

Chapter 1 Introduction

1.1 The case for planning

As the title of this book suggests, its objective is to enable auditors to carry out audits in an efficient manner. To be efficient an audit needs to be effective both in terms of cost and in achieving the audit objectives. The process of performing an efficient and effective audit can be divided into the following three parts:

- planning;
- implementation; and
- completion.

This book has been divided into three sections with these headings to assist reference during the course of an audit.

Part I of this book considers the steps that should be taken to enable the auditor to plan an efficient and effective audit. Paragraph 4 of International Standard on Auditing (UK and Ireland) ('ISA') 300 *Planning an audit of financial statements* states: 'The objective of the auditor is to plan the audit so that it will be performed in an effective manner'. The important point to note here is that the audit must be performed 'in an effective manner'. Inadequate attention paid to the planning of the audit may result in a lot of wasted time and effort, and very often means that some risk areas that should be addressed are missed. Worse than this, the firm may not comply fully with Auditing Standards. These are mandatory and obviously there would be implications for the firm's audit registration should the firm receive a compliance visit from either the QAD, AQR or ACCA Monitoring Unit. It is therefore absolutely essential that adequate time and effort is put into the planning of each job.

It is still the case that many practices consider planning to be a necessary evil, undertaken as a cursory task at the beginning of the job or, even worse, as a form-filing exercise at the end. It is important that everyone is committed to the auditing process and understands the benefits to be gained from effective planning. These many benefits include the ability to:

- identify and concentrate on the problem and high risk areas;
- help the auditor decide on ways of auditing particular areas;
- help the auditor assign work to the appropriate level of staff, with the relevant experience;
- enable the auditor to communicate to staff what work they have to do and which working papers are expected;
- avoid, or at least predict, the possible overruns on budgeted fees and ensure that the audit is carried out efficiently and effectively;
- facilitate the control and review of work; and
- ensure that the auditor is able to reach an appropriate audit opinion.

In many respects, it is the last two points that are the most important. Many people do not invest the necessary time and effort in planning because they believe that they have insufficient time. This is particularly true in the current economic environment, where many clients are still putting their accountants under pressure to reduce or maintain fee levels. Many auditors are tempted to just wade in and only appreciate later that this will usually result in more work being undertaken. At SWAT UK we encounter many auditors who don't realise that they are over-auditing, and that considerable amounts of audit work could be cut out yet still leave them with sufficient appropriate audit evidence to support their audit opinion. This is invariably the result of a lack of planning and careful thought upfront.

In addition, it is important to note that a job that has been properly planned is much easier and quicker to review. This not only saves the valuable time of the more expensive members of the audit team, it also reduces the chances of something important being missed, thus reducing audit risk.

1.2.3 FRC Practice Notes

Practice Notes are intended to assist auditors in applying Auditing Standards of general application to particular circumstances and industries. Practice Notes are persuasive rather than prescriptive. However, they are indicative of good practice, even though they may be developed without the full process of consultation and exposure used for FRC Standards.

This book deals with the general principles of auditing, and accordingly does not cover the specific requirements of auditing any particular type of entity or industry. However, auditors of specialised entities should still find much that this book has to say useful. Practice Notes dealing solely with issues pertaining to audits in the Republic of Ireland are outside the scope of this book.

A new chapter (Chapter 21) has been included in this edition which addresses the guidance set out in PN 23 *Special considerations in auditing financial instruments* which was revised by the FRC in July 2013.

1.2.4 FRC Bulletins

Bulletins are issued to provide auditors with timely guidance on new or emerging issues. Like Practice Notes, Bulletins are also persuasive rather than prescriptive, and indicative of good practice.

Many Bulletins cover matters pertaining to specialist audit reports such as those relating to interim statements, public sector and listed entities, etc. revised and other specific reports. These are outside the scope of this book, as are Bulletins solely pertaining to audits in the Republic of Ireland.

This edition has been updated to include the changes made by FRC Bulletin 4 (Revised June 2015): *Recent Developments in Company Law, The Listing Rules and Auditing Standards that affect United Kingdom Auditor's Reports*.

1.2.5 Statements of Standards for Reporting Accountants

These are also issued by the FRC and are outside the scope of this book.

1.2.6 Audit Regulations

The Audit Regulations are published by the ICAEW on behalf of the ICAEW, ICAS and ICAI and must be complied with. Provisions relating to firms as a whole rather than to individual audit principals are outside the scope of this book.

1.2.7 Other publications

The various Institutes, the ACCA and the CCAB also publish a number of useful newsletters and guidance for auditors. The ICAEW Audit & Assurance Faculty in particular publishes a lot of useful guidance. Firms should ensure that at least one senior member of the audit team is a member of the Audit & Assurance Faculty.

There are also various Acts of Parliament and Statutory Instruments which contain general rules for the appointment, function and removal of auditors, and rules governing which entities require an audit, such as the Companies Act and Charities Act. Some entities are governed by their own special legislation, which may also state whether they are required to be audited. This book assumes that the auditor has checked the relevant legislative and other requirements and has determined that the entity in question does, indeed, require an audit.

Independent examinations, assurance engagements, interim statements, abbreviated audit reports and audit reports not on financial statements are all outside the scope of this book.

1.3 Getting started

Not only must auditors not wade straight into the audit, but they must also not rush into the planning process without adequate preparation. This is particularly true in the year of transition to FRS 102 when it would be very easy to focus on this, albeit important, area and miss other issues as a result. Obviously, the

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first step is to consider independence and acceptance procedures so as to ensure that the practice can actually undertake the assignment. This issue will be addressed in more detail in Chapter 2. The second step is to ensure that there is sufficient background information on the client and that sufficient time is spent updating and reviewing this information.

