MODULE 3

Topic 1 – Understanding the client and introduction to risk

If you fail to plan,
you are planning to fail

Benjamin Franklin

Topic 1.1 – Audit planning

The auditing standards – 300 series

ASA 300	*Planning an Audit of a Financial Report* (Compiled)		1 Dec 2015	15 Dec 2016
ASA 315	*Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* (Compiled)		1 Dec 2015	15 Dec 2016
ASA 315	*Identifying and Assessing the Risks of Material Misstatement*	Extra	4 Feb 2020	15 Dec 2021 early adoption permitted
ASA 320	*Materiality in Planning and Performing an Audit* (Compiled)		1 Dec 2015	15 Dec 2016
ASA 330	*The Auditor's Responses to Assessed Risks* (Compiled)		1 Dec 2015	15 Dec 2016

ASA300.2 – why do we need planning?

- Devote appropriate attention to important areas of the audit.
- Identify and resolve potential problems on a timely basis.
- Organise and manage the audit engagement so that it is performed in an effective and efficient manner.
- Assisting in the selection of engagement
- Facilitating the direction and supervision of engagement team members and the review of their work.

Who does the planning?

- The **engagement partner** and other **key members** of the engagement team shall be involved in planning the audit, including planning and participating in the discussion among engagement team members. (ASA300.5)
- Who are key members?
- They should check the independence and ethical clearance of all team members.
- We don't start planning until we have a signed engagement letter!

What is included in the audit plan?

- We call the plan an audit ___________
- Nature, timing and extent of the audit evidence required
- Nature = ______ audit procedures are going to be used to gather the evidence.
- Timing = ______ the audit procedures and evidence will be gathered
- Extent = ________ evidence will be gathered

- There will be a plan for every account or group of accounts in the financial statements

What does planning the audit involve?

Understanding the client

- ASA 315
- You need to know everything about your client

Identifying the ROMMs

- ASA 315
- 2 sources – inherent risks and control risks
- Assess IR and CR

Apply the Audit Risk Model

- Determine the Detection Risk

Develop a response to the risks

- ASA 330 – Design your audit strategy and approach – document in your audit programs

The standard is a bit confusing

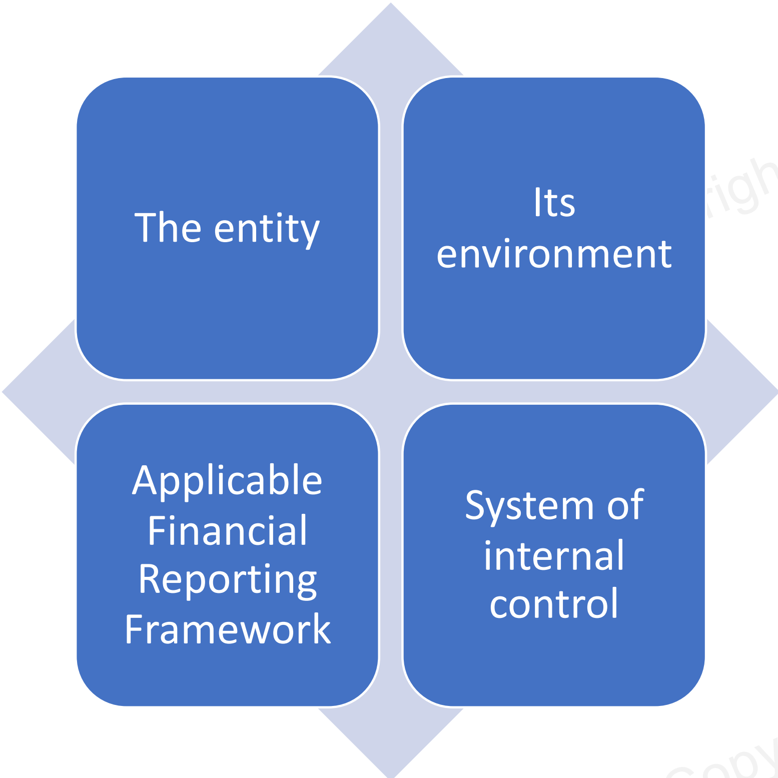
- It tells auditors they have to identify Risks of Material Misstatements (ROMMs) (para 13 & 14)
- And then it instructs auditors to gather information to understand the client

- But in reality – you do these in reverse – so that is how we are going to work through the process in this module.

