and management, the entity's objectives and strategies and the related business risks that may result in material misstatements, significant communications with regulators and matters they believe warrant particular attention during the audit.

Typically, an audit planning memorandum would contain the following sections:

- Background information
- Objectives of the audit
- Assessment of engagement risk
- Other auditors or experts
- Materiality
- Inherent risks
- Conclusions regarding the control environment
- Level of reliance on the client's CIS systems
- Quality of the accounting and internal control systems
- Audit approach
- Timing and scheduling of audit work
- Audit budget

The audit plan (programme)

- The audit plan includes the details of the planned audit procedures for material classes of transactions, account balances and disclosures.
- As the auditor performs audit procedures outlined in the audit plan, the audit plan is updated and changed to reflect the further audit procedures considered necessary given the circumstances.

- **Audit evidence**

If the auditor determines from the understanding of the business that inherent risk is low and from the understanding of internal controls that control risk is low, then less evidence is required.

- **Audit procedures**

In planning the timing of audit work, crucial procedures should be performed first.

- **Documentation**

The auditor should document the overall audit strategy and the audit plan, including reasons for significant changes made during the audit engagement.

Thank you for your attention

Any Questions?