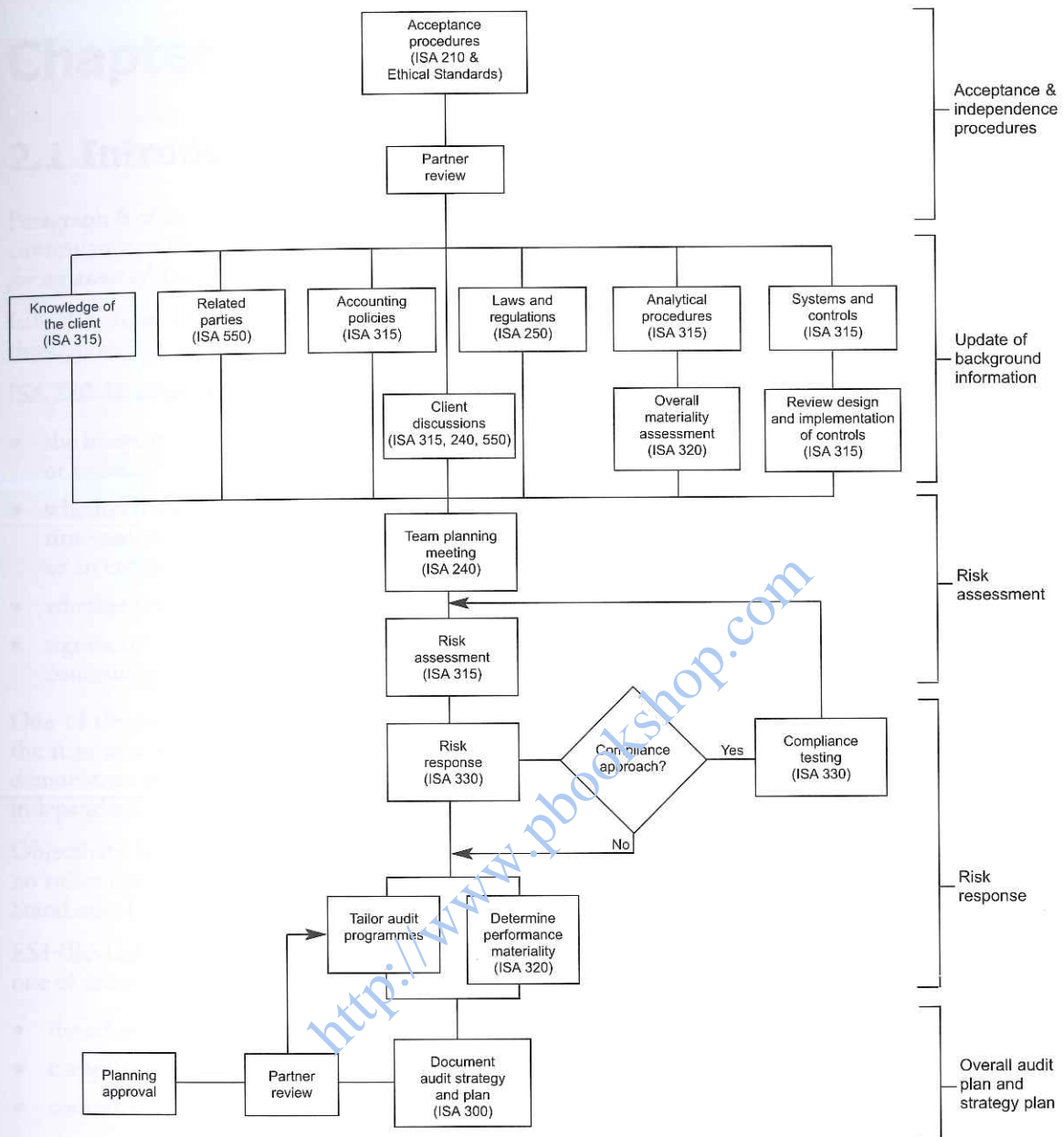
The stages of audit planning have been set out below and will then be dealt with in more detail within Part I. Each stage must be properly documented:

- a) assessing client acceptance and auditor independence;
- b) reviewing correspondence and discussing matters with the client;
- c) updating and reviewing the permanent file;
- d) recording or updating the systems notes, and assessing the design and implementation of controls;
- e) undertaking preliminary analytical procedures;
- f) assessing overall materiality and section-specific materiality;
- g) assessing risk at the financial statement and assertion levels and determining suitable responses to those risks;
- h) considering the audit approach that should be taken on each individual section of the audit;
- i) assessing performance materiality;
- j) determining which staff should undertake which tasks and for how long they will be needed;
- k) documenting the overall audit strategy and plan; and
- l) review and authorisation of the planning by the partner.

There are several points during the audit where added input is required from the client in order to complete the planning process. This means in practice that audit planning cannot usually be completed in a single step and may require at least three stages. As the planning should be substantially complete before the core audit work begins, this means starting the audit planning early, ideally before the client's year end.

Whilst there is plenty of flexibility in the order in which the elements of audit planning may be completed, the following flowchart gives a suggested order of attack.

1.3.1 The planning process



Chapter 2 Acceptance procedures

2.1 Introduction

Paragraph 6 of ISA 300 requires the auditor to undertake appropriate procedures regarding acceptance and continuance at the beginning of the audit in accordance with the requirements of ISA 220 *Quality control for an audit of financial statements*.

It is clear from ISAs that such work should not be set in stone, and should be monitored and reassessed throughout the audit as required.

ISA 220.A8 notes that such procedures include the consideration of:

- the integrity of the owners, key management and those charged with governance (for example, directors or trustees);
- whether the audit team is competent to perform the engagement, and whether its members have sufficient time and resources – this is particularly important where the practice is dealing with either a large entity or an entity working in a specialist area;
- whether the firm and the audit team can comply with ethical requirements; and
- significant matters that have arisen during the current or previous audit, and their implications for continuing the relationship.

One of the main reasons for such preliminary procedures is to ensure that the engagement partner and the firm as a whole are independent. Auditors must, if they are to undertake a proper audit, be able to demonstrate that they have been objective. This objectivity can only be assured if a firm is, and is seen to be, independent.

Objectivity is the state of mind which has regard to all considerations relevant to the task in hand, but no other considerations. Both objectivity and independence are key concepts in the revised FRC Ethical Standards (ES).

ES1 (Revised) *Integrity, objectivity and independence* requires firms with more than three partners to designate one of them as ethics partner with responsibility for:

- the adequacy of the firm's ethical policies and procedures;
- compliance with Ethical Standards;
- communication to partners and staff within the firm; and
- the provision of related guidance to individual partners.

ES1 expects firms with only two or three partners to regularly discuss ethical issues amongst themselves to ensure that a consistent approach is adopted and that the ESs are followed. Sole practitioners are expected to take advice on difficult or judgmental matters either from their professional body's ethics helpline or through discussion with a practitioner from another firm. In all cases, it is important that such discussions are documented.

In order for both the practice and the individual to demonstrate independence, ESs identify a number of specific issues that need to be addressed. A firm's independence and objectivity can best be assessed by completion of a questionnaire at the start of each assignment. An example form is shown below, taken from the PCAS audit system. The equivalent in the Kestrian system is schedule 1/2 in the permanent file.

ES PASE**Yes / No**

Will the alternative provisions in ES PASE be applied in respect of the above non audit services? (Note: the client must have informed management in order to apply the alternative provisions.) _____

Will the exemptions in ES PASE be applied in respect of the above non audit services? (Note: this must be disclosed in the accounts and the audit report.) _____

Notes

1. If the client does not have informed management for a non-audit service and the exemptions in ES PASE are not applied then either that service must not be provided or the firm must not act as auditor.
2. Safeguards and, where applicable, the application of ES PASE must be specified at the end of this form in respect of each non-audit service.

