

Principles of Auditing: An Introduction to International Standards on Auditing

Chapter 9 – Auditor's Response to Assessed Risk (ISA 330, ISA 500)

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‘The objective of the auditor is to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks.’ – ISA 330

Audit procedures responsive to the assessed risks of material misstatement

The auditor must design and perform further audit procedures whose nature, timing and extent are based on, and are responsive to, the assessed risks.

- The nature of an audit procedure refers to its purpose (that is, test of controls or substantive procedure) and its type (that is, inspection, observation, inquiry, confirmation, recalculation, re-performance or analytical procedure).
- Timing of an audit procedure refers to when it is performed, or the period or date to which the audit evidence applies.
- Extent of an audit procedure refers to the quantity to be performed, for example, a sample size or the number of observations of a control activity.

Overall responses to address the assessed risks of material misstatement include

- Emphasising to the engagement team the need to maintain professional scepticism.
- Assigning more experienced staff or those with special skills or using experts.
- Providing more supervision.
- Incorporating additional elements of unpredictability in audit procedures.
- Making general changes to the nature, timing or extent of audit procedures.

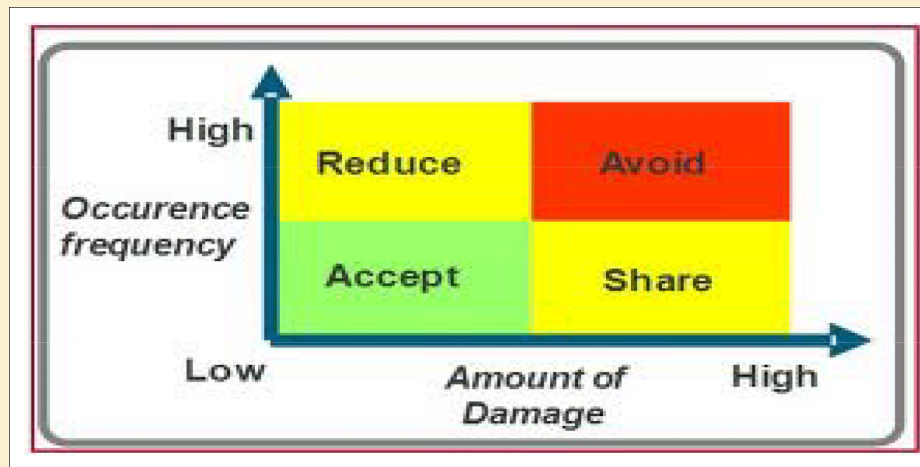
Response to ineffective control environment

The auditor may respond to an ineffective control environment by:

- Conducting more audit procedures as of the period end rather than at an interim date.
- Obtaining more extensive audit evidence from substantive procedures.
- Increasing the number of locations to be included in the audit scope.

Persuasive evidence

- The higher the auditor's assessment of risk, the more persuasive audit evidence she needs.
- When obtaining more persuasive audit evidence because of a higher assessment of risk, the auditor may increase the quantity of the evidence, or obtain evidence that is more relevant or reliable.



This figure helps to assess the risks. The occurrence and frequency together with the amount of damage involved give insight in the response to the risks.

The auditor must include in the audit documentation the overall responses to address the assessed risks of material misstatement and the nature, timing and extent of the further audit procedures performed. The auditor should also document the linkage of those procedures with the assessed risks at the assertion level; and the results of the audit procedures, including the conclusions where these are not otherwise clear.

Evidence

- *Evidence* is anything that can make a person believe that a fact, proposition or assertion is true or false.
- Audit evidence is information used by the auditor in arriving at the conclusions on which the auditor's opinion is based.
(ISA 500)
 - It includes the accounting records and other information underlying the financial statements.

Audit evidence is different from the legal evidence

- In a civil lawsuit, evidence must be strong enough to incline a person to believe one side or the other.
- In a criminal case evidence must establish proof of a crime beyond a *reasonable doubt*.
- Audit evidence provides only *reasonable assurance*.

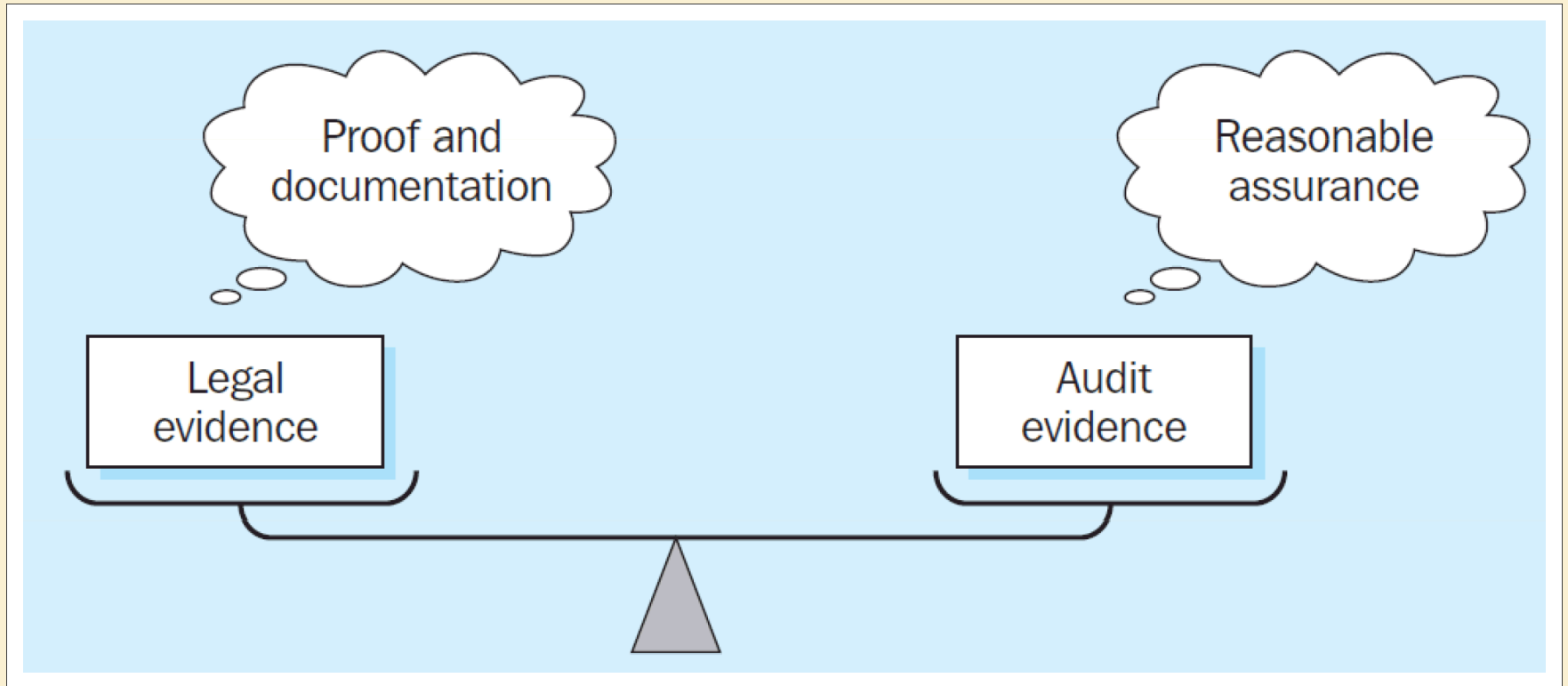


Illustration 9.1 Legal Evidence and Audit Evidence

Legal proof and evidence

- **Legal standards of proof**
 - Beyond a reasonable doubt
 - Preponderance of evidence
 - Clear and convincing evidence
 - Probable cause.
- **Legal evidence**
 - Proof results direct or circumstantial
 - Source
 - *real* tangible and can be presented to a court for inspection;
 - testimonial *evidence* given by witnesses under oath;
 - original documentary evidence.

US classes

Assertions are representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

Management makes assertions that can be grouped into three groups:

- 1) Assertions about classes of transactions and events for the period under audit
- 2) Assertions about account balances at the period end
- 3) Assertions about presentation and disclosure.

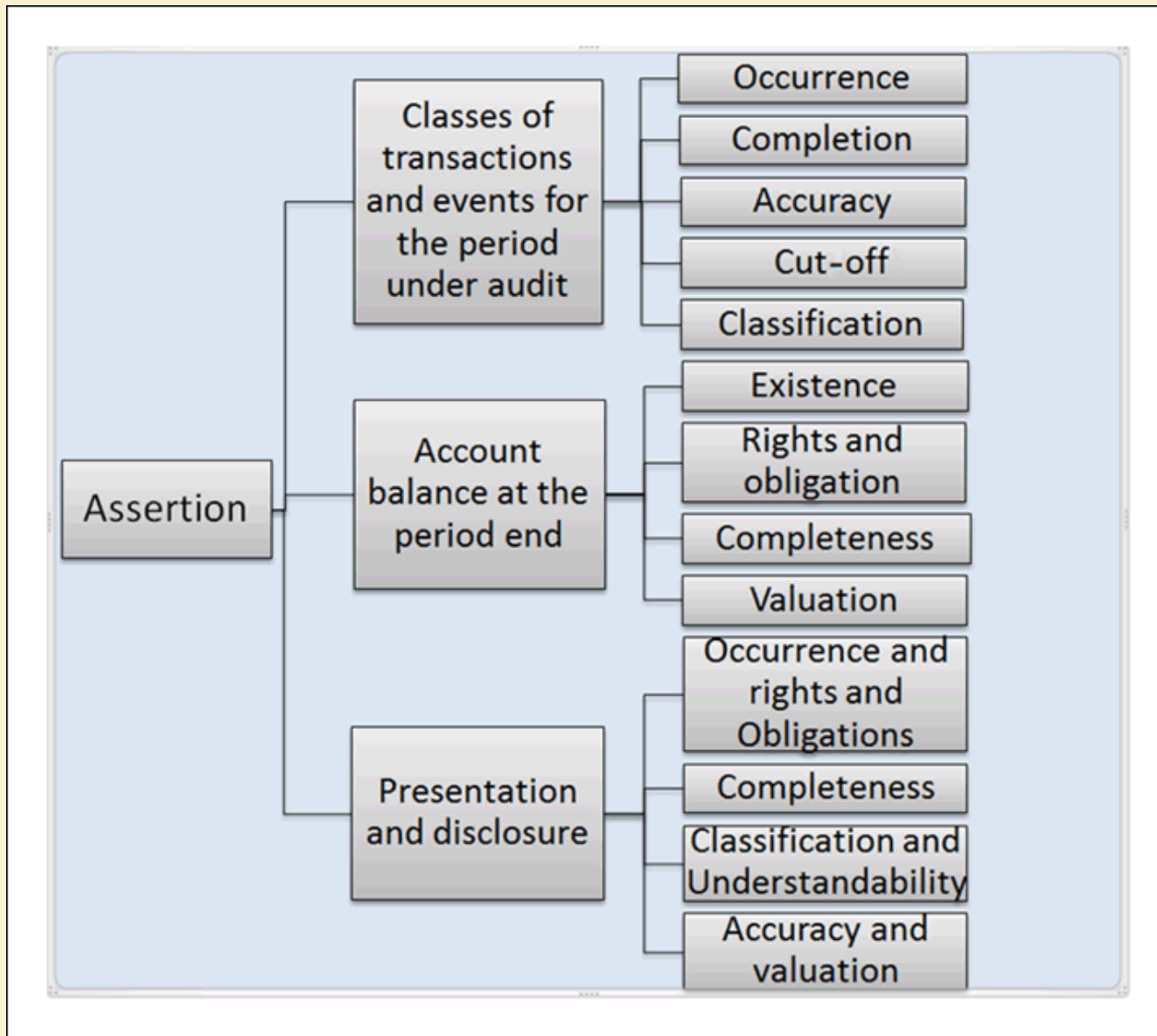


Illustration 9.2 Financial Statement Assertions Grouped by Substantive Test Areas

Assertions about classes of transactions and events for the period under audit (from Chapter 1)

Occurrence	Transactions and events that have been recorded have occurred and pertain to the entity.
Completeness	All transactions and events that should have been recorded have been recorded.
Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately.
Cut-off	Transactions and events have been recorded in the correct accounting period.
Classification	Transactions and events have been recorded in the proper accounts.

Assertions about account balances at the period end (from Chapter 1)

Existence	Assets, liabilities and equity interests exist
Rights and obligations	The entity holds or controls the rights to assets and liabilities are the obligations of the entity.
Completeness	All assets, liabilities and equity interests that should have been recorded have been recorded.
Valuation and allocation	Assets, liabilities and equity interests are included in the financial statements at appropriate amounts and any resulting valuation adjustments are appropriately recorded.

Assertions about presentation and disclosure (from Chapter 1)

Occurrence and rights and obligations	Disclosed matters have occurred and pertain to the entity.
Completeness	All disclosures that should have been included in the financial statements have been included.
Classification and understandability	Financial information is appropriately presented and described, and disclosures are clearly expressed.
Accuracy and valuation	Financial and other information are disclosed fairly and at appropriate amounts.

Test of controls

- Test of controls are audit procedures designed to evaluate the operating effectiveness of controls in preventing, or detecting and correcting, material misstatements at the assertion level.
- The greater the reliance the auditor places on the effectiveness of a control, the more persuasive the audit evidence the auditor must obtain. – ISA 330.

The auditor must design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if:

- the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively (the auditor will rely on the operating effectiveness of controls in determining substantive procedures); or
- substantive procedures alone cannot provide sufficient appropriate audit evidence at the assertion level.

In designing and performing tests of controls, the auditor must:

- Perform other audit procedures in combination with inquiry to obtain audit evidence about the operating effectiveness of the controls, including: how the controls were applied at relevant times; the consistency with which they were applied; and by whom or by what means they were applied.
- Determine whether the controls to be tested depend upon other controls (indirect controls), and, if so, whether it is necessary to obtain audit evidence supporting the effective operation of those indirect controls.

The auditor may test the operating effectiveness of controls at the same time as evaluating their design and implementation.

For example, the auditor's risk assessment procedures may have included inquiring about management's use of budgets, observing management's comparison of monthly budgeted and actual expenses, and inspecting reports about the variances between budgeted and actual amounts. These audit procedures provide knowledge about budgeting policies and whether they have been implemented, but may also provide audit evidence about the effectiveness of the operation of budgeting policies in preventing or detecting material misstatements in the classification of expenses.

Using previous audit evidence

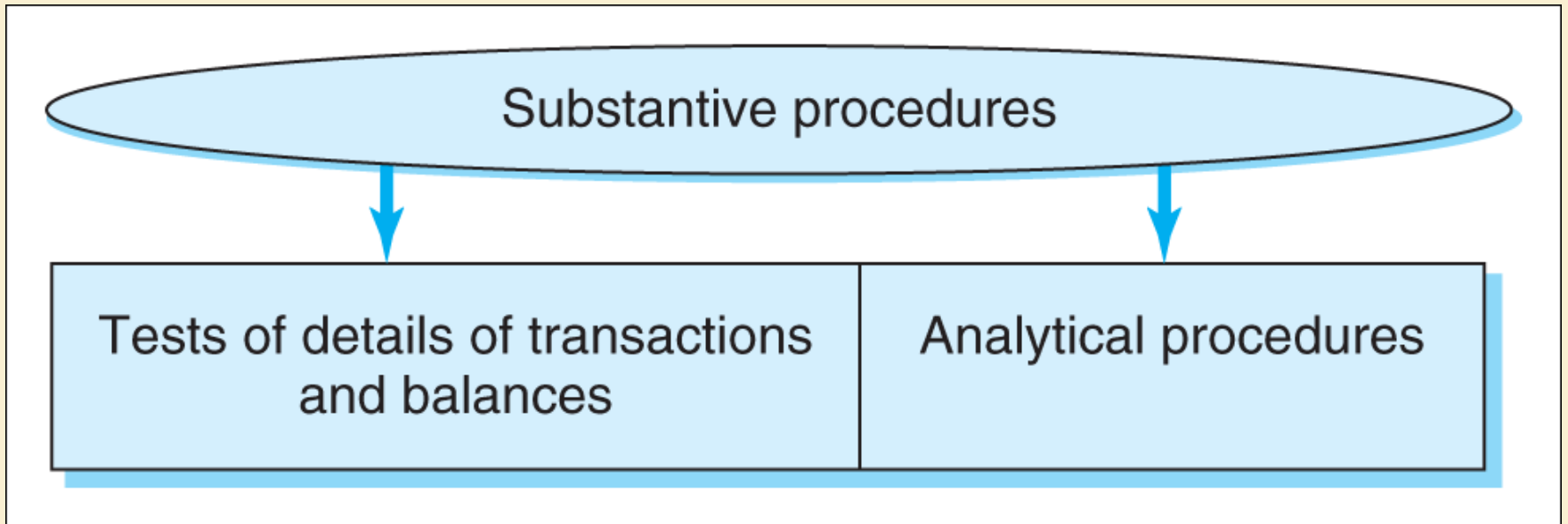
- In certain circumstances, audit evidence obtained from previous audits may provide audit evidence where the auditor may perform audit procedures to establish its continuing relevance.
- Changes may affect the relevance of the audit evidence obtained in previous audits so there may no longer be a basis for continued reliance.
 - A change that causes data to be accumulated or calculated differently does affect it.
- However, ISA 330 requires controls to be retested at least once in every third year.

Substantive procedures

Defined

A substantive procedure is an audit procedure designed to detect material misstatements at the assertion level.

Two types – (1) tests of details of classes of transactions, account balances and disclosures and (2) substantive analytical procedures.



Nature of substantive procedures

- Tests of details of transactions are audit procedures related to examining the processing of particular classes of transactions through the accounting systems.
- Tests of balances are substantive tests that provide either reasonable assurance of the validity of a general ledger balance or identifies a misstatement in the account.
- Analytical procedures.

Tests of balances

- Tests of balances are used to examine the actual details making up high turnover accounts such as cash, accounts receivable, accounts payable, etc.

Why is tests of balances so important?

- Because the auditor's ultimate objective is to express an opinion on financial statements that are made up of account balances.

Tests of balances (Continued)

In tests of balances the auditor is concerned with overstatement or **understatement** of the line item in the financial statement.

- Test makes use of the inherent properties of double-entry accounting systems.
- From the auditor's perspective, this means that a test of one side of the transaction simultaneously tests the other side of the transactions.

Interim testing using substantive procedures

- In some instances, primarily as a practical matter, substantive procedures may be performed at an interim date. Only using interim testing procedures will increase the risk that misstatements existing at the period end will not be detected.
- Performing audit procedures at an interim date may assist the auditor in identifying and resolving issues at an early stage of the audit.

Search for unrecorded liabilities

- A substantive test usually performed on accounts payable is a search for unrecorded liabilities. This test provides evidence as to completeness and some evidence as to valuation.
- To search for unrecorded liabilities, the auditor reviews disbursements made by the client for a period after the balance sheet date.
- Due to pressure from vendors, most unrecorded accounts payable are paid within a reasonable time after the balance sheet date. By reviewing cash disbursements subsequent to the balance sheet date, the auditor has a good idea of the potential population of unrecorded accounts payable.

Sufficient appropriate audit evidence

- The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. – ISA 500
- Reasonable assurance is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. – ISA 200

Sufficient appropriate audit evidence (Continued)

- *Sufficiency* is the measure of the quantity of audit evidence.
- *Appropriateness* is the measure of quality of audit evidence; that is, its relevance and reliability its in providing support for the conclusions on which the auditor's opinion is based.

The auditor's judgement as to what constitutes sufficient appropriate audit evidence is influenced by

- results of audit procedures performed, including whether such audit procedures identified specific instances of fraud or error;
- source and reliability of the available information;
- the significance of the potential misstatement and the likelihood of having a material effect on the financial statements: the more material the item, the greater the sufficiency and appropriateness of evidence;
- the effectiveness of management's responses and controls to address the risks;
- the experience gained during previous audits with respect to similar potential misstatements;
- persuasiveness of the audit evidence;
- understanding of the entity and its environment, including its internal control.

Consideration	Effect on sufficient and appropriate evidence
Materiality of the item being examined.	The more material the item the greater the amount of evidence required.
Effectiveness of management's responses to risk.	More effective management responses to risk and controls decreases quality and quantity of evidence required.
Prior audit experience with the client.	Prior audit experience with the client will indicate how much evidence was taken before and if that was enough.
Auditor's assessment of inherent and control risks.	The higher the inherent or control risk, the greater the amount of evidence required.
Reliability of the available information.	The less reliable the source of information, the greater the amount of evidence required.
Whether fraud or error is suspected.	If fraud is suspected, the amount of evidence required increases.

Illustration 9.4 Sufficient Appropriate Audit Evidence

- Relevance of evidence is the appropriateness (pertinence) of the evidence to the audit objective being tested.
- Reliability is the quality of information when it is free from material error and bias and can be depended upon by users to represent faithfully that which it either purports to represent or could reasonably be expected to represent.

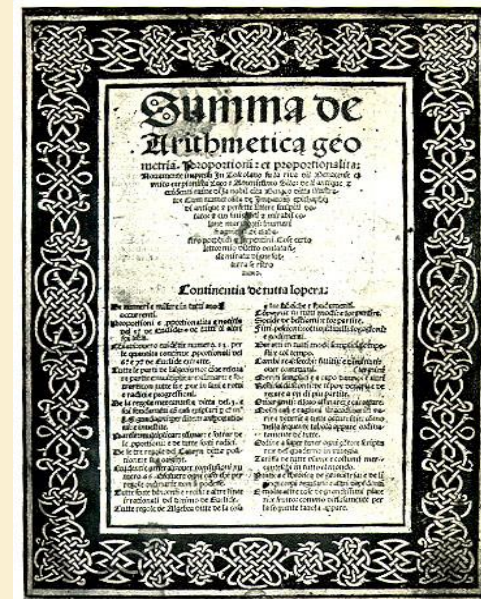


Illustration 9.5 The Quality of Audit Evidence

Reliability of audit evidence

While recognising that exceptions may exist, the following generalisations about the reliability of audit evidence may be useful.

- Audit evidence obtained directly by the auditor (e.g. observation, re-performance) is more reliable than audit evidence obtained indirectly or by inference.
- Audit evidence is more reliable when it exists in documentary form, whether paper, electronic, or other medium.
- Audit evidence is more reliable when it is obtained from independent sources outside the entity.
- The effectiveness of the client's internal control structure has a significant impact on reliability of evidence.
- Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.



Persuasive evidence

- ✓ Unlike legal evidence, audit evidence does not have to be conclusive to be useful. Ordinarily, the auditor finds it necessary to rely on audit evidence that is persuasive rather than conclusive and will often seek audit evidence from different sources or of a different nature to support the same assertion.
- ✓ Not all the information available is examined. Conclusions can be reached about controls, transactions, or the account balance by using a sample of the available information that is analysed by statistical sampling or judgement.

Thank you for your attention

Any Questions?