- Audits are risk-based - identifying and assessing risks is critical to the audit process

Topic 1.2 – Understanding the entity

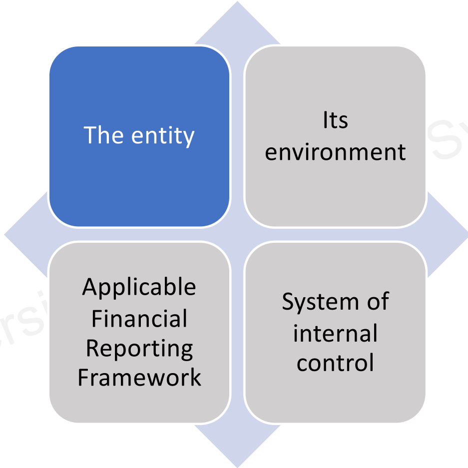
What do we need to know?



What do we need to know?

The entity ASA315.19(a)(i) and (iii)

- Organisational structure
- Ownership
- Governance
- Business model
- How much IT is integrated into the business model
- Performance measures – internal and external

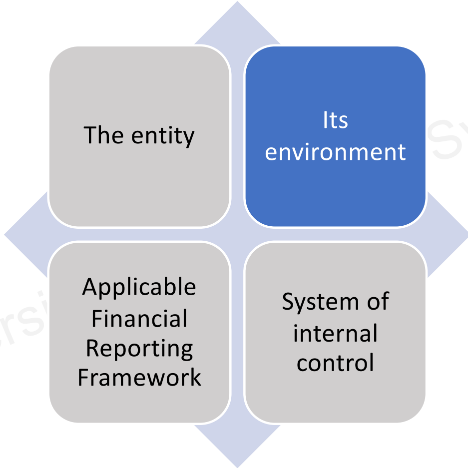


Students should read more on this in ASA315

What do we need to know?

The entity's environment ASA315.19(a)(ii)

- Industry
  - Competitive environment?
  - Supplier & customer relationships
  - Technological developments
- Regulatory environment
  - Legislation and regulation – incl tax
  - Other govt policy that may affect the entity
- Other factors
  - General economic conditions
  - Interest rates & financing
  - Inflation

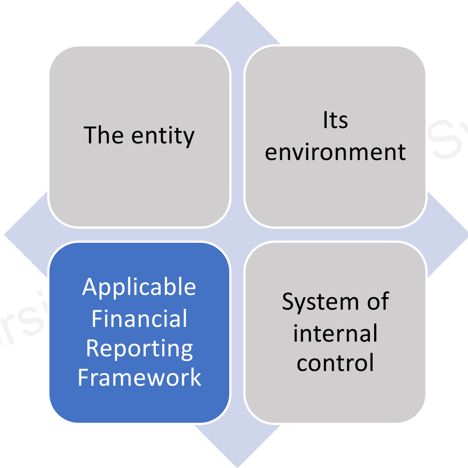


Students should read more on this in ASA315

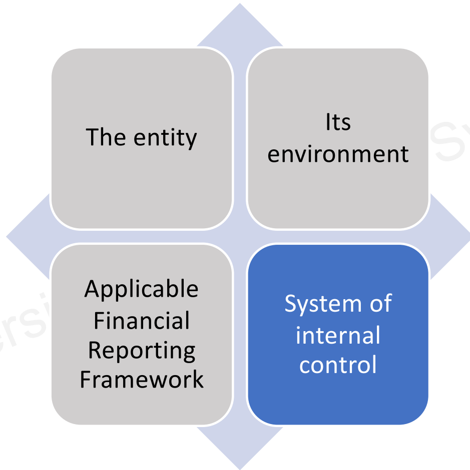
What do we need to know?

Applicable financial reporting framework
ASA315.19(b)

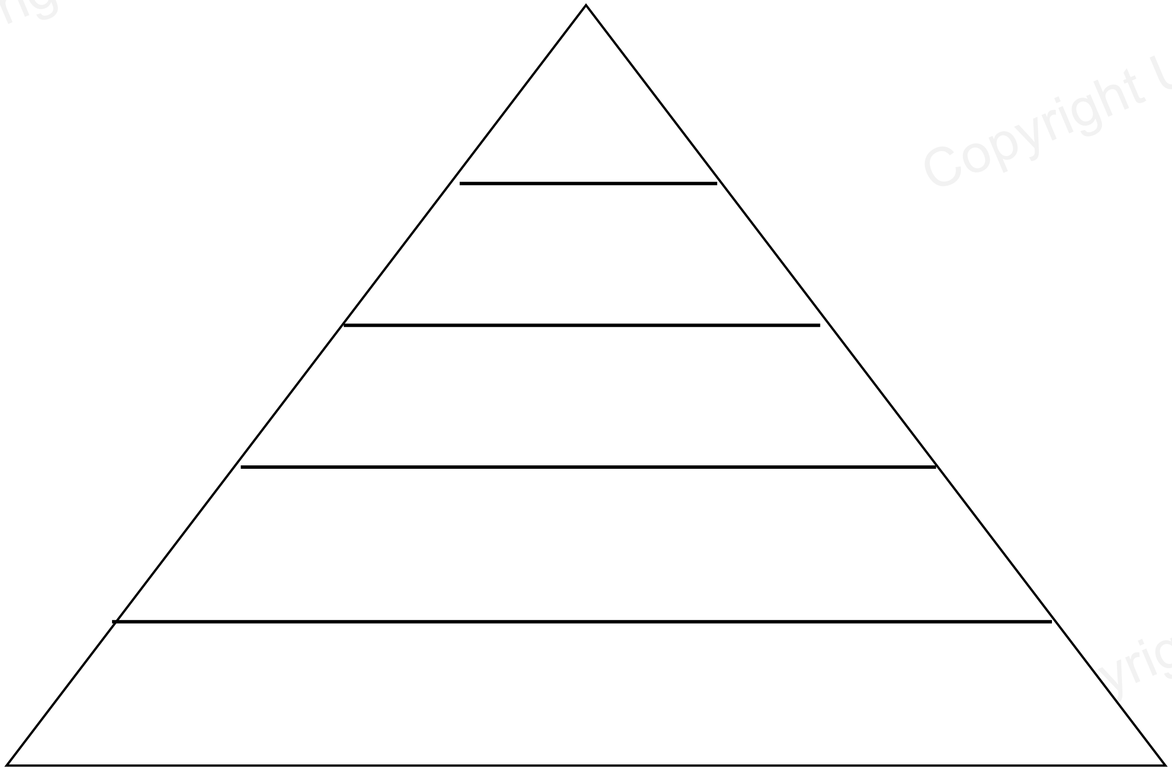
- Which accounting jurisdiction is the entity reporting in? Australia? EU? US?
- Accounting policy choices by the entity
- Reasons for changes in accounting policy choice



What do we need to know?



Entity's systems of internal control ASA315.21-27



Students should read more on this in ASA315

Topic 1.3.1 – Identifying the ROMMs

BUSINESS RISKS

How do we identify the most likely places for misstatements? (errors or fraud)

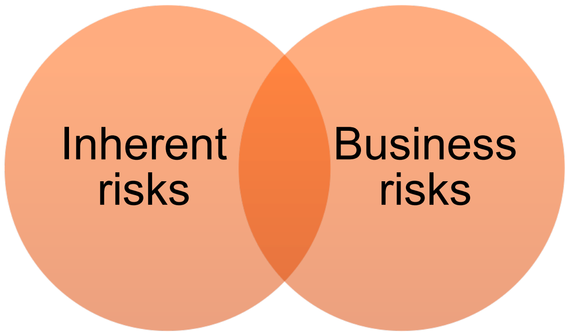
- What are the Business Risks?
- Business risks = risks that management won’t meet the objectives of shareholders. For ASX listed entities _______
- Brainstorming risks with the audit team

- But these don’t always result in ROMMs
- We need to narrow it down to the ___________ RISKS

Inherent Risk vs. Business Risk

- **Business Risk (IR):** The risk that the entity will **fail to achieve it's business objectives**.
- This is **different** to **Inherent Risk** which focuses on the **risk of material misstatement** (i.e. significant error or fraud) within the financial report. **E.g. incorrect values or information or omission of significant information**)
  - Business risk is very broad and not all business risks result in risks of material misstatement.

Not all inherent risks are business risks



Not all business risks are inherent risks

UTS

Topic 1.3.2 – Identifying the ROMMs

INHERENT RISKS

What is an inherent risk?

- Inherent risk is described as 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 controls. ASA315.4
- Something that has a greater **chance of there being an error, mistake or fraud**
- Quantitative or qualitative

What might indicate an inherent risk?

Inherent risk factor	Example
Complexity	
Subjectivity	
Change	
Uncertainty	
Management bias	
Fraud risk factor	

Are all IRs going to be important?

Assessing Risks of Material Misstatement at the Assertion Level

Assessing Inherent Risk (Ref: Para. A205–A217)

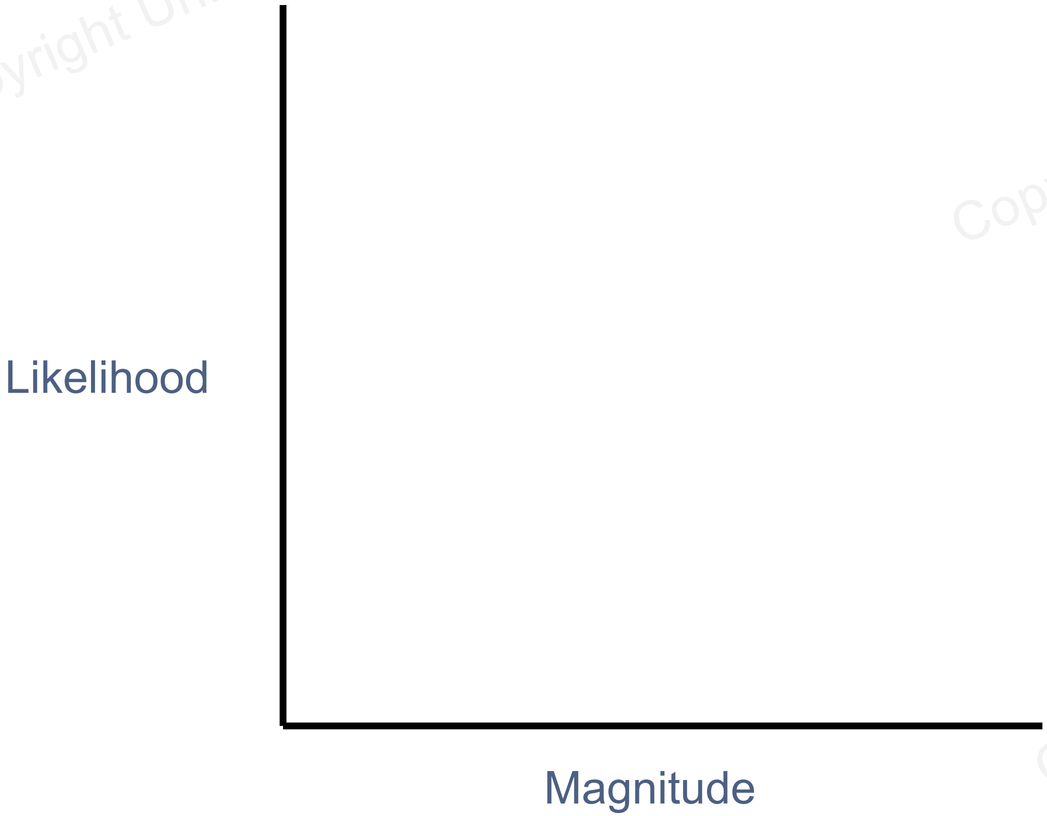
31. For identified risks of material misstatement at the assertion level, the auditor shall assess inherent risk by assessing the likelihood and magnitude of misstatement. In doing so, the auditor shall take into account how, and the degree to which:

    (a) Inherent risk factors affect the susceptibility of relevant assertions to misstatement; and

    (b) The risks of material misstatement at the financial report level affect the assessment of inherent risk for risks of material misstatement at the assertion level. (Ref: Para. A215–A216)

32. The auditor shall determine whether any of the assessed risks of material misstatement are significant risks. (Ref: Para. A218–A221)

What does ASA315.31-32 mean in plain English?



Significant Risks (i.e. Inherent Risk)

The Auditor must determine whether any identified risk is a **'significant risk'**, being a **risk of material misstatement** that requires special audit consideration'.

Factors to consider include:

- The **risk of fraud** and/or **Going concern** considerations
- Relationship to recent **significant economic, accounting or other developments** that require specific attention
- **Complexity** of the transactions
- Involvement of significant transactions with **related parties**
- **Degree of subjectivity** in measuring financial information
- Whether significant transactions are **unusual or outside the normal course of business** for the entity.

Topic 1.3.3 – Identifying the ROMMs

CONSIDERING THE RISK OF FRAUD

- Reminder from ASA200.11

Objective

11. The objective of the auditor is to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial report and assertion levels thereby providing a basis for designing and implementing responses to the assessed risks of material misstatement.

- We have a specific standard on fraud – ASA ____

What is fraud?

Misstatements

Fraud

Error

Two Types of Fraud

- **Fraudulent Financial Reporting may involve:**
  - Manipulation, falsification or alteration of records
  - Suppression or omission of the effects of transactions from records or documents
  - Recording of transactions without substance
  - Intentional misapplication of accounting policies.
- **Misappropriation of Assets may involve:**
  - Embezzling receipts
  - Stealing assets
  - Causing an entity to pay for goods not received
  - Using an entity's assets for personal use.

Responsibilities

MANAGEMENT

- Design internal controls to prevent / detect fraud

AUDITOR

- Professional scepticism – be aware of the potential for fraud
- Discuss the potential sources with the team
- Ask management about their processes for preventing fraud
- Investigate any potential risk factors
- If a risk factor exists – gather audit evidence

Fraud Risk Triangle (Cressey 1973)

What about Control Risks?

- We know that ROMMs come from Inherent Risks or Control Risks
- When will we look at Control Risks?

Control risks are covered in this Module, but in a different Topic

Topic 1.4 Audit planning and strategy

The outcome of gathering all of this information about risk

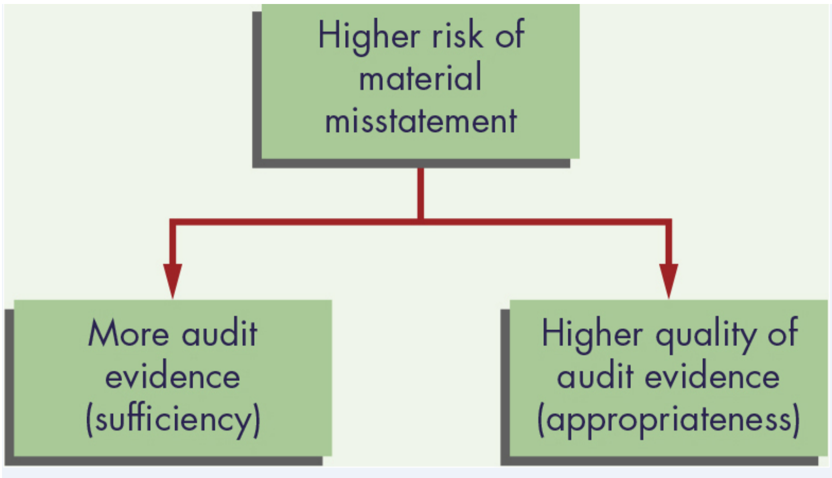
- Inherent Risk assessment – Low, Medium or High?
- Control Risk assessment – Low, Medium or High?

- Use this information in the audit risk model to determine the Detection Risk

- DR will help the auditor design their audit strategy – how will they gather the evidence they require?

Impact of Increased Risk of Misstatement on Audit Plan

- **Risk Assessment** is very important as it determines the **Audit Plan/Strategy**. An audit focuses **more effort** (time and resources) on those accounts/areas that are at **greater risk of material misstatement**, and less time and resources expended on auditing accounts at low risk of material misstatement.



Audit Planning

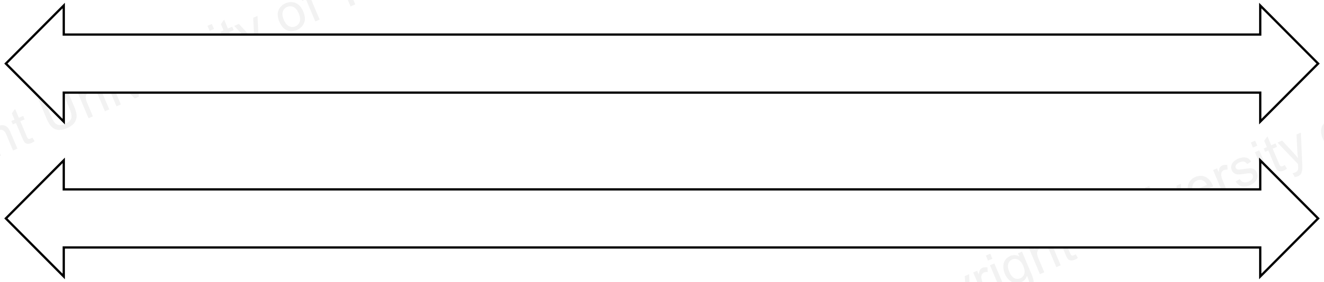
- The planning stage has two aspects:

  1. **Developing an Overall Audit Strategy:** sets the overall scope and direction of the audit.

Lower Assessed level of Control Risk **Control-based Approach**	⟵ Mixed Approach ⟶	Predominantly **Substantive-based Approach**
(More control testing performed and less substantive testing)		(More substantive testing and less/no control testing)

Audit strategy may be anywhere along this continuum.

Audit strategy and detection risk



Audit strategy and audit planning

- Create an overall strategy for the audit

- Audit programs for various accounts should be customised based on the IR and CR

Account	ROMMs	Strategy
Sales / Acc Rec	Low	
Inventory	High	
PPE	Medium	

To recap

- We need to understand the client
- Otherwise we cannot assess the level of Inherent Risk (or Control risk – but we'll look at that in a different Topic)
- We then determine the Detection Risk (DR) – this drives our audit strategy

- Up next – other ways to identify potential ROMMs