Independence Questions**1 Undue dependence on an audit client****Yes / No**

Do the total fees for this client/group of clients exceed:

- 10% of the annual fee income of the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated? _____
- 15% of the annual fee income of the audit firm or the part of the firm by reference to which the audit engagement partner's profit share is calculated? _____

Is this client/group of clients highly prestigious? _____

Is this client/group a public interest client or group? _____

Notes

1. FRC Ethical Standards require an external independent quality control review where the regular annual fee income will regularly exceed 10%.
2. Where fees will regularly exceed 15% this is an insurmountable threat and the firm must resign.
3. The above figures become 5% and 10% respectively for listed or public interest entities.
4. A public interest client is one that would attract national attention if a problem were publicised.

2 Loans to or from a client, guarantees; overdue fees

Do you or any of your staff have any loans or guarantees to or from the client? _____

Are there any overdue fees for any services? _____

3 Goods and services: hospitality

Have you or any of your staff accepted any material goods or services on favourable terms or received undue hospitality from the company? _____

4 Litigation

Is there any actual or threatened litigation between yourself and the client in relation to fees, audit work, or other work? _____

5 Family or other personal relationships

Do you or any of your staff have any personal or family connections with the company or its officers? _____

6 Ex-partners or senior employees

Has any officer of the company been a partner or senior employee in the practice? _____

Is the partner or any senior employee on the audit joining or involved in substantive negotiations with the client? _____

Safeguards

Where any non-audit services are provided or any of the above independence questions (numbered 1 to 13) have been answered 'yes', specify what safeguards are proposed (including the application of ES PASE) to maintain integrity and independence, and to ensure the availability of resources and the ability to perform the audit properly.

Conclusion

Having regard to any safeguards identified above, I am satisfied that appropriate procedures regarding the acceptance and continuance of this client relationship and audit engagement have been followed, and that the conclusions reached in this regard are appropriate and have been properly documented. In arriving at this conclusion I confirm that I have:

- obtained all relevant information from the firm (and where applicable network firms) to identify and evaluate circumstances and relationships that may create a threat to independence;
- evaluated information on identified breaches, if any, of the firm's independence policies and procedures to determine whether they create a threat to independence for this audit engagement;
- taken appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards;
- documented the conclusion on independence and any relevant discussions within the firm that support this view; and
- informed the client of all significant facts and matters that bear upon the firm's objectivity and independence as required by ES1.56.

Engagement Partner: _____ Date: _____

Consultation

(Complete where appropriate)

In my opinion the steps proposed are sufficient to maintain independence and to ensure the availability of resources and the ability to perform the audit properly.

Second Partner: _____ Date: _____

The remainder of this chapter considers independence issues in the same order as the subjects appear on the questionnaire.

2.2 Undue dependence on an audit client

ES4 (Revised) *Fees, remuneration and evaluation policies, litigation, gifts and hospitality* suggests that there is a potential independence problem due to a self-interest threat where the total fee income either to the practice as a whole, or to the profit pool of the partner concerned, from one client or group of connected clients exceeds 15 per cent of the gross practice income. For listed or other public interest companies the equivalent figure is 10 per cent. Where it is expected that this level will be regularly breached (that is, ignoring one-off extras), the firm should resign as auditor.

The Standard goes on to say that independence should be considered at levels of five per cent below these – that is, at 10 per cent and 5 per cent respectively. In these instances, the partner should inform the firm's ethics partner, and consider whether appropriate safeguards need to be applied to maintain objectivity and independence. For unlisted entities that fall into the 10-15 per cent bracket, an external independent quality control review of the audit must be undertaken before the audit report is finalised.

The practice must also consider its position where the client is highly prestigious or has a high profile, even though the fee may not be particularly high, as there is a greater threat in this instance that the auditor will not wish to 'upset' the client.

From an audit point of view, the first thing that should be done is to obtain details of all of connected clients. This will not only be clients within a group but also those clients that are in the same sphere of influence. In some cases, the clients may not even have common ownership (note that the 15 per cent rule does not apply in such scenarios) but may just be connected via, for example, a trade association that has a tendency to recommend a particular auditor to its members. In this situation, the risk would be that if one audit client were to be upset, he or she could influence the others. This type of information, once obtained, should be placed on the permanent file and reviewed on an annual basis.

Having completed this list, the auditor needs to establish the level of the relevant fees, remembering that this will be the total fees for the client, not just the audit fee. It will also include any associated fees that might be obtained – for example, from the provision of financial services. The audit partner should then consider whether there is a potential problem. If there is, the practice should arrange an external independent quality control review by an organisation such as SWAT UK Limited.

2.3 Loans to or from an audit client; guarantees; overdue fees

The existence of any financial relationships – be they loans, guarantees or overdue fees – will obviously have an impact on the independence of the practice as a whole and also on the partners and staff. ES2 (Revised) *Financial, business, employment and personal relationships* addresses these matters and contains a number of outright prohibitions.

2.3.1 Overdue fees

The issue that occurs most often is that of overdue fees. The particular concern with overdue fees is that where a significant part is not paid before the auditor's report on the financial statements for the following year is due to be issued, a self-interest threat to the auditor's objectivity and independence is created, because worries about recoverability of the fees could, for example, cause the practice to back down on a contentious issue when otherwise it would not have done.

The auditor should review the firm's own debtors' ledger to ensure that there are no amounts outstanding from a client when the audit planning is due to commence. Paragraph 24 of ES4 (Revised) requires the actual amount of last year's audit fee and the arrangements for its payment to be agreed with the client before the firm formally accepts appointment as auditor for next year.

If there are overdue amounts that cannot be regarded as trivial, the audit engagement partner, in consultation with the ethics partner (if the firm has appointed one), should consider whether the firm can continue as auditor or whether it is necessary to resign. Where the outstanding fees are in dispute and the amount involved is significant, the threats to the auditor's objectivity and independence may be such that no safeguards can eliminate them or reduce them to an acceptable level. If the firm does not resign from the audit engagement, appropriate safeguards should be applied, e.g. independent second partner review or external review and the ethics partner (if applicable) should be informed.

2.3.2 Financial interest in an audit client or affiliate thereof

Apart from a limited number of specific exceptions, the audit firm, or any partner in the audit firm, or a person in a position to influence the audit or an immediate family member of such a person may not hold:

- a) any direct financial interest in an audit client or affiliate thereof;
- b) any indirect financial interest in an audit client or affiliate thereof, where the investment is material to the audit firm or the individual, or to the intermediary; or
- c) any indirect financial interest in an audit client or affiliate thereof, where the person holding it has both:
 - i) the ability to influence the investment decisions of the intermediary; and
 - ii) actual knowledge of the existence of the underlying investment in the audited entity.

In this context, 'immediate family' means a spouse or equivalent (that is, a partner) or a dependent. 'Indirect financial interests' include holdings held by a partner in the audit firm who is not in a position to influence the conduct and outcome of the audit, or an immediate family member of such a partner, in an authorised unit or investment trust, an open-ended investment company or an equivalent investment vehicle that the firm audits. Such interests can therefore be held as long as they are not material to the individual, and the individual has no influence over the investment decisions of the audit client.

The specific exceptions to this prohibition are detailed in (a) to (d) below.

- a) Where an immediate family member of a partner, who is not in a position to influence the conduct and outcome of the audit, holds a financial interest in an audited entity or affiliate thereof due to its compensation arrangements (for example, a share option scheme, where the shares have not vested), or an interest in a decision made, or a transaction undertaken, by an entity with whom they have a contractual business or employment arrangement (for example, a partnership agreement). However, where such interests are significant or the relevant partner has close working contacts with the engagement team, the ethics partner must consider whether any safeguards need to be put in place.
- b) Where any of those persons listed above are members or shareholders of an audited entity as a result of membership requirements, or equivalent. In this case, the audit firm must ensure that only the minimum number of shares needed are held, and that this shareholding is not material to either the audited entity or the individual. Such a shareholding must be disclosed to the audit client.
- c) Where a direct or indirect financial interest is held in a trustee capacity by a person in a position to influence the conduct and outcome of the audit, or by an immediate family member of such a person, provided that:
 - i) the person is not an identified potential beneficiary of the trust; and
 - ii) the financial interest held by the trust in the audited entity is not material to the trust; and
 - iii) the trust is not able to exercise significant influence over the audited entity or an affiliate of the audited entity; and
 - iv) the relevant person does not have significant influence over the investment decisions made by the trust, in so far as these decisions relate to the financial interest in the audited entity.
- d) A direct or an indirect financial interest is held in a trustee capacity by the audit firm or by a partner in the audit firm (other than a partner in a position to influence the conduct and outcome of the audit), or an immediate family member of such a person, provided the person is not an identified potential beneficiary of the trust.

It is important that partners and professional staff report to the firm any immediate family, close family and other personal relationships involving an audit client that they consider might create a threat to the auditor's objectivity or a perceived loss of independence, so that an assessment of the issue can be made and any safeguards deemed necessary can be put in place.

In the case of an immediate family member of a person in a position to influence the conduct and outcome of the audit, that person must cease to hold a position in which he or she exerts such influence on the audit.

In the case of a close family member of a person in a position to influence the conduct and outcome of the audit, or any family member of a partner in the firm, the issue should be reported to the audit engagement partner, who should take appropriate action – if necessary in consultation with the firm's ethics partner. This might involve 'Chinese walls' to ensure that the individual does not become involved in any way. In many respects, the bigger the practice, the easier this will be. However, this may not be sufficient, and it may be decided that either the person must cease to hold a position to influence the conduct and outcome of the audit, or the firm should resign as auditor.

2.7 Ex-partners or senior employees

There is also a potential risk of independence being compromised where a partner or member of staff within the practice becomes involved in the management of the audit client, either on a permanent basis or a temporary basis (such as secondment). This will be a particular problem where that involvement is at a senior level – for example, as finance director.

2.7.1 Permanent positions with an audit client

There are various safeguards that should be implemented to ensure that this does not become an insurmountable threat. For example, the firm should ensure that no significant connections remain between the firm and the individual leaving the practice. This means all capital balances and similar financial interests (including retirement benefits) should be fully settled – unless these are made in accordance with predetermined arrangements that cannot be influenced by any remaining connections between the officer and the firm. In addition, the individual should not participate or appear to participate in the firm's business or professional activities. Such situations are more likely to be an issue where the individual was a principal within the practice rather than a senior employee.

All staff and principals involved in audit work must be aware of their duty to inform the practice if they enter into negotiations to join a client entity. At such a point their involvement in the audit must cease. If this occurs during the course of an audit, it is important to ensure that any significant audit decisions made by the partner or member of staff concerned are reviewed, to ensure that objectivity has not been compromised. If the person joining the client is an audit partner, the review should be performed by an audit partner who is not involved in the audit engagement. Where the audit firm, due to its size, does not have a partner who was not involved in the audit engagement, such a review should be performed by an external reviewer, such as SWAT UK Limited.

The firm must resign as auditor in the following circumstance: where the individual joining an audit client is a partner who has been involved in the audit of that client at any time in the previous two years in any of the following capacities:

- as audit engagement partner;
- as engagement quality control reviewer;
- as key partner involved in the audit; or
- as a partner in the chain of command,

and is appointed as a director or to a key management position with the client. If the person joining the client in such a role is anyone else from the audit team, the partner needs to consider the composition of the team and whether it needs to be strengthened to guard against any self-interest, familiarity or threats of intimidation.

Where such a relationship has been entered into by a person in a position to influence the conduct and outcome of the audit, or an immediate family member thereof, either the relationship should be terminated or the person should surrender the position in which they exert such influence on the audit engagement.

2.9 Beneficial interests and trusteeships

There are certain circumstances where a practice will be precluded from acting as auditor for the client. This issue of various beneficial interests is considered below.

2.9.1 Beneficial interests in shares and other investments

ES2 (Revised) notes that none of the following:

- the audit firm;
- any partner in the audit firm;
- a person in a position to influence the conduct and outcome of the audit; nor
- an immediate family member of such a person;

may hold:

- a) any direct financial interest in an audit client or its affiliates;
- b) any indirect financial interest in an audit client or its affiliates where the interest is material to the audit firm or the individual, or to the intermediary; or
- c) any indirect financial interest in an audit client or its affiliates where the person holding it has both
 - i) the ability to influence the investment decisions of the intermediary; and
 - ii) actual knowledge of the existence of the underlying investment in the audited entity.

Such circumstances constitute an insurmountable threat of self-interest and the firm will be precluded from acting for that client in an audit capacity. The firm should only act if the interests are disposed of.

2.9.2 Beneficial interest in trusts

Where a direct or an indirect financial interest in the audit client or its affiliates is held in a trustee capacity by a person in a position to influence the conduct and outcome of the audit, or an immediate family member of such a person, a self-interest threat may be created – either because the existence of the trustee interest may influence the conduct of the audit, or because the trust may influence the actions of the audited entity. Accordingly, such a trustee interest may only be held when:

- the relevant person is not an identified potential beneficiary of the trust; and
- the financial interest held by the trust in the audit client is not material to the trust; and
- the trust is not able to exercise significant influence over the audit client or its affiliates; and
- the relevant person does not have significant influence over the investment decisions made by the trust, in so far as they relate to the financial interest in the audit client.

Any of these possibilities, particularly the last three, could cause problems. The issue revolves around whether the trustee is 'a person in a position to influence the conduct and outcome of the audit'.

A direct or an indirect financial interest in the audited client or its affiliates held in a trustee capacity by the audit firm, or by a partner in the audit firm or their immediate families, can only be held when that person is not an identified potential beneficiary of the trust.

Where the audit firm acts as trustee, and the trust holds in aggregate one per cent or more of the issued capital of the company, details of the trust investment must be disclosed in the directors' report or the auditors' report.

Chapter 7 Assessing risk

7.1 Introduction

Chapters 3, 4 and 5 looked at the gathering of information relevant to the audit, and Chapter 6 looked at the assessment of materiality. So, now we are ready to bring all that information together as we consider risk. The auditor's assessment of, and response to, risk arguably represent the most important stages of the audit. Chapters 7, 8 and 9 look at this process in more detail.

7.2 General principles

Before looking in detail at how the auditor assesses risk on a particular audit, it is useful to take a step back and look at why there is risk.

Risk derives from the expression of opinion in the audit report, and there are three key elements to consider:

- **The auditor states that the audit has been conducted in accordance with ISAs.**

This may not be the case if the auditor does not have the necessary procedures in place. If the omission is something mandatory, then the auditor will have issued an incorrect report.

- **The opinion that the financial statements give a true and fair view.**

This is obviously the key judgment, and much of this chapter deals with how the auditor addresses the risk of giving an incorrect opinion.

- **The opinion that the financial statements have been properly prepared in accordance with the relevant statute, and for companies, that the directors' report and strategic report are consistent with the financial statements.**

The use of accounts preparation packages has in some ways made accounts preparation easier. However, some auditors have become over-reliant on such packages, and this increases the risk of incorrect or missing disclosure. Thoughtful completion of a disclosure checklist is still the best approach to ensuring correct disclosure.

The first and third risks described above are under the auditors' control. Proper use of an appropriate, up-to-date audit system and disclosure checklist should almost eliminate these risks. The second risk is less straightforward.

7.3 Audit risk

Paragraph 17 of ISA 200 *Overall objectives of the independent auditor and the conduct of an audit in accordance with ISAs* requires the auditor to '...obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level...'

Audit risk is defined by ISA 200 as the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risks of material misstatement and detection risk, which can be illustrated as follows:

<i>Valuation and allocation</i>	Assets, liabilities, and equity interests are included in the financial statements at appropriate points, and any resulting valuation or allocation adjustments are appropriately recorded, and financial and other information is disclosed at appropriate points.		✓	✓
<i>Rights and obligations</i>	The entity holds or controls the rights to assets; liabilities are the obligations of the entity; and events, transactions and other matters pertain to the entity.		✓	✓
<i>Cut off</i>	Transactions and events have been recorded in the correct accounting period.	✓		
<i>Classification and understandability</i>	Financial information is appropriately presented and described, and disclosures are clearly expressed.			✓

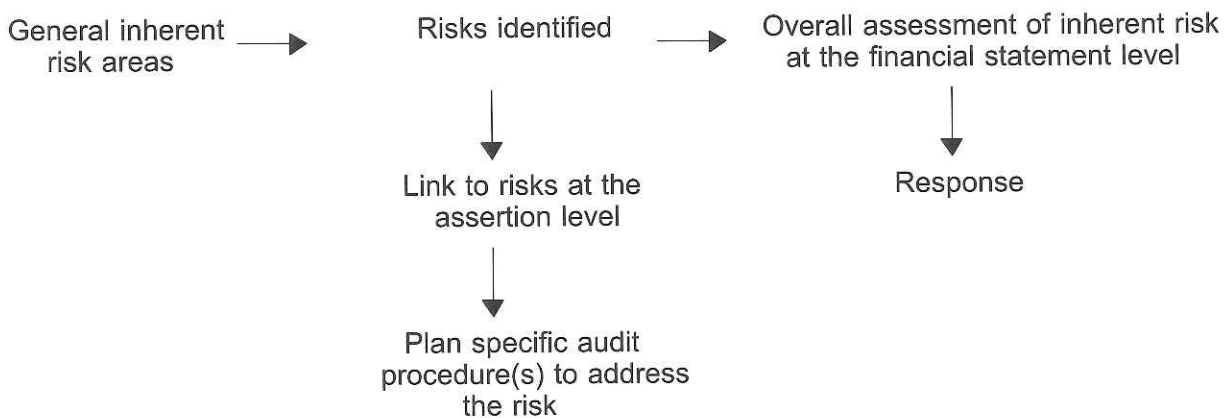
Inherent risk is therefore the susceptibility of these assertions to misstatement before we consider any controls over the assertions.

Some assertions are generally considered to be more important than others in relation to particular types of asset, liability or transaction – for example:

- a) complex calculations are more likely to be misstated than simple calculations. Thus the inherent risk in a complex calculation (such as absorption of overheads into 'work in progress') will be higher; and
- b) the use of accounting estimates that are subject to significant measurement uncertainty have a higher inherent risk than financial statements consisting of relatively routine, factual data.

7.5 Assessing inherent risk

Since inherent risk factors can affect the approach to the audit generally, as well as impacting on individual assertions, the approach of most audit systems in assessing inherent risk can be illustrated in the following diagram.



Many audit systems make use of detailed questionnaires to help the auditor identify relevant inherent risk factors. A completed worked example of such a questionnaire, taken from the PCAS model file, is given below. The equivalent schedule in the Kestrian system is B3(i)-(iv).

- whether this is a new or longstanding client; and
- whether there have been any audit qualifications in recent years.

7.5.11 Control environment

Where the entity is controlled by people who have a reasonable level of experience and competence in managing such a business, the risks are likely to be lower. However, many owner-managers have expertise in the area that their business trades in, but none in business administration. This lack of competence in managing a business may result in increased risk of error. The auditor should consider the past history and any earlier problems experienced with the client.

In many owner-managed companies, even where there is a separate accounting department, the directors will be in a position to override any controls and exert influence over the transactions that occur. The auditor must therefore assess at the planning stage the impact this will have on risk.

7.5.12 The entity's risk assessment process

In many clients, it is unlikely that there will be many, if any, risk assessment procedures that the auditor can use in identifying relevant risks. However, in this respect most charities are a step ahead of their commercial equivalents, due to the requirement placed on them for trustees to review the risks facing the charity and to take steps to mitigate them where possible. Auditors of clients with charitable status should always ask if the trustees have a risk register which they can review.

7.5.13 Information systems

The auditor should consider whether the accounting records are kept up to date. If they are actually written up at the time a transaction takes place, there is less likelihood of there being errors within the records. This can be a problem at smaller clients where, for example, a bookkeeper processes all the month's transactions at the end of the month.

Any change in the accounting system should already have been identified, documented and tested for design and implementation. Nevertheless, however well-planned any change in the system, it will inevitably cause problems and potential errors may arise as a result, especially in respect of major IT upgrades.

7.5.14 Control activities and monitoring controls

Here, the auditor is looking to identify whether and how management monitors the controls over the systems and key business processes, and whether there may have been any breaches or failures during the period. These could give rise to misstatements due to error and/or fraud.

7.5.15 Fraud and error

ISA 240 *The auditor's responsibilities relating to fraud in an audit of financial statements* makes clear that, due to the nature of fraud, there will always be a risk, even in an audit properly planned and performed under ISAs, that a material fraud may not be identified. Nevertheless, the auditor should obtain reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. In doing so, the auditor should maintain an attitude of professional scepticism throughout the audit. Professional scepticism is discussed in greater detail in Chapter 8 in the context of the audit team meeting.

During periods of change, the accounts become far more susceptible to error. When a member of staff leaves or joins, there is far greater likelihood of an error occurring. If this is the case, the impact on the general risk of the entity must be assessed. There may also be a specific risk to a certain class of assets or transactions, depending on the area in which the member of staff works.

- If there has been any previous experience or incidents that could call into question the integrity or competence of the management, there may be a risk of fraud or error respectively. Such instances should

- Significant risks arise on most audits. It can be deduced from this that if the risk assessment has not identified any significant risks, the auditor should probably review the risk assessment again to ensure that none have been missed.
- The effect of any identified controls related to the risk should be excluded when making the decision.
- Routine, non-complex transactions that are subject to systematic processing are less likely to give rise to significant risks because they have lower inherent risks.
- Significant risks often relate to significant non-routine transactions that are unusual, either due to their size or nature, and occur infrequently, and to judgmental matters (for example, accounting estimates).
- Significant risks are often derived from business risks that may result in a material misstatement.

When considering the nature of the risks, the auditor should consider:

- 1) whether the risk is a risk of fraud;
- 2) whether the risk is related to recent significant economic, accounting or other developments;
- 3) the complexity of transactions;
- 4) whether the risk involves significant transactions with related parties;
- 5) the degree of subjectivity in the measurement of financial information related to the risk; and
- 6) whether the risk involves significant transactions that are outside the entity's normal course of business, or which otherwise appear unusual.

ISAs identify a number of risks which are significant by default, in particular:

- all risks of material misstatement due to fraud (ISA 240.27); and
- significant related party transactions outside the entity's normal course of business (ISA 550.18).

Whilst the risk from undisclosed related parties or related party transactions is not significant by default, it is highly likely that the risk will nevertheless be identified as being significant. There are also a number of mandatory procedures in ISA 550 which must be performed in response to such an issue (see section 34.3.1).

Whilst ISA 540 does not automatically designate estimates with high uncertainty risk as having significant risks, paragraph 11 of the ISA does require the auditor to specifically consider whether this is the case. Due to the nature of accounting estimates, it is likely that many will have high estimation uncertainty and, therefore, may well be associated with significant risks. Again, there are a number of mandatory procedures in the ISA to be performed in response to significant risks in relation to accounting estimates (see section 15.5.5).

Revenue recognition

There is also a presumption that there are fraud risks in relation to revenue recognition (ISA 240.26). This is not quite the same as an automatic significant risk, as it may be possible to rebut this presumption. Where this is the case, ISA 240 specifically requires the reason(s) for drawing such a conclusion to be explicitly documented on the audit file.

Contrary to popular belief amongst auditors, this is not simply a question of cut-off. Paragraph A28 of ISA 240 explores a number of different ways that revenue may be inappropriately recognised, including premature revenue recognition due to an inappropriate accounting policy, fictitious revenues (invoices), and inappropriate deferral of revenue to later periods. The auditor should therefore consider all audit assertions and the fraud possibilities affecting each one.

ISA 240 gives an example of when rebuttal may be possible in paragraph A30, namely a company leasing out a single property. The chances of revenue being subject to fraud is slim as it would be immediately noticed. It would also be extremely difficult to perpetrate if the property was under a lease agreement and the rent was paid by direct bank transfer on a regular basis.

In practice, however, it is extremely difficult to rebut this presumption, as most clients will be too large and/or complicated. The presence of material cash sales or income will also negate the ability to rebut the presumption. In the vast majority of audits, therefore, it is expected that revenue recognition will be identified as a significant risk.

This issue has been high on the agenda of both the Quality Assurance Department (QAD) of the ICAEW and SWAT UK for some time now, and yet many auditors have still not got to grips with the issue. As can be seen in section 9.3.2, the implications for failing to recognise the significance of this risk can be serious.

The move to FRS 102 is not expected to bring any dramatic changes in terms of revenue recognition policies so there should be little impact on the risk assessment in this area.

Management override of controls

Management override of controls is another significant risk area. This is considered in more detail below in section 9.3.1.

7.6 Control risk

Control risk is the risk that the client's systems and procedures will not prevent or detect a material error from affecting the final accounts. The documentation, review of design, checking of implementation and testing of the operational effectiveness (often optional) of systems and controls were all considered in detail in Chapter 4. Having completed these tasks, the auditor should now consider the impact of this work on the risk of material misstatement.

Control risk over a particular assertion can only be confirmed as being other than high if the relevant controls have been tested for operational effectiveness. More generally, the auditor's assessment of the general control environment and high level controls may influence the assessment of general risk.

7.7 Detection risk

This is the risk that the auditor will fail to spot that the accounts are materially misstated. It is dealt with by the audit tests and approach that is adopted by the audit team, aspects looked at in detail in Part II. This includes the auditor's judgment on how to test an area and the conclusions drawn from the test results obtained. It should be remembered that detection risk is ultimately influenced by the judgment exercised by the auditor during the audit.

7.8 Conclusion

Many audit systems use checklists or questionnaires to help the auditor determine risk. Whilst these can be useful, they should not be applied without thought, especially when auditing entities in niche sectors. The auditor should consider all of the answers that have been given and ensure they have been adequately addressed by the audit planning.

Within most audit systems, the risk assessment will affect the amount of audit work to be undertaken, so it is vital to complete the risk assessment stage properly. An overly prudent assessment will lead to overauditing, inefficiency and added expense. On the other hand, an unduly lenient assessment may result in insufficient audit work being undertaken and material misstatements going undetected.

The auditor's response to risk is considered in Chapter 9.

Chapter 8 Audit team planning meeting

8.1 Introduction

Both ISA 240 and ISA 315 require an audit team meeting at the planning stage, principally for matters such as sharing knowledge, discussing audit issues and risks, determining the overall audit approach and communicating relevant matters within the audit team. Even if such a meeting were not mandatory under ISAs, it would still be highly recommended.

8.2 Attendance

Paragraph 10 of ISA 315 notes that, 'The engagement partner and other key engagement team members shall discuss...'. Whilst the phrase 'other key engagement team members' is not defined, common sense would take this to mean, as a minimum in addition to the audit engagement partner, the audit manager and the audit senior.

However, there can be benefits in all members of the audit team attending, despite this appearing at first glance to be a time-consuming option. The benefits include:

- communication is more effective as everyone is at the original discussion and does not need to be subsequently briefed on the matters discussed (see below);
- all team members have an opportunity to share knowledge and information about the client. Where junior staff have worked on the engagement in an earlier year, they often have detailed knowledge about the client's staff and accounting records that can be valuable to the audit planning process; and
- it can be a good opportunity for more junior staff to develop their professional judgment and audit skills by listening to the input of the partner and manager.

Paragraph 10 of ISA 315 also states: 'The engagement partner shall determine which matters are to be communicated to engagement team members not involved in the discussion.' This might comprise the more junior members of staff who were unable to attend the meeting.

Many small audits are carried out entirely by the engagement partner, who may be a sole practitioner. In such situations, having personally conducted the planning of the audit, the engagement partner should still consider the susceptibility of the entity's financial statements to material misstatement due to fraud, including in relation to related party transactions.

8.3 Matters to be discussed

This discussion is aimed at the following:

- understanding and considering the susceptibility of the company's financial statements to material misstatement due to fraud or error, specifically including in relation to related party transactions;
- reviewing the audit approach to these risk areas (see Chapter 9);
- emphasising the need for professional scepticism when carrying out the audit and reviewing the test results (see section 8.4 below); and
- sharing the insights of team members based on their knowledge of the entity, and exchanging information about business risks.

However, other relevant matters can also be discussed as the auditor sees fit.

The requirement to discuss the risk of fraud and error from related party transactions is a new requirement in paragraph 12 of the clarified ISA 550 *Related parties*. The guidance material in the ISA gives a number of suggestions of issues which could be discussed in connection with this:

- the nature and extent of the client's relationships and transactions with related parties;
- the importance of maintaining professional scepticism throughout the audit regarding related party relationships and transactions;
- circumstances or conditions that may indicate the existence of related party relationships or transactions that management has not identified or disclosed, e.g. a complex structure, use of special-purpose entities for off-balance sheet transactions, or an inadequate information system;
- those records or documents that may indicate the existence of related party relationships or transactions;
- the importance attached by the client to the identification, appropriate accounting for, and disclosure of related party relationships and transactions and the related risk of management override of relevant controls; and
- specific consideration of how related parties may be involved in fraud, e.g.:
 - a) how special-purpose entities controlled by management might be used to facilitate earnings management; and
 - b) how transactions between the client and a known business partner of a key member of management could be arranged to facilitate misappropriation of the client's assets.

In general terms, it is important that the audit team members approach the discussion with a questioning mind, setting aside any beliefs they may have that management and the directors are honest and have integrity. The meeting should be a 'brainstorm' or wide-ranging, open exchange of ideas between team members, and should not be limited by any preconceived ideas about the client.

In the course of the meeting new risks may be identified, and these should be added to the risk documentation.

Documenting the discussion

It is fairly common to see a detailed planning memorandum prepared to supplement and draw together the content of the various standard planning forms. This is an excellent approach and should be encouraged. However, no matter how well-prepared, a planning memorandum drafted before the planning meeting can only ever be evidence of a briefing, it does not provide any evidence of the discussions that took place.

In order to document the discussions, it is therefore necessary to have a separate file note or minute of the meeting. Another option would be an updated version of the planning memorandum that includes notes taken at the meeting.

The notes taken at the meeting should record:

- Who was present at the meeting. This is particularly important in evidencing that the discussions were led by the audit engagement principal. (See FRC thematic review in section 7.5.15.)
- The topics discussed, again ensuring that those matters required to be discussed by the ISAs are recorded.

8.4 Professional scepticism

An auditor is required under the ISAs (UK and Ireland) to carry out their work with professional scepticism. Professional bodies and regulators frequently criticise audit firms for failing to evidence that they have exercised professional scepticism during the audit. Essentially, a high-quality audit features the exercising of professional judgment by the auditor and a mind-set which includes professional scepticism being applied at both the planning stage and during the execution of the audit fieldwork.

Adopting an approach of professional scepticism will also involve a critical assessment of audit evidence and being alert for audit evidence which may contradict other audit evidence or may call into question the reliability of the information gathered from management and those charged with governance (TCWG).

While the ISAs (UK and Ireland) recognise the importance of professional scepticism being applied by the auditor, it is nevertheless a personal and professional trait to be adopted by the auditor. The auditor must

recognise that professional scepticism is an integral part of their work and is closely interrelated to the fundamental concepts of independence and objectivity.

Training audit staff to be professionally sceptical is an important issue. Audit work needs to be undertaken to satisfy the relevant audit assertions and therefore creating an internal culture that recognises the importance of professional scepticism on all audits, regardless of past experiences with the audit client, is a pivotal activity that needs to be promoted within all firms so that it can be demonstrated that professional scepticism has been applied.

The global financial crisis in 2008–09 highlighted a weak approach to professional scepticism in areas of the financial statements which are particularly subjective, such as fair values, related party transactions and going concern assessments. Professional bodies and regulators believe that it is in the public's interest to re-emphasise to both auditors and others which play an important role in an audit of financial statements of the need to adopt and maintain a degree of professional scepticism during the course of an audit.

Professional scepticism enables the auditor to exercise professional judgment – especially concerning decisions relating to:

- the nature, timing and extent of audit procedures to be performed;
- whether sufficient appropriate audit evidence has been obtained and whether more needs to be done to achieve the objectives of the ISAs (UK and Ireland);
- the evaluation of management's judgments in applying the entity's applicable financial reporting framework; and
- the drawing of conclusions based on the audit evidence obtained, for example, assessing the reasonableness of estimates made by management in preparing the financial statements.

What is professional scepticism?

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. The ISAs (UK and Ireland) explicitly require that the auditor plan and performs the audit with professional scepticism and keeping in mind that circumstances may be present which cause the financial statements to be materially misstated.

The problem that many auditors have with the concept of professional scepticism is that there is no single way of demonstrating that the auditor has exercised scepticism when conducting an audit in accordance with ISAs (UK and Ireland). Notwithstanding this problem, professional scepticism is a mind-set and a sceptical mind-set will enable the auditor to question aspects of the entity and the financial statements that are being audited rather than merely accepting information at face value. This questioning mind-set will then enable the auditor to form conclusions on the information at hand. The concept of professional scepticism is very closely related to the concepts of independence and objectivity – two traits which are fundamental ethical principles. The auditor's independence enhances the auditor's ability to act with integrity, be objective and maintain an attitude of professional scepticism.

Professional scepticism can also be exercised by being alert to audit evidence which may contradict other audit evidence obtained. It can also be exercised by calling into question the reliability of documents or responses to inquiries and it also includes being alert to conditions that may indicate a potential fraud risk and thus developing audit procedures that adequately respond to the circumstances.

Applying professional scepticism when reviewing audit evidence is a critical aspect. Audit evidence has to be both sufficient and appropriate as well as covering the relevant audit assertions. An auditor can demonstrate professional scepticism by questioning and considering both the sufficiency and appropriateness of the audit evidence gathered in light of the circumstances. Where the auditor has doubt concerning the reliability of information or where evidence points to potential fraud risk, the ISAs (UK and Ireland) require the auditor to investigate further and determine what additional procedures are necessary to resolve the issue.

Firms often run into difficulty with regulators and professional bodies during audit file reviews because they believe that management and TCWG are honest and their integrity is intact. While this may be the case in the majority of audits, a belief that a client is honest and has integrity does not relieve the auditor of their responsibility under the ISAs (UK and Ireland) to maintain professional scepticism or be satisfied with less than persuasive audit evidence when obtaining reasonable assurance.

What audit firms can do to ensure professional scepticism is achieved

The firm's leadership and the examples that it sets will essentially drive the internal culture of the audit firm. Therefore audit engagement partners need to ensure that audit staff understand the importance of professional scepticism and the need to have a questioning mind. Audit firms should have policies and procedures in place that accord with the requirements of ISQC (UK and Ireland) 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Engagements*. Such policies and procedures should contain specific emphasis on the importance of exercising professional scepticism throughout the course of an audit. In addition, the firm should consider documenting the importance of exercising professional scepticism when:

- establishing policies and procedures which are designed to promote an internal culture recognising that quality is essential when performing engagements;
- promoting a quality-oriented internal culture through clear, consistent and frequent actions and messages from all levels of the firm's management;
- ensuring that the firm has sufficient personnel with the necessary competence, capabilities and commitment to ethical principles;
- developing and implementing internal training and continuing professional development for all levels of the firm's personnel.

Demonstrating professional scepticism does not just apply at firm level – it should also be demonstrated at the engagement level. The audit engagement partner is responsible for the overall quality of the audit to which they are assigned and this is why it is important that audit engagement partners communicate the importance of professional scepticism to staff who are deployed on the audit. Audit staff should not be hindered by clients in the execution of their duties and should not be in fear of reprisals and in issuing auditor's reports which are appropriate in the circumstances.

Audit team meeting

Audit planning is an integral aspect of an audit and the audit team planning meeting is an ideal opportunity to re-affirm the importance of professional scepticism. An important part of the team meeting is for the team to discuss the susceptibility of the financial statements to material misstatement. This could be due to fraud and/or error and, in the meeting, it is the opportunity to discuss not only the susceptibility of the financial statements to material misstatement, but also HOW the financial statements could be materially misstated due to fraud or error. Many audit firms fall into the trap of relying on past experience concerning the honesty and integrity of clients and hence document that there are no issues relating to fraud/error on the grounds that no fraud/error was noted in prior year audits. This is clear evidence of failing to maintain professional scepticism. So how can this be overcome?

During the audit team meeting, the team should discuss how management COULD override internal controls to perhaps commit a fraud or how employees COULD manipulate weaknesses in internal controls for personal financial gain or how related party relationships may give rise to a fraud risk factor. These are some of the key points that should be discussed among the engagement team to demonstrate that professional scepticism is being applied. It may be the case that there is no fraud/error present but the idea of applying professional scepticism is for the auditor to remain alert to the possibility that there could be fraud/error (indeed fraud, by its very nature, is designed not to be detected).

As well as fraud issues, the team should also discuss how the financial statements COULD be materially misstated because of error. The word 'could' is capitalised to emphasise that it might not necessarily be the case that fraud has taken place once the audit has been completed or the financial statements may not contain any errors, but a sceptical mind-set will approach the audit with an awareness that such misstatements due to fraud or error COULD have happened during the period under audit.

The audit engagement partner should also demonstrate the application of professional scepticism when taking responsibility for:

- the direction, supervision and performance of the audit;
- reviews of work performed; and
- the engagement team undertaking appropriate consultation on difficult or contentious matters and considering the conclusions reached from such consultations.

Professional scepticism needs to be applied throughout the entire audit, even at the stage of accepting the engagement (for example, when considering the integrity of the principal owners and management). In addition, professional scepticism should be applied:

- in identifying and assessing risks of material misstatement;
- designing the nature, timing and extent of further audit procedures which are responsive to the assessed levels of risk;
- evaluating audit evidence – such as recognising the need to increase the quantity of audit evidence or obtain evidence which is more relevant and reliable for areas which have a higher assessed risk;
- designing and performing substantive analytical procedures;
- addressing situations when management refuse to allow the auditor to send a confirmation request; and
- forming an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

It is also particularly important to apply professional scepticism when addressing areas of the financial statements that are complex, significant or contain a high degree of judgment on the part of the client and challenge management's assumptions, for example:

- Accounting estimates, including fair value accounting estimates and related disclosure – particularly:
 - evaluating the reasonableness of the significant assumptions used by management for accounting estimates that give rise to significant risks;
 - determining whether changes in accounting estimates or in the method for making them from the prior period are appropriate in the circumstances; and
 - reviewing the judgments and decisions made by management in the making of accounting estimates to identify whether there are indicators of possible management bias.
- Related party transactions and relationships and remaining alert during the audit for information which may indicate previously unidentified or undisclosed related party relationships or transactions.
- Significant transactions outside the ordinary course of business and evaluating whether the business rationale (or lack thereof) of the transactions suggests that they may have been entered into so as to engage in fraudulent financial reporting or to conceal misappropriation of assets or the reliability of external confