Audit, Business Processes and Digitalization [BL 5]

Business Level II | CA Sri Lanka

Study Text

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Contents of the Curriculum

PART E: FUNDAMENTALS OF AUDIT AND ASSURANCE

E.1: Risk Assessments

This chapter covers those aspects of the external audit which will be considered at the earliest stages, during planning

The importance of understanding the entity being audited and its environment is a key aspect of audit planning as it helps the auditor to identify potential risk areas on which to focus. Various techniques can be used here such as enquiry, analytical procedures, observation and inspection. The risk assessment stage allows the auditor to respond with a proposed audit approach which may be controls based or totally substantive

The auditor also needs to consider the risks of fraud and this is examined towards the end of this chapter

Notes:

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E.1.1. Introduction to risk

A risk assessment carried out under the SLAuS helps the auditor to identify financial statement areas which are susceptible to material misstatement and provides a basis for designing and performing further audit procedures

The overall objectives of the auditor

To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and to report on the financial statements, and communicate as required by the SLAuS, in accordance with the auditor's findings

In order to obtain assurance about whether the financial statements are free from material misstatement, the auditor needs to consider how and where misstatements are most likely to arise. A risk assessment under the SLAuS helps the auditor to ensure the key areas more susceptible to material misstatement are adequately investigated and tested during the audit. It also helps the auditor identify low risk areas where reduced testing may be appropriate, ensuring time is not wasted by over-testing these areas

The SLAuS also deal with the general responsibilities of the auditor, as well as the auditor's further considerations relevant to the application of those responsibilities to specific topics. If the auditor does not conduct an audit in accordance with a recognized set of auditing standards (such as the SLAuS), important responsibilities may not be fulfilled.

Furthermore, the auditor needs to be able to refer to globally recognized standards in the auditor's report. If all audits are conducted in accordance with standards setting out what is expected of auditors, this means that users of the financial statements should be able to be as confident in one auditor's opinion as another's

Professional skepticism, professional judgement and ethical requirements

Auditors are required to carry out the audit with an attitude of professional skepticism, exercise professional judgement and comply with ethical requirements

Professional skepticism is 'an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence'

Professional judgement is the 'application of relevant training, knowledge and experience in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement'

Professional skepticism

SLAuS 200 (para. 15) states that auditors must 'plan and perform an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated'.

This requires the auditor to be alert to:

- Audit evidence that contradicts other audit evidence obtained
- Information that brings into question the reliability of documents and responses to enquiries to be used as audit evidence
- Conditions that may indicate possible fraud
- Circumstances that suggest the need for audit procedures in addition to those required by SLAuS

Professional judgement

SLAuS 200 (para. 16) also requires the auditor to exercise professional judgement in planning and performing an audit of financial statements.

Professional judgement is required in the following areas:

- Materiality and audit risk
- Nature, timing and extent of audit procedures
- Evaluation of whether sufficient appropriate audit evidence has been obtained
- Evaluating management's judgements in applying the applicable financial reporting framework
- Drawing conclusions based on the audit evidence obtained

Ethical requirements

SLAuS 200 (para. 14) states that the auditor must comply with the relevant ethical requirements, including those relating to independence, that are relevant to financial statement audit engagements.

The profession requires members to conduct themselves and provide services to the public according to the ethical standards we looked at earlier in this text. By upholding these standards, the profession's reputation and standing is protected. Ethical behavior serves to protect the public interest

Audit risks

Auditors usually follow a risk-based approach to auditing as required by SLAuS. In this approach, auditors analyse the risks associated with the client's business, transactions and systems which could lead to misstatements in the financial statements and direct their testing to risky areas

How to identify audit risks

A competent auditor needs to be able to identify those risks that may lead to a misstatement in the financial statements. One of the most important things to realize is that what makes a risk an audit risk (as opposed to a general operational or business risk) is the link to the financial statements

Imagine you are auditing a manufacturing company (XYZ Co with a profit before tax of Rs. 600m) and the following information comes to light about your client

XYZ Co has significant plant and machinery which it uses to make its products. During the year the efficiency of the company's machinery was improved significantly. This was because a comprehensive review of each piece of machinery was undertaken and an assessment was made as to whether a minor repair, extensive refurbishment or a complete replacement was needed. XYZ then took the appropriate action in each case and spent a total of Rs. 150m in doing so.

There is judgement involved here as to whether some of the expenditure is capital or revenue expenditure and the situation is unlikely to be clear-cut.

Therefore, there is a risk that the Rs. 150m has not been correctly accounted for. In addition:

(a) Amounts included in non-current assets might not actually exist, as they are really repairs (related assertion is existence of non-current assets).

(b) The repairs expense may be incomplete (or indeed the non-current assets may be incomplete if expenditure of a capital nature has also been included in repairs).

So, one of the audit risks arising is 'expenditure on repairs is incorrectly recorded as non-current assets, resulting in assets that do not exist being included in the statement of financial position'.

Once the auditor has identified the audit risks, procedures can be put in place in response to that risk

Overall audit risk

Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. It is a function of the risk of material misstatement (inherent risk and control risk) and the risk that the auditor will not detect such misstatement (detection risk)

In the previous section we looked at identifying individual risks that could lead to misstatements in the financial statements and we referred to these risks as audit risks.

The SLAuS refer to the individual risks as the risks of material misstatement. Each of these individual risks can contribute to the overall audit risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated

Audit risk has two major components:

(a) One is dependent on the entity, and is the risk of material misstatement arising in the financial statements (inherent risk and control risk)

(b) The other is dependent on the auditor, and is the risk that the auditor will not detect material misstatements in the financial statements (detection risk)

Audit risk = inherent risk × control risk × detection risk

Inherent risk

Inherent risk is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material either individually or when aggregated with other misstatements, before consideration of any related internal controls

Inherent risk is affected by the nature of the entity; for example, the industry it is in and the regulations it falls under, and also the nature of the strategies it adopts.

Control risk

Control risk is the risk that a material misstatement, that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, individually or when aggregated with other misstatements, will not be prevented or detected and corrected on a timely basis by the entity's internal control

Detection risk

Detection risk is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements

The third element of audit risk is detection risk. This is the component of audit risk that the auditors have a degree of control over, because if risk is too high to be tolerated, the auditors can carry out more work to reduce this aspect of audit risk and, therefore, audit risk as a whole

Although increasing sample sizes or doing more work can help to reduce detection risk, the following actions can also improve the effectiveness and application of procedures and therefore help to reduce detection risk:

- Adequate planning
- Assignment of more experienced personnel to the engagement team
- The application of professional skepticism
- Increased supervision and review of the audit work performed

Management of audit risk

SLAuS 200 (para. 17) states that 'to obtain reasonable assurance, the auditor shall obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion'

Auditors will want their overall audit risk to be at an acceptable level, or it will not be worth them carrying out the audit. In other words, if the chance of them giving an inappropriate opinion and being sued is high, it might be better not to do the audit at all

The auditors will obviously consider how risky a new audit client is during the acceptance process and may decide not to go ahead with the relationship. However, they will also consider audit risk for each individual audit and will seek to manage the risk

It is important to understand that there is not a standard level of audit risk which is generally considered by auditors to be acceptable. This is a matter of audit judgement and so will vary from firm to firm and audit to audit. Audit firms are likely to charge higher fees for higher risk clients. Regardless of the risk level of the audit, however, it is vital that audit firms always carry out an audit of sufficient quality

Classroom assignments test

RS Co is a long-established client of your firm. It manufactures bathroom fittings and fixtures, which it sells to a range of wholesalers, on credit. You are the audit senior and have recently been sent the following extract from the draft statement of financial position by the finance director.

	Budget		*Actual*	
	Rs. m	Rs. m	Rs. m	Rs. m
Non-current assets		453		367
Current assets				
Trade accounts receivable	1,134		976	
Bank	–		54	
Current liabilities				
Trade accounts payable	967		944	
Bank overdraft	9		–	

During the course of your conversation with the finance director, you establish that a major new customer the company had included in its budget went bankrupt during the year.

Required

Identify any potential risks for the audit of RS and explain why you believe they are risks.

ANSWER

Potential risks relevant to the audit of RS:

(a) **Credit sales.** RS makes sales on credit. This increases the risk that RS's sales will not be converted into cash. Trade receivables is likely to be a risky area and the auditors will have to consider what the best evidence that customers are going to pay is likely to be.

(b) **Related industry**. RS manufactures bathroom fixtures and fittings. These are sold to wholesalers, but it is possible that RS's ultimate market is the building industry. This is a notoriously volatile industry, and RS may find that its results fluctuate too, as demand rises and falls. This suspicion is added to by the bankruptcy of the wholesaler in the year. The auditors must be sure that accounts which present RS as a viable company are in fact correct.

(c) **Controls**. The fact that a major new customer went bankrupt suggests that RS did not undertake a very thorough credit check on that customer before agreeing to supply them. This implies that the controls at RS may not be very strong.

(d) **Variance**. The actual results are different from budget. This may be explained by the fact that the major customer went bankrupt, or it may reveal that there are other errors and problems in the reported results, or in the original budget.

(e) **Bankrupt wholesaler**. There is a risk that the result reported contains balances due from the bankrupt wholesaler, which are likely to be irrecoverable.

Business risk

The other major category of risk which the auditor should be aware of is business risk and this came up earlier when we talked about focusing on risks that impact on the financial statements. It is useful to consider it briefly so you do not confuse it with audit risk

Business risk is a risk resulting from significant conditions, events, circumstances, actions or inactions that could adversely affect an entity's ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies

Business risk is the risk inherent to the company in its operation. It cannot be eliminated, but it must be managed by the company

Company's strategy, plan or the way in which it measures success may result in an audit risk. For example, if a company has a particular strategy and uses calculated financial measures such as KPIs to judge if that strategy has been successful, this could lead to a risk of management bias when calculating the components of the KPI. For example, if a company is judged (and valued) according to how quickly it grows its sales, the auditors should increase testing to detect the overstatement of sales

E.1.2. Materiality

Materiality for the financial statements as a whole and performance materiality must be calculated at the planning stages of all audits. The calculation or estimation of materiality should be based on experience and judgement. Materiality for the financial statements as a whole must be reviewed throughout the audit and revised if necessary

SLAuS 320 Materiality in Planning and Performing an Audit (para. 8) provides guidance for auditors in this area and states that the objective of the auditor is to 'apply the concept of materiality appropriately in planning and performing the audit'.

SLAuS 320 (para. 2) does not define materiality (in relation to the financial statements as a whole) and notes that it may be discussed in different terms by different financial reporting frameworks.

LKAS 1 Presentation of Financial Statements includes the following in relation to materiality:

Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions that users make on the basis of the financial statements. Materiality depends on the size and nature of the item judged in the surrounding circumstances. The size and nature of the item or a combination of both could be the determining factor

The following statements are generally true regardless of the reporting framework:

(a) Misstatements are considered to be material if they, individually or in aggregate, could reasonably be expected to influence the economic decisions of users.

(b) Judgements about materiality are made in the light of surrounding circumstances and are affected by the size and nature of a misstatement or a combination of both.

(c) Judgements about matters that are material to users of financial statements are based on a consideration of the common financial information needs of users as a group.

The practical implication of this is that the auditor must be concerned with identifying 'material' errors, omissions and misstatements. Both the amount (quantity) and nature (quality) of misstatements need to be considered, eg. lack of disclosure regarding ongoing litigation is likely to be considered material

To implement this, the auditor therefore has to set their own materiality levels – this will always be a matter of judgement and will depend on the level of audit risk.

The higher the anticipated risk, the lower the value of materiality will be.

The materiality level will impact on the auditor's decisions relating to:

- How many items to examine
- Which items to examine
- Whether to use sampling techniques
- What level of misstatement is likely to result in a modified audit opinion

Determining and calculating materiality and performance materiality when planning the audit

During planning, the auditor must establish materiality for the financial statements as a whole, but must also set performance materiality levels

Determining materiality for the financial statements as a whole involves the exercise of professional judgement

Generally, a percentage is applied to a chosen benchmark as a starting point for determining materiality for the financial statements as a whole. The following factors may affect the identification of an appropriate benchmark:

- Elements of the financial statements (eg. assets, liabilities, equity, revenue, expenses)
- Whether there are items on which users tend to focus
- Nature of the entity, industry and economic environment
- Entity's ownership structure and financing
- Relative volatility of the benchmark

Performance materiality is 'the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole'.

Performance materiality also refers to 'the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures'

2.1.2 Example: Materiality levels

Consider an audit of financial statements of a retailer (X Co) with annual sales of Rs. 10,000 million and a profit before tax of Rs. 1,000 million.

Based on the benchmarks in 2.1 the audit firm might consider 0.5% to 1% of revenue and 5% of profit before tax when setting materiality for the financial statements as a whole.

Rs. 10,000m x 1% = 100m and Rs. 10,000m x 0.5% = Rs. 50m

Rs. 1,000m x 5% = Rs. 50m

Materiality for the **financial statements as a whole** (or overall materiality) is set by the auditors at Rs. 50m.

However, to prevent non-detection of a series of misstatements below that threshold aggregating to an amount above materiality for the financial statements as a whole, a lower **performance materiality** is needed which can be used as a 'working materiality'.

The auditor may use a percentage of the financial statement materiality for performance materiality which will depend on risk. The firm may use 75% of overall materiality for low risk audits, 60% for medium and 50% for high risk ones. Suppose X Co is classified as low risk and performance materiality is then set at Rs. 37.5 million. This could be used when auditing most of the financial statement areas.

However, X Co made an isolated error last year when recording its sales. Although the audit of X Co is low risk overall, the risk of a misstatement in sales is considered medium. When auditing sales the auditor will use 60% of the overall materiality of Rs. 50million as the performance materiality which is Rs. 30 million.

Revision of materiality

The level of materiality must be revised for the financial statements as a whole if the auditor becomes aware of information during the audit that would have caused the auditor to have determined a different amount during planning

If the auditor concludes that a lower amount of materiality for the financial statements as a whole is appropriate, the auditor must determine whether performance materiality also needs to be revised, and whether the nature, timing and extent of further audit procedures are still appropriate

Documentation of materiality

SLAuS 320 (para. 14) requires the following to be documented:

- ❑ Materiality for the financial statements as a whole
- ❑ Materiality level or levels for particular classes of transactions, account balances or disclosures if applicable
- ❑ Performance materiality
- ❑ Any revision of the above as the audit progresses

E.1.3. Understanding the entity and its environment

The auditor is required to obtain an understanding of the entity and its environment in order to be able to assess the risks of material misstatements

SLAuS 315 Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment states that the objective of the auditor is to:

