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Audit Risk

Chartered Accountancy
Corporate Level
Advanced Audit & Assurance (AAA)

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Advance Audit & Assurance (AAA)
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AUDIT RISK....................................

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Auditors Responsibility

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

Professional scepticism 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 states that auditors must plan and perform an audit with an attitude of professional scepticism, recognising that circumstances may exist that cause the financial statements to be materially misstated.

Professional scepticism requires the auditor to be alert to:

- Audit evidence that contradicts other audit evidence obtained
- Evidence that brings into question the reliability of documents and the responses to inquiries 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 SLAuSs

Professional scepticism needs to be maintained throughout the audit to reduce the risks of overlooking unusual transactions, over-generalising when drawing conclusions, and using inappropriate assumptions in determining the nature, timing and extent of audit procedures and evaluating the results of them. Professional scepticism is also necessary to the critical assessment of audit evidence. This includes questioning contradictory audit evidence and the reliability of documents and responses from management and those charged with governance.

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Professional judgment

SLAuS 200 also requires the auditor to exercise professional judgment in planning and performing an audit of financial statements. Professional judgment 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 judgments in applying the applicable financial reporting ramework
- Drawing conclusions based on the audit evidence obtained

Ethical requirements

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

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).

Auditors usually follow a risk-based approach to auditing as required by SLAuSs. 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 realise is what makes a risk an audit risk (as opposed to a general operational or business risk) is the link to the financial statements. If an auditor does not maintain a focus on those risks that may lead to a misstatement in the financial statements, the audit will be a very long process and not at all efficient.

Example……………………

Imagine you are auditing a manufacturing company (XYZ Co with a profit before tax of Rs.60 million) 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.15 million in doing so.'

From the above you can see management had identified a general (business) risk from their point of view - that the plant and machinery was not efficient enough for the needs of the business. Management has taken what they consider to be the appropriate action by replacing, overhauling or repairing the machinery.

There may also be further operational risks arising as a result, such as staff not being used to the new machinery and taking some time to get up to speed. However an auditor needs to look past these and ask him or herself how the issues above could ultimately lead to a misstatement in the financial statements. This will bring out the audit risks. Where will the repairs, refurbishment and new machinery end up in the financial statements and what could go wrong? Where should it end up?

LKAS 16 tells you that the expenditure must generate future economic benefit in order to be included in non-current assets. Other costs that do not meet this criterion should be included as repairs in the statement of profit or loss. In our scenario we appear to have some expenditure on replacement assets, some on extensive refurbishment and some on general repairs.

There is judgment 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.15 million has not been correctly accounted for, and:

- *Amounts included in non-current assets might not actually exist, as they are really repairs (related assertion is existence of non-current assets).*
- *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, if the scenario above came up in the exam 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.

The procedural approach

The procedural approach is when the auditor performs a set of established and routine tests on the business. These tests are standardized across organization and industry, and the tests applied are not customized to the client or their business. This means that individual organisational risks are not considered outside of those identified through the standardised procedures.

The procedural approach is in direct contrast to the risk-based approach and it is not in accordance with SLAuSs. In a procedural approach, the auditor would perform a set of standard tests regardless of the client and its business. The risk of the auditor providing an incorrect opinion on the truth and fairness of the financial statements might be higher if a procedural approach was adopted.

Overall audit 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 SLAuSs 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.

Now we will consider the concept of the overall audit risk and, in particular, the audit risk model. Understanding this model helps the auditor to take action to reduce overall audit risk to an acceptable level. Where we refer to audit risk below we are referring to the overall risk that an inappropriate audit opinion is expressed.
Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.
Audit risk has two major components. One is dependent on the entity, and is the risk of material misstatement arising in the financial statements (inherent risk and control risk). 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).

Inherent risk

Inherent risk is the susceptibility of an assertion to a misstatement that could be material individually or when aggregated with other misstatements, assuming there were no related internal controls.

Inherent risk is the risk that items will be misstated due to the characteristics of those items, such as the fact they are estimates or that they are important items in the accounts. The auditors must use their professional judgment and all available knowledge to assess inherent risk. If no such information or knowledge is available then the inherent risk is high.

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. We shall look at more examples of inherent risks later in this chapter.

Control risk

The other element of the risk of material misstatements in the financial statements is control risk. Control risk is the risk that a material misstatement that could occur in an assertion 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, 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.

One way to decrease detection risk is to increase sample sizes. Sampling risk and non-sampling risk are components of detection risk,

However, increasing sample sizes and carrying out more work is not the only way to manage detection risk. This is because detection risk is a function of the effectiveness of an audit procedure and of its application by the auditor.

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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***

All of the above reduce the possibility that an auditor might select an inappropriate audit procedure, misapply an appropriate audit procedure, or misinterpret the audit results.

Management of audit risk

SLAuS 200 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.
As we have seen above, it is not in the auditors' power to affect inherent or control risk. These are risks integral to the client, and the auditor cannot change the level of these risks. The auditors, therefore, manage overall audit risk by manipulating detection risk, the only element of audit risk they have control over.
This is because the more audit work the auditors carry out, the lower detection risk becomes, although it can never be entirely eliminated due to the inherent limitations of audit.

The auditors will decide what level of overall risk is acceptable and then determine a level of audit work so that detection risk is as low as possible. 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 judgment and so will vary from firm to firm and audit to audit. Audit firms

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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.

Business risk approach

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. ***Business risk is the risk inherent to the company in its operations and, as we discussed, the auditor is concerned with those business risks which are, or can lead to, risks of material misstatement in the financial statements.***

This 'business risk' approach was developed because it is often the case that the risk of the financial statements being misstated arises predominantly from the business risks of the company.

The table below highlights some of the factors that may exist.

Principal risk	Immediate financial statement implications
Economic pressures causing reduced unit sales and eroding margins	Inventory values (LKAS 2) Going concern
Economic pressures resulting in demands for extended credit	Receivables recoverability
Product quality issues related to inadequate control over supply chain and transportation damage	Inventory values – net realisable value and inventory returns
Customer dissatisfaction related to inability to meet order requirements	Going concern
Customer dissatisfaction related to invoicing errors and transportation damage	Receivables valuation
Unacceptable service response call rate related to poor product quality	Going concern Litigation – provisions and contingencies Inventory – net realisable value
Out-of-date IT systems affecting management's ability to make informed decisions	Anywhere

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Advantages of business risk approach

There are a number of reasons why firms may adopt the business risk approach prefer it to historic approaches:

• Added value is given to clients, as the approach focuses on the business as a whole

• Audit attention focused on high-level controls, with extensive use of analytical procedures, increases audit efficiency and therefore reduces cost

• Does not focus on merely routine processes, which technological developments have rendered less prone to error than has historically been the case

• Responds to the importance placed by regulators and the government on corporate governance

• Lower engagement risk (risk of auditor being sued) as a result of broader understanding of the client's business and practices.

Operational - industry	
Volatile industry	Significant issues relating to **going concern** arising, auditors should direct their audit work in this area.
Retail units affected by bomb threats	Potential issues relating to **receivables' recoverability**. Retail units/shops may not be able to pay rent/honour leases if they are not receiving sufficient income from sales. The potential fall in income related to the retail units could affect the valuation **of tangible non-current assets** – is there a need for an impairment review?
Operational – personnel	
Loss of FD	This could have a significant impact on the **calculation and presentation of the financial statements** if they are now drafted by an inexperienced person. There is also a significant impact on the **control environment**, which will affect assessment of control risk.

Finance	
Interest rates	The issues relating to high interest rates will affect the **interest figure** in the statement of profit or loss. It may also affect the **going concern** assumption.
Compliance	
New law	Depending on the timing of the new legislation and the outcomes discussed above, this could affect **events after the reporting period**, contingencies or **provisions.** It could also potentially affect going concern.

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 provides guidance to auditors in this area and states the objective of the auditor is to apply the concept of materiality appropriately in planning and performing the audit.

SLAuS 320 does not define materiality (in relation to the financial statements as a whole) but notes that, whilst it may be discussed in different terms by different financial reporting frameworks, the following are generally the case:

(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; for example, a lack of disclosure regarding ongoing litigation is likely to be considered material.

Some misstatements may fall under specified benchmarks, but are still considered material overall due to their qualitative effects.

Magnitude by itself, without regard to the nature of the item and the circumstances in which the judgment has to be made, may not be a sufficient basis for a materiality judgment. As a result, qualitative factors may cause misstatements of quantitatively small amounts to be material.

Examples of this are given SLAuS 320:

• Law, regulation or the applicable financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (for example, related-party transactions, and the remuneration of management and those charged with governance).

• Some disclosures are key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company)

• Attention is sometimes focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, a newly acquired business).

Materiality 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 auditors' 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?

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➢ Materiality for the financial statements as a whole

Determining **materiality for the financial statements as a whole** involves the exercise of professional judgment. 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

The following **benchmarks and percentages** may be appropriate in the calculation of materiality for the financial statements as a whole.

Value	%
Profit before tax	5
Gross profit	½ – 1
Revenue	½ – 1
Total assets	1 – 2
Net assets	2 – 5
Profit after tax	5 – 10

Which benchmark or benchmarks are appropriate will depend on the nature of the business being audited.

The percentage guidelines of assets and profits that are commonly used for materiality must be handled with care. The auditor must bear in mind the **focus** of the company being audited.

In some companies, **post-tax profit** is the key figure in the financial statements, as the level of dividend is the most important factor in the accounts.

In **owner-managed businesses**, if owners are paid a salary and are indifferent to dividends, the key profit figure stands higher in the statement of profit or loss, say at **gross profit** level. Alternatively, in this situation, the auditor should consider a figure that does not appear in the statement of profit or loss: **profit before directors' salaries and benefits**.

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Some companies are **driven by assets** rather than the need for profits. In such examples, higher materiality might need to be applied to assets. In some companies, say charities, **costs** are the driving factor, and materiality might be considered in relation to these. While rules or guidelines are helpful to auditors when assessing materiality, they must always keep in mind the **nature** of the business they are dealing with. Materiality must be **tailored to the business and the anticipated user** of financial statements, or it is not truly materiality. Refer back to the definition of materiality and consider **all the elements** of it.

➢ Performance materiality

Consider what would happen if this materiality for the financial statements as a whole was applied directly to, for example, different account balances (such as receivables, inventory etc). It could be that a number of balances (or elements making up those balances) are untested or dismissed on the grounds they are immaterial. However, a number of errors or misstatements could exist in those untested balances, and these could aggregate to a material misstatement.

For this reason the auditor is required to set **performance materiality** levels, which are lower than the materiality for the financial statements as a whole and this means a lower threshold is applied during testing. The risk of misstatements which could add up to a material misstatement is therefore reduced.

As we can see below, performance materiality really has two definitions (taken from SLAuS 320).

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.***

This indicates that the auditor sets a level or levels of materiality lower than overall materiality for the purposes of performing procedures in general (for example on a low-risk area) and this is just to account for aggregation. However, an even lower level is set for certain balances, transactions or disclosures where there is an increased risk or if qualitative considerations (discussed below) necessitate it.

As you can see, determining performance materiality is very much dependent on the auditor's professional judgement. In summary is affected by

• The nature and extent of misstatements identified in prior audits.
• The auditor's understanding of the entity
• Result of risk assessment procedures.

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. A revision to materiality might be required, for example, if during the audit it appears that actual results are going to be significantly different from the expected results, which were used to calculate materiality for the financial statements as a whole during planning.

Documentation of materiality

SLAuS 320 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

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.

Why do we need an understanding?

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.

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The following table summarises this simply.

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
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 (which we looked at in Chapter 5)
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

How do we gain an understanding?

SLAuS 315 sets out the methods that the auditor shall use to obtain the understanding and they were shown in the table in Section 5.1. In addition 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:

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• 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

Risk assessment procedures

A combination of the following procedures should be used as risk assessment procedures:
• **Enquiries** of management, internal auditors and others within the entity
• **Analytical procedures**
• **Observation** and **inspection**

SLAuS 315 also states the auditor shall consider whether information obtained from client acceptance or continuance processes is relevant. If the engagement partner has performed other engagements for the entity, he/she shall consider whether information from these is relevant to identifying risks of material misstatement.

SLAuS 315 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.
SLAuS 315 also requires the engagement partner and other key team members to discuss the susceptibility of the financial statements to material misstatement, and the application of the applicable financial reporting framework to the entity's facts and circumstances. The engagement partner shall determine what matters are to be communicated to team embers not involved in the discussion.

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 or 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 matters such as outstanding litigation, or compliance with laws and regulations. Sales and marketing personnel may give information about marketing strategies and sales trends.
If the client has an internal audit function, enquiries should be made of internal auditors as appropriate as part of risk assessment procedures.

Observation and inspection
These techniques are likely to confirm the answers made 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 or visiting premises and meeting staff.

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Analytical procedures

Analytical procedures must be used as risk assessment procedures.
Analytical procedures consist of the evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. They also encompass the investigation of identified fluctuations and relationships that are consistent with other relevant information or deviate significantly from predicted amounts.

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:
• **Similar information** for prior periods
• **Anticipated results** of the entity, from budgets or forecasts
• **Predictions** prepared by the auditors
• **Industry information**

(b) Those 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) Those between financial information and relevant non-financial information, such as the relationship of payroll costs to number of employees.

A variety of methods can be used to perform the procedures discussed above, ranging from **simple comparisons** to **complex analysis** using statistics, on a company level, branch level or individual account level. **Ratio analysis** can be a useful technique when carrying out analytical procedures.

We consider ratio analysis in which considers analytical procedures as a form of substantive procedures when collecting audit evidence. Ratio analysis can also be used when applying analytical procedures at the risk assessment stage.

The choice of procedures is a matter for the auditors' professional judgment. The use of information technology may be extensive when carrying out analytical procedures during risk assessment.

Auditors may also use specific industry information or general knowledge of current industry conditions to assess the client's performance.

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Assessing the risks of material misstatement

When the auditor has obtained an understanding of the entity, he 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 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

Significant risks

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

Significant risks are those that require special audit consideration.

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

The auditor is required to exercise professional scepticism and professional judgement to decide whether a risk is significant. When using professional judgement to determine the severity of a risk, the auditor needs to examine the likelihood of the risk occurring, and the seriousness of the risk event on business operations. The following factors need to be considered:

• Whether the risk is related to recent significant economic, accounting or other developments; and therefore requires special audit consideration.
• The degree of subjectivity in the measurement of financial information related to the risk, especially those measurements involving a wide range of measurement uncertainty.
• If the risk involves a significant transaction with a related party in the normal course of business.
• The complexity of the transaction.
• If the risk involves a significant transaction which is outside the normal course of business for the entity, or which otherwise appear to be unusual.

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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
When the auditor identifies a significant risk, if he has not done so already, he shall obtain an understanding of the entity's controls relevant to that risk.

Companies that use e-business
When considering the effect on the financial statements of a company using e-commerce, 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 capitalisation 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
• Over-reliance on e-commerce
• Systems and infrastructure failures or crashes

Responding to the risk assessment and documentation

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* 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 issues such as emphasising to the team the importance of professional scepticism, 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. 'Nature' refers to the purpose and the type of test that is carried out, which include **tests of controls** and **substantive tests**.

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 must 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.

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

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Examples of responses to audit risks

Examples of risks	Possible responses
Risk that inventory has a lower net realisable value (NRV) 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.

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Examples of risks	Possible responses
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/re-perform a reconciliation of a sample of till records to actual bankings.
Receipts/invoicing significantly in advance/arrears of provision of 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/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.

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Examples of risks	Possible responses
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.
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 (e.g provisions, revenue recognition accounting policies).

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.

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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

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Question 01

You are an audit supervisor of Cupid & Co, planning the final audit of a new client, Prancer Construction Co, for the year ending 30 September 20X7. The company specialises in property construction and providing ongoing annual maintenance services for properties previously constructed. Forecast profit before tax is $13·8m and total assets are expected to be $22·3m, both of which are higher than for the year ended 30 September 20X6.

You are required to produce the audit strategy document. The audit manager has met with Prancer Construction Co's finance director and has provided you with the following notes, a copy of the August management accounts and the prior year financial statements.

Meeting notes

The prior year financial statements recognise work in progress of $1·8m, which was comprised of property construction in progress as well as ongoing maintenance services for finished properties. The August 20X7 management accounts recognise $2·1m inventory of completed properties compared to a balance of $1·4m in September 20X6. A full year-end inventory count will be undertaken on 30 September at all of the 11 building sites where construction is in progress. There is not sufficient audit team resource to attend all inventory counts.

In line with industry practice, Prancer Construction Co offers its customers a five-year building warranty, which covers any construction defects. Customers are not required to pay any additional fees to obtain the warranty. The finance director anticipates this provision will be lower than last year as the company has improved its building practices and therefore the quality of the finished properties.

Customers who wish to purchase a property are required to place an order and pay a 5% non-refundable deposit prior to the completion of the building. When the building is complete, customers pay a further 92·5%, with the final 2·5% due to be paid six months later. The finance director has informed you that although an allowance for receivables has historically been maintained, it is anticipated that this can be significantly reduced.

Information from management accounts

Prancer Construction Co's prior year financial statements and August 20X7 management accounts contain a material overdraft balance. The finance director has confirmed that there are minimum profit and net assets covenants attached to the overdraft.

A review of the management accounts shows the payables period was 56 days for August 20X7, compared to 87 days for September 20X6. The finance director anticipates that the September 20X7 payables days will be even lower than those in August 20X7.

Required:

(a) Describe the process Cupid & Co should have undertaken to assess whether the PRECONDITIONS for an audit were present when accepting the audit of Prancer Construction Co. (3 marks)

(b) Identify THREE main areas, other than audit risks, which should be included within the audit strategy document for Prancer Construction Co, and for each area provide an example relevant to the audit. (3 marks)

(c) Using all the information provided describe SEVEN audit risks, and explain the auditor's response to each risk, in planning the audit of Prancer Construction Co. Note: Prepare your answer using two columns headed Audit risk and Auditor's response respectively. (14 marks)
(20 marks)

Question 02

You are an audit supervisor of Caving & Co and you are planning the audit of Hurling Co, a listed company, for the year ending 31 March 20X7. The company manufactures computer components and forecast profit before tax is $33 ·6m and total assets are $79 ·3m.

Hurling Co distributes its products through wholesalers as well as via its own website. The website was upgraded during the year at a cost of $1 ·1m. Additionally, the company entered into a transaction in February to purchase a new warehouse which will cost $3 ·2m. Hurling Co's legal advisers are working to ensure that the legal process will be completed by the year end. The company issued $5m of irredeemable preference shares to finance the warehouse purchase.

During the year the finance director has increased the useful economic lives of fixtures and fittings from three to four years as he felt this was a more appropriate period. The finance director has informed the engagement partner that a revised credit period has been agreed with one of its wholesale customers, as they have been experiencing difficulties with repaying the balance of $1 ·2m owing to Hurling Co. In January 20X7, Hurling Co introduced a new bonus based on sales targets for its sales staff. This has resulted in a significant number of new wholesale customer accounts being opened by sales staff. The new customers have been given favourable credit terms as an introductory offer, provided goods are purchased within a two-month period. As a result, revenue has increased by 5% on the prior year.

The company has launched several new products this year and all but one of these new launches have been successful. Feedback on product Luge, launched four months ago, has been mixed, and the company has just received notice from one of their customers, Petanque Co, of intended legal action. They are alleging the product sold to them was faulty, resulting in a significant loss of information and an ongoing detrimental impact on profits. As a precaution, sales of the Luge product have been halted and a product recall has been initiated for any Luge products sold in the last four months.

The finance director is keen to announce the company's financial results to the stock market earlier than last year and in order to facilitate this, he has asked if the audit could be completed in a shorter timescale. In addition, the company is intending to propose a final dividend once the financial statements are finalised.

Hurling Co's finance director has informed the audit engagement partner that one of the company's non-executive directors (NEDs) has just resigned, and he has enquired if the partners at Caving & Co can help Hurling Co in recruiting a new NED. Specifically he has requested the engagement quality control reviewer, who was until last year the audit engagement partner on Hurling Co, assist the company in this recruitment. Caving & Co also provides taxation services for Hurling Co in the form of tax return preparation along with some tax planning advice. The finance director has recommended to the audit committee of Hurling Co that this year's audit fee should be based on the company's profit before tax. At today's date, 20% of last year's audit fee is still outstanding and was due to be paid three months ago.

Required:

(b) Describe EIGHT audit risks, and explain the auditor's response to each risk, in planning the audit of Hurling Co. Note: Prepare your answer using two columns headed Audit risk and Auditor's response respectively. (16 marks)

(c) (i) Identify and explain FIVE ethical threats which may affect the independence of Caving & Co's audit of Hurling Co; and (ii) For each threat, suggest a safeguard to reduce the risk to an acceptable level. Note: The total marks will be split equally between each part. Prepare your answer using two columns headed Ethical threat and Possible Safeguard respectively. (10 marks)

Question 03

You are an audit supervisor of Chania & Co and are planning the audit of your client, Sitia Sparkle Co which manufactures cleaning products. Its year end was 31 July 20X6 and the draft profit before tax is \$33·6 million. You are supervising a large audit team for the first time and will have specific responsibility for supervising and reviewing the work of the audit assistants in your team.

Sitia Sparkle Co purchases most of its raw materials from suppliers in Africa and these goods are shipped directly to the company's warehouse and the goods are usually in transit for up to three weeks. The company has incurred \$1·3 million of expenditure on developing a new range of cleaning products which are due to be launched into the market place in November 20X6. In September 20X5, Sitia Sparkle Co also invested \$0·9 million in a complex piece of plant and machinery as part of the development process. The full amount has been capitalised and this cost includes the purchase price, installation costs and training costs.

This year, the bonus scheme for senior management and directors has been changed so that rather than focusing on profits, it is instead based on the value of year-end total assets. In previous years an allowance for receivables, made up of specific balances, which equalled almost 1% of trade receivables was maintained. However, the finance director feels that this is excessive and unnecessary and has therefore not included it for 20X6 and has credited the opening balance to the profit or loss account.

A new general ledger system was introduced in May 20X6; the finance director has stated that the data was transferred and the old and new systems were run in parallel until the end of August 20X6. As a result of the additional workload on the finance team, a number of control account reconciliations were not completed as at 31 July 20X6, including the bank reconciliation. The finance director is comfortable with this as these reconciliations were completed successfully for both June and August 20X6. In addition, the year-end close down of the purchase ledger was undertaken on 8 August 20X6.

Required:

Describe SIX audit risks, and explain the auditor's response to each risk, in planning the audit of Sitia Sparkle Co. Note: Prepare your answer using two columns headed Audit risk and Auditor's response respectively. (12 marks)

Question 04

You are an audit supervisor of Amethyst & Co and are currently planning the audit of your client, Aquamarine Co (Aquamarine) which manufactures elevators. Its year end is 31 July 2016 and the forecast profit before tax is $15·2 million.

The company undertakes continuous production in its factory, therefore at the year end it is anticipated that work in progress will be approximately $950,000. In order to improve the manufacturing process, Aquamarine placed an order in April for $720,000 of new plant and machinery; one third of this order was received in May with the remainder expected to be delivered by the supplier in late July or early August.

At the beginning of the year, Aquamarine purchased a patent for $1·3 million which gives them the exclusive right to manufacture specialised elevator equipment for five years. In order to finance this purchase, Aquamarine borrowed $1·2 million from the bank which is repayable over five years.

In January 2016 Aquamarine outsourced its payroll processing to an external service organisation, Coral Payrolls Co (Coral). Coral handles all elements of the payroll cycle and sends monthly reports to Aquamarine detailing the payroll costs. Aquamarine ran its own payroll until 31 December 2015, at which point the records were transferred over to Coral.

The company has a policy of revaluing land and buildings and the finance director has announced that all land and buildings will be revalued at the year end. During a review of the management accounts for the month of May 2016, you have noticed that receivables have increased significantly on the previous year end and against May 2015.

The finance director has informed you that the company is planning to make approximately 65 employees redundant after the year end. No decision has been made as to when this will be announced, but it is likely to be prior to the year end.

Required:

(b) Describe SIX audit risks, and explain the auditor's response to each risk, in planning the audit of Aquamarine Co. (12 marks)

(c) Explain the additional factors Amethyst & Co should consider during the audit in relation to Aquamarine Co's use of the payroll service organisation. (3 marks) (20 marks)

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Question 05

You are an audit supervisor of Pluto & Co and are currently planning the audit of your client, Venus Magnets Co (Venus) which manufactures decorative magnets. Its year end is 31 December 2015 and the forecast profit before tax is $9·6 million.

During the year, the directors reviewed the useful lives and depreciation rates of all classes of plant and machinery. This resulted in an overall increase in the asset lives and a reduction in the depreciation charge for the year.

Inventory is held in five warehouses and on 28 and 29 December a full inventory count will be held with adjustments for movements to the year end. This is due to a lack of available staff on 31 December. In October, there was a fire in one of the warehouses; inventory of $0·9 million was damaged and this has been written down to its scrap value of $0·2 million. An insurance claim has been submitted for the difference of $0·7 million. Venus is still waiting to hear from the insurance company with regards to this claim, but has included the insurance proceeds within the statement of profit or loss and the statement of financial position.

The finance director has informed the audit manager that the October and November bank reconciliations each contained unreconciled differences; however, he considers the overall differences involved to be immaterial.

A directors' bonus scheme was introduced during the year which is based on achieving a target profit before tax. In order to finalise the bonus figures, the finance director of Venus would like the audit to commence earlier so that the final results are available earlier this year.

Required:

Describe FIVE audit risks, and explain the auditor's response to each risk, in planning the audit of Venus Magnets Co. (10 marks)

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Question 06

You are the audit supervisor of Maple & Co and are currently planning the audit of an existing client, Sycamore Science Co (Sycamore), whose year-end was 30 April 2015. Sycamore is a pharmaceutical company, which manufactures and supplies a wide range of medical supplies. The draft financial statements show revenue of $35·6 million and profit before tax of $5·9 million.

Sycamore's previous finance director left the company in December 2014 after it was discovered that he had been claiming fraudulent expenses from the company for a significant period of time. A new finance director was appointed in January 2015 who was previously a financial controller of a bank, and she has expressed surprise that Maple & Co had not uncovered the fraud during last year's audit.

During the year Sycamore has spent $1·8 million on developing several new products. These projects are at different stages of development and the draft financial statements show the full amount of $1·8 million within intangible assets. In order to fund this development, $2·0 million was borrowed from the bank and is due for repayment over a ten-year period. The bank has attached minimum profit targets as part of the loan covenants

The new finance director has informed the audit partner that since the year end there has been an increased number of sales returns and that in the month of May over $0·5 million of goods sold in April were returned. Maple & Co attended the year-end inventory count at Sycamore's warehouse. The auditor present raised concerns that during the count there were movements of goods in and out the warehouse and this process did not seem well controlled. During the year, a review of plant and equipment in the factory was undertaken and surplus plant was sold, resulting in a profit on disposal of $210,000.

Required: Describe SIX audit risks, and explain the auditor's response to each risk, in planning the audit of Sycamore Science Co. (12 marks)

Question 07

You are the audit senior of Rhino & Co and you are planning the audit of Kangaroo Construction Co (Kangaroo) for the year ended 31 March 2013. Kangaroo specialises in building houses and provides a five-year building warranty to its customers. Your audit manager has held a planning meeting with the finance director. He has provided you with the following notes of his meeting and financial statement extracts: Kangaroo has had a difficult year; house prices have fallen and,

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as a result, revenue has dropped. In order to address this, management has offered significantly extended credit terms to their customers. However, demand has fallen such that there are still some completed houses in inventory where the selling price may be below cost. During the year, whilst calculating depreciation, the directors extended the useful lives of plant and machinery from three years to five years. This reduced the annual depreciation charge. The directors need to meet a target profit before interest and taxation of $0·5 million in order to be paid their annual bonus. In addition, to try and improve profits, Kangaroo changed their main material supplier to a cheaper alternative. This has resulted in some customers claiming on their building warranties for extensive repairs. To help with operating cash flow, the directors borrowed $1 million from the bank during the year. This is due for repayment at the end of 2013.

Financial statement extracts for year ended 31 March

	DRAFT 2013 $m	ACTUAL 2012 $m
Revenue	12·5	15·0
Cost of sales	(7·0)	(8·0
Gross profit	5·5	7·0
Operating expenses	(5·0)	(5·1)
Profit before interest and taxation	0·5	1·9
Inventory	1·9	1·4
Receivables	3·1	2·0
Cash	0.8	1·9
Trade payables	1·6	1·2
Loan	1·0	–

Required:

Using the information above:
(i) Calculate FIVE ratios, for BOTH years, which would assist the audit senior in planning the audit; and (5 marks)
(ii) Using the information provided and the ratios calculated, identify and describe FIVE audit risks and explain the auditor's response to each risk in planning the audit of Kangaroo Construction Co.(10 marks) **(20 marks)**

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