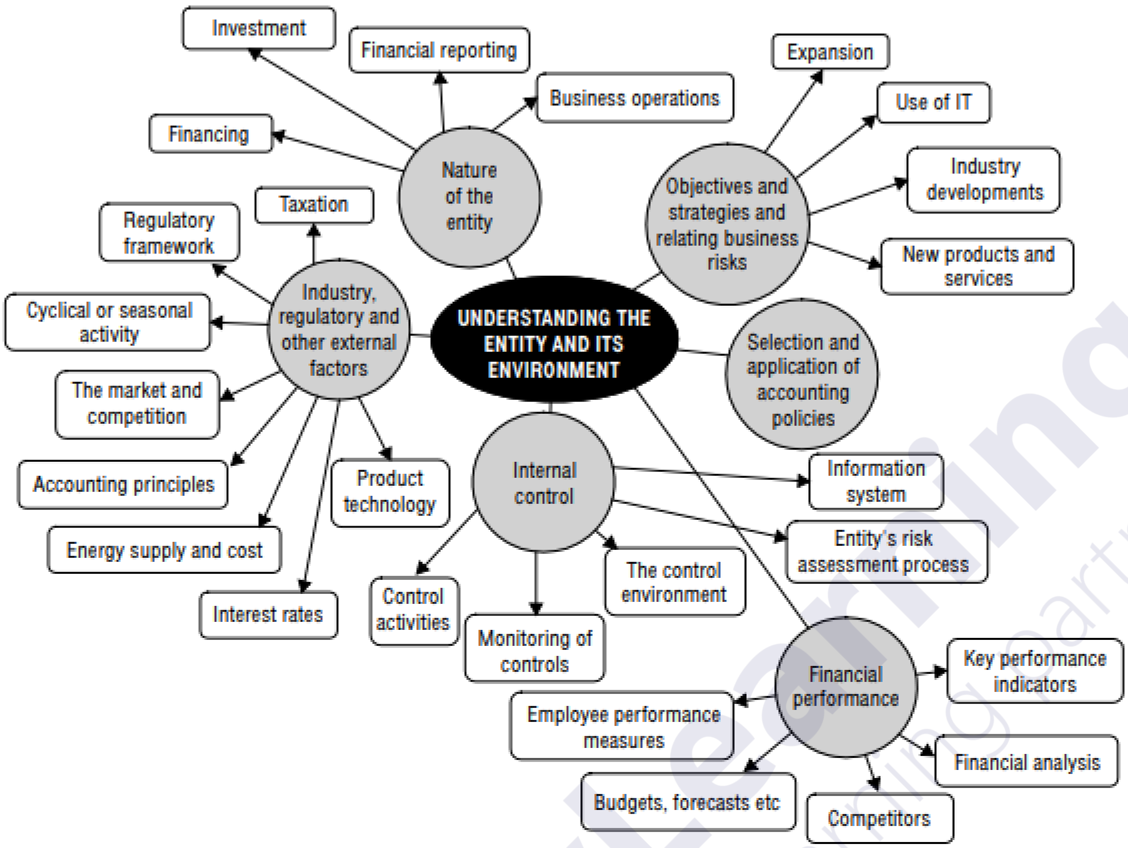
Identify and assess the risks of material misstatement, whether due to fraud or error, through understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement

Obtaining an understanding of the entity and its environment	
Why?	• To identify and assess the risks of material misstatement in the financial statements • To enable the auditor to design and perform further audit procedures • To provide a frame of reference for exercising audit judgement, for example, when setting audit materiality (SLAuS 315 (Revised): para. A1)

What?	• Industry, regulatory and other external factors, including the applicable financial reporting framework • Nature of the entity, including operations, ownership and governance, investments, structure and financing • Entity's selection and application of accounting policies • Objectives and strategies and related business risks that might cause material misstatement in the financial statements • Measurement and review of the entity's financial performance • Internal control (SLAuS 315 (Revised): paras. 11–12)
How?	• Enquiries of management, appropriate individuals within the internal audit function and others within the entity • Analytical procedures • Observation and inspection • Prior period knowledge • Client acceptance or continuance process • Discussion by the audit team of the susceptibility of the financial statements to material misstatement • Information from other engagements undertaken for the entity (SLAuS 315 (Revised): paras. 6–10)

What do we need an understanding

The SLAuS 315 ((Revised): paras. A24–A48) sets out a number of requirements about what the auditors shall consider in relation to obtaining an understanding of the business. The general areas are shown in the following diagram



How do we gain an understanding

SLAuS 315 sets out the methods that the auditor shall use to obtain the understanding; to the sources shown in the diagram above, the auditor will refer to the following to help in obtaining an understanding of the entity and its environment:

- The permanent audit file where information of continuing importance to the audit is kept
- Audit working papers from the previous year's audit file
- Information from the client's website
- Publications or websites related to the industry the client operates in

A combination of the following procedures should be used to obtain an understanding:

- Enquiries of management, internal auditors and others within the entity
- Analytical procedures
- Observation and inspection

SLAuS 315 ((Revised): para. 9) states that if the auditor is going to use information from prior year audits, the auditor shall determine whether changes have occurred that could affect the relevance to the current year's audit

Enquiry

The auditors will usually obtain most of the information they require from staff in the accounts department, but may also need to make enquiries of other personnel: for example, production staff and those charged with governance.

Those charged with governance may give insight into the environment in which the financial statements are prepared. In-house legal counsel may help with understanding such matters as outstanding litigation and compliance with laws and regulations. Sales and marketing personnel may give information about marketing strategies and sales trends

Analytical procedures

Analytical procedures consist of evaluations of financial information through analysis of plausible relationships among both financial and non-financial data. Analytical procedures also encompass investigation of identified fluctuations or relationships that are inconsistent with other relevant information or that differ from expected values by a significant amount

Analytical procedures can be used at all stages of the audit. SLAuS 315 requires their use during the risk assessment stage of the audit. Analytical procedures include:

(a) The consideration of comparisons with:

(i) Similar information for prior periods

(ii) Anticipated results of the entity, from budgets or forecasts

(iii) Predictions prepared by the auditors

(iv) Industry information

(b) The consideration of the relationship between elements of financial information that are expected to conform to a predicted pattern based on the entity's experience, such as the relationship of gross profit to sales.

(c) The consideration of the relationship between financial information and relevant non-financial information, such as the relationship of payroll costs to number of employees

CASE STUDY

The following draft figures have been obtained by the auditors of Grey Co:

EXTRACT DRAFT FIGURES FOR YEAR ENDED 30 SEPTEMBER

	20X1	*20X0*
	Rs'000	Rs'000
Revenue	6,408,279	7,794,301
Gross profit	2,412,797	2,891,686
Profit before interest and tax	527,112	501,556
Property plant and equipment	308,947	352,001
Inventories	1,247,487	1,199,384
Receivables	1,491,498	1,792,635
Trade payables	998,123	1,050,754
Other current liabilities (incl. bank)	107,501	81,634

The auditors have calculated the following ratios as part of the planning process:

	20X1
Gross profit margin	$\frac{2,412,797}{6,408,279} \times 100 = 37.65\%$
Receivables collection period	$\frac{1,491,498}{6,408,279} \times 365 = 85 \text{ days}$
Inventory holding period	$\frac{1,247,487}{(6,408,279 - 2,412,797)} \times 365 = 114 \text{ days}$
Current ratio	$\frac{1,247,487 + 1,491,498}{998,123 + 107,501} = 2.47$
Acid test ratio	$\frac{1,491,498}{998,123 + 107,501} = 1.35$
Return on capital employed	$\frac{527,112}{(308,947 + 1,247,487 + 1,491,498) - (998,123 + 107,501)} \times 100 = 27.1\%$

20X0

Gross profit margin
$$\frac{2,897,686}{7,794,301} \times 100 = \quad 37.1\%$$

Receivables collection period
$$\frac{1,792,635}{7,794,301} \times 365 \quad = \quad 84 \text{ days}$$

Inventory holding period
$$\frac{1,199,384}{(7,794,301 - 2,891,686)} \times 365 = 89 \text{ days}$$

Current ratio
$$\frac{1,199,384 + 1,792,635}{1,050,754 + 81,634} \quad = \quad 2.64$$

Acid test ratio
$$\frac{1,792,635}{1,050,754+81,634} \quad = \quad 1.58$$

Return on capital employed
$$\frac{501,556}{(352,001 + 1,199,384 + 1,792,635) - (1,050,754 + 81,634)} \times 100 = 22.7\%$$

A comparison of the 20X1 and 20X0 figures shows the following areas which may need further investigation together with the additional work which would be included in the audit plan to address the issues identified.

Revenue

The figures show that there has been a drop in revenue of over Rs. 1,386 million. The auditors would discuss this with the client. It could indicate several things:

- That the company has had a bad year in 20X1, with potential impact on the assessment of going concern
- That the company had a particularly good year in 20X0, and 20X1 is more representative of what the company expected
- A major customer has been lost
- There have been errors in recording sales
- Lack of completeness in the recording of sales
- Misclassification of sales
- Incorrect application of cut-off
- Inaccuracies (eg arithmetical) in the accounting records
- Possible fraud

The auditors should carry out further analysis to assess any explanations given to them by the client. For example, because the gross profit percentage and receivables collection period are similar to last year, that might indicate that there was not an error in sales recording.

Further work would be planned to include a more detailed substantive analytical review on the sales figure, by obtaining detailed analysis of sales by month and by product to see if this reveals any more answers about why the sales figure has dropped in 20X1.

Profit before interest and tax

The auditors might expect the profit before interest and tax figure to drop because the revenue figure has dropped by a significant amount compared to last year. However, the profit before interest and tax figure being approximately the same as it was in 20X0 could indicate several things:

- That the company has implemented cost saving measures and has made substantial savings in administrative expenses
- That there have been errors in recording expenses
- That the amount of interest payable by the company has reduced
- That management has tried to improve profit figures by not recording all relevant expenses for the year

The auditors should discuss this with the client to find out if any cost-saving measures have been implemented or if there any other factors which could have resulted in a reduction in expenses. The auditors may also plan to perform detailed testing of expenses at the year end in order to make sure they have been captured in the correct period and not incorrectly recorded in the following year.

Receivables

The receivables figure has reduced by over Rs. 300 million compared to 20X0. This could indicate several things:

- There were fewer sales in the last few months of this year compared to last year, so there are less outstanding receivables at the year end.
- Customers are paying more quickly than they did in the previous year, so there are less outstanding receivables at the year end.
- There have been errors in recording sales and receivables.

The auditors should discuss this with the client and plan to perform further analysis based on the results of the detailed month by month revenue testing. The auditors would also plan to perform a more detailed analysis on the age of outstanding receivables compared to last year in order to see if this reveals any more information about why receivables have fallen.

Inventories

The inventories figure has increased slightly compared with 20X0, however the inventory holding period has increased from 89 days to 114 days. The rise in inventory holding period could be due to:

- A reduction in the total number of products sold
- Incorrect valuation of inventories at the year end
- An error in the cost of sales or inventories figures

The auditors should discuss this with the client and could perform further analysis based on the results of the detailed revenue testing. The auditors would also plan to perform additional procedures around the valuation of inventories, as well as carefully reviewing the results of the inventory count testing performed at the year end to check that inventory was counted accurately.

Observation and inspection

These techniques are likely to confirm the answers given to enquiries made of management. They will include observing the normal operations of a company, reading documents or manuals relating to the client's operations and visiting premises and meeting staff (SLAuS 315 (Revised: para. A18)

Companies that use e-business

When considering the effect on the financial statements of a company using ecommerce, the auditor needs to consider whether the skills and knowledge of team members are appropriate to perform the audit, and also whether an expert is required.

The auditor also needs to have a good understanding of the business to assess the significance of e-commerce and its effect on audit risk. The auditor should consider the following

- ❑ The entity's business activities and industry
- ❑ The entity's e-commerce strategy
- ❑ The extent of e-commerce activities
- ❑ Outsourcing arrangements

Specific risks affecting entities that engage in e-commerce include:

- ❑ Loss of transaction integrity
- ❑ Security risks
- ❑ Improper accounting policies (eg. capitalization of expenditure, translation of foreign currency, allowances for warranties and returns, revenue recognition)
- ❑ Non-compliance with taxation and other laws and regulations
- ❑ Failure to ensure that contracts are binding
- ❑ Overreliance on e-commerce
- ❑ Systems and infrastructure failures or crashes

E.1.4. Assessing the risks of material misstatement

When the auditor has obtained an understanding of the entity, they shall assess the risks of material misstatement in the financial statements, also identifying significant risks

Identifying and assessing the risks of material misstatement

SLAuS 315 ((Revised): para. 5) says that the auditor shall identify and assess the risks of material misstatement at the financial statement level and at the assertion level for classes of transactions, account balances and disclosures.

It requires the auditor to take the following steps:

- Identify risks throughout the process of obtaining an understanding of the entity and its environment
- Assess the identified risks and evaluate whether they relate more pervasively to the financial statements as a whole
- Relate the risks to what can go wrong at the assertion level
- Consider the likelihood of the risks causing a material misstatement

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'

In representing that the financial statements are in accordance with the applicable financial reporting framework, management implicitly or explicitly makes assertions regarding recognition, measurement and presentation and disclosure of the various elements of financial statements and related disclosures

Significant risks

Significant risks are complex or unusual transactions that may indicate fraud, or other special risks

As part of the risk assessment described above, the auditor shall determine whether any of the risks are significant risks.

The following factors indicate that a risk might be significant:

- Risk of fraud
- Its relationship with recent economic, accounting or other developments
- The degree of subjectivity in the financial information
- It is an unusual transaction
- It is a significant transaction with a related party
- The complexity of the transaction

Routine, non-complex transactions are less likely to give rise to significant risk than unusual transactions or matters of management judgement.

This is because unusual transactions are likely to have more:

- Management intervention
- Complex accounting principles or calculations
- Manual intervention
- Opportunity for control procedures not to be followed

Case study analysis

You are involved with the audit of Tantpro Co, a small company. You have been carrying out procedures to gain an understanding of the entity. The following matters have come to your attention:

The company offers standard credit terms to its customers of 60 days from the date of invoice. Statements are sent to customers on a monthly basis. However, Tantpro does not employ a credit controller and, other than sending the statements on a monthly basis, it does not otherwise communicate with its customers on a systematic basis. On occasion, the sales ledger clerk may telephone a customer if the company has not received a payment for some time. Some customers pay regularly according to the credit terms offered to them, but others pay on a very haphazard basis and do not provide a remittance advice. Sales ledger receipts are entered onto the sales ledger but not matched to invoices remitted. The company does not produce an aged list of balances.

Required

From the above information, assess the risks of material misstatement arising in the financial statements. Outline the potential materiality of the risks and discuss factors in the likelihood of the risks arising.

Answer

The key risk arising from the above information is that trade receivables will not be carried at the appropriate **value** in the financial statements, as some may be irrecoverable. Where receipts are not matched against invoices in the ledger, the balance on the ledger may include old invoices that the customer has no intention of paying.

It is difficult to assess at this stage whether this will be material. Trade receivables is likely to be a material balance in the financial statements, but the number of irrecoverable balances may not be material. Analytical procedures, for example, to see if the level of receivables has risen year-on-year in a manner that is not explained by price rises or levels of production, might help to assess this.

A key factor that affects the likelihood of the material misstatement arising is the poor controls over the sales ledger. The fact that invoices are not matched against receipts increases the chance of old invoices not having been paid and not noticed by Tantpro. It appears reasonably likely that the trade receivables balance is overstated in this instance.

E.1.5. Responding to the risk assessment

The auditor shall formulate an approach to the assessed risks of material misstatement

The main objective of SLAuS 330 The Auditor's Responses to Assessed Risks (para. 3), is to obtain 'sufficient appropriate audit evidence regarding the assessed risks of material misstatement, through designing and implementing appropriate responses to those risks'

Overall responses

Overall responses include such issues as emphasizing to the team the importance of professional skepticism, allocating more staff, using experts or providing more supervision.

Overall responses to address the risks of material misstatement at the financial statement level will be changes to the general audit strategy or re-affirmations to staff of the general audit strategy.

For example:

- Emphasizing to audit staff the need to maintain professional skepticism
- Assigning additional or more experienced staff to the audit team
- Providing more supervision on the audit
- Incorporating more unpredictability into the audit procedures
- Making general changes to the nature, timing or extent of audit procedures

Responses to the risks of material misstatement at the assertion level

The SLAuS says that the auditor 'shall design and perform further audit procedures whose nature, timing and extent are based on and are responsive to the assessed risks of material misstatement at the assertion level'

Tests of controls

Tests 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'

Substantive procedures

Substantive procedures are audit procedures designed to detect material misstatements at the assertion level. They consist of tests of details (of classes of transactions, account balances and disclosures) and substantive analytical procedures

The auditor shall always carry out substantive procedures on material items. The SLAuS says that, 'irrespective of the assessed risk of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance and disclosure' (SLAuS 330: para. 18).

In addition, the auditor shall carry out the following substantive procedures:

- Agreeing or reconciling the financial statements to the underlying accounting records
- Examining material journal entries

- Examining other adjustments made in preparing the financial statements

Substantive procedures fall into two categories: analytical procedures and tests of details

Analytical procedures as substantive procedures tend to be appropriate for large volumes of predictable transactions (for example, wages and salaries). Tests of detail may be appropriate to gain information about account balances; for example, inventory and trade receivables

Examples of responses to audit risks

Examples of risks	Possible responses
Risk that inventory has a lower net realisable value than cost and is therefore overstated (eg NRV falls due to the client being in an industry where tastes/fashions change quickly).	• Examine the instructions to identify slow moving inventory lines when attending the inventory count. • Increase the emphasis on reviewing the year end aged inventory analysis for evidence of slow moving inventory. • Ascertain sales values for items sold post year end that were in inventory at the year end to ensure their NRV was higher than the cost recorded as part of the inventory value in the financial statements.
Assets are desirable / more susceptible to theft leading to a risk that recorded assets do not exist (eg inventory/non-current assets).	• Focus on testing internal controls over those assets (including physical controls to prevent theft). • Increase sample sizes for inspecting recorded assets, ensuring any material assets are verified (in the context of performance materiality).
Increased risk of revenue expenditure being incorrectly classified as capital (or vice versa), leading to misstatement of assets/expenses (eg extensive refurbishment of non-current assets where judgement is needed to establish whether the nature of the work is to enhance the asset or repair/replace it).	• Obtain a breakdown of related costs and review accounting entries against invoices/details of work done to ensure expenditure is correctly treated as capital/revenue. • Perform a detailed review of repairs accounts for any items which should be included in non-current assets. • Review the asset register to ensure only capital items have been included.
Increased risk of incomplete or unrecorded income due to fraud or theft (eg large amounts of cash collected and held prior to banking).	• Perform analytical procedures focusing on comparing revenue with expected seasonal/monthly patterns. • If a retail client, perform/reperform a reconciliation of a sample of till records to actual bankings.

Examples of risks	Possible responses
Receipts/invoicing significantly in advance/arrears of providing services or goods, therefore leading to an increased risk of revenue being in the wrong period (eg deposits received in advance, reservation fees, contracts spanning the year end).	• For a sample of revenue entries recorded prior to the year end, agree the transactions as relating to pre year end sales by inspecting the contract / other supporting documentation. • Trace post year end transactions back to a supporting contract/documentation to test that revenue was recorded in the proper period. • For a sample of contracts or GDNs, verify the revenue was recognised according to the provision of services/goods. • Perform analytical procedures where monthly revenue is compared to expectations and budgeted revenue. Unexpected deviations should be investigated.
Invoices received (or payments made) in advance/arrears of goods or services delivery date leading to overstatement or understatement of costs and/or liabilities.	• Review post year end bank statements / cash book payments for evidence of amounts relating to the financial year but not included in liabilities. • For a sample of documents pre and post year end indicating date of delivery of goods/services (eg GRNs), verify the cost and liability were recorded in the appropriate period.
There is an increased risk of irrecoverable debts (eg due to the nature of the client's industry or customers), resulting in assets being potentially overstated.	• Identify year end receivable balances still outstanding at the date of the audit by reviewing post year end receipts from customers. For amounts still outstanding establish whether these are provided for. • Review aged receivables analysis and customer correspondence files for evidence of disputes with receivables and consider the adequacy of any related receivables allowance.

Examples of risks	Possible responses
Significant client borrowing and/or overdraft with cash flow problems which may indicate going concern problems.	• Review correspondence with the bank/lender for any evidence of withdrawal or extension of facilities. • If there are bank covenants linked to performance on which facilities depend, review compliance with these, and increase testing on areas where management could manipulate performance indicators (such as provisions). • Review post year end results and cash flow forecasts (if prepared) for evidence the company can continue as a going concern.
New client systems/controls/staff impacting on amounts recorded in the financial statements, increasing the risk of errors and the risk of internal controls not operating effectively.	• Undertake additional visits (eg interim audit) to assess the effectiveness of controls operating over areas affected. • Perform extra work to document and evaluate new systems/controls, performing tests of controls where necessary. • Increase sample sizes for substantive testing over financial statement areas impacted.
Management has an incentive to manipulate performance, increasing the risk of profits being overstated (eg remuneration or bank funding is reliant on performance).	• Focus on and increase testing on judgemental areas in the financial statements (eg provisions, revenue recognition accounting policies).

Above are just some examples of risks you may encounter in an exam question on audit risks and responses. The best response to each risk will depend on the particular circumstances of the client and the environment in which it operates.

Your approach should not be to simply learn a list of responses. Instead, your focus should be on understanding the link between audit risks and responses, and being able to identify and explain risks and suitable responses when presented with different scenarios

E.1.6. Fraud, law and regulations

When carrying out risk assessment procedures, the auditor shall also consider the risk of fraud or non-compliance with law and regulations causing a misstatement in the financial statements

Fraud is 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' (SLAuS 240: para. 11(a)). Fraud may be perpetrated by an individual, or colluded in, with people internal or external to the business.

Fraud risk factors are 'events or conditions that indicate an incentive or pressure to commit fraud or provide an opportunity to commit fraud'

Specifically, there are two types of fraud causing material misstatement in financial statements:

(a) Fraudulent financial reporting

(b) Misappropriation of assets

Fraudulent financial reporting 'involves intentional misstatements, including omissions of amounts or disclosures in financial statements, to deceive financial statement users'

This may include:

- ❑ Manipulation, falsification or alteration of accounting records/supporting documents
- ❑ Misrepresentation (or omission) of events or transactions in the financial statements
- ❑ Intentional misapplication of accounting principles

Misappropriation of assets 'involves the theft of an entity's assets and is often perpetrated by employees in relatively small and immaterial amounts. However, it can also involve management who are usually more able to disguise or conceal misappropriations in ways that are difficult to detect'

This is the theft of the entity's assets (for example, cash, inventory). Employees may be involved in such fraud in small and immaterial amounts, but it can also be carried out on a larger scale by management who may then conceal the misappropriation, for example, by:

- ❑ Embezzling receipts (for example, diverting them to private bank accounts)
- ❑ Stealing physical assets or intellectual property (inventory, selling data)
- ❑ Causing an entity to pay for goods not received (payments to fictitious vendors)
- ❑ Using assets for personal use

Fraud and the auditor

SLAuS 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements provides guidance for auditors in this area

The primary responsibility for the prevention and detection of fraud is with those charged with governance and the management of an entity. This is effected by having a commitment to creating a culture of honesty and ethical behavior and active oversight by those charged with governance

Risk assessment

Risk assessment procedures to obtain information in identifying the risks of material misstatement due to fraud shall include the following:

(a) Enquiries of management regarding:

(i) Management's assessment of the risk that the financial statements may be misstated due to fraud

(ii) Management's process for identifying and responding to the risk of fraud

(iii) Management's communication to those charged with governance in respect of its process for identifying and responding to the risk of fraud

(iv) Management's communication to employees regarding its views on business practices and ethical behavior

(v) Knowledge of any actual, suspected or alleged fraud

(b) Enquiries of internal audit for knowledge of any actual, suspected or alleged fraud, and its views on the risks of fraud

(c) Obtaining an understanding of how those charged with governance oversee management's processes for identifying and responding to the risk of fraud and the internal control established to mitigate these risks

(d) Enquiries of those charged with governance for knowledge of any actual, suspected or alleged fraud

(e) Evaluating whether any unusual relationships have been identified in performing analytical procedures that may indicate risk of material misstatement due to fraud

(f) Considering whether any other information may indicate risk of material misstatement due to fraud

(g) Evaluating whether any fraud risk factors are present

Written representations

SLAuS 240 (para. 39) requires the auditor to obtain written representations from management and those charged with governance that:

(a) They acknowledge their responsibility for the design, implementation and maintenance of internal control to prevent and detect fraud.

(b) They have disclosed to the auditor management's assessment of the risk of fraud in the financial statements.

(c) They have disclosed to the auditor their knowledge of fraud/suspected fraud involving management, employees with significant roles in internal control, and others where fraud could have a material effect on the financial statements.

(d) They have disclosed to the auditor their knowledge of any allegations of fraud/suspected fraud communicated by employees, former employees, analysts, regulators or others

Communication to management and those charged with governance

When the auditor identifies fraud or receives information that a fraud may exist, the auditor shall report this on a timely basis to the appropriate level of management

The auditor also needs to consider whether there is a responsibility to report to the regulatory or enforcement authorities – the auditor's professional duty of confidentiality may be overridden by laws and statutes in certain jurisdictions

E.1.7. Documentation of risk assessment

Auditors must ensure they have documented the work done at the risk assessment stage, such as the discussion among the audit team of the susceptibility of the financial statements to material misstatements, significant risks, and overall responses

SLAuS 315 and 330 contain a number of general requirements about documentation, and we shall briefly run through those here.

The following matters shall be documented during planning:

- The discussion among the audit team concerning the susceptibility of the financial statements to material misstatements, including any significant decisions reached
- Key elements of the understanding gained of the entity regarding the elements of the entity and its internal control components specified in SLAuS 315, the sources of the information gained and the risk assessment procedures carried out
- The identified and assessed risks of material misstatement at the financial statement level and at the assertion level
- Risks identified and related controls evaluated
- The overall responses to address the risks of material misstatement at the financial statement level
- Nature, extent and timing of further audit procedures linked to the assessed risks at the assertion level
- Results of audit procedures
- If the auditors have relied on evidence about the effectiveness of controls from previous audits, conclusions about how this is appropriate
- Demonstration that the financial statements agree or reconcile with the underlying accounting records

Chapter review questions

1. Complete the definitions

   ………………… risk is the risk that …………….. may give an …………………..opinion on the financial statements. ………………… risk is the ……………………. of an assertion to a …………………. that could be material, assuming there were no related ………….. ……………

2. If control risk and inherent risk are assessed as sufficiently low, substantive procedures can be abandoned completely

   True
   False

3. Which procedures might an auditor use in gaining an understanding of the entity

4. The audit team is required to discuss the susceptibility of the financial statements to material misstatements

   True
   False

5. Auditors have a duty to detect fraud

   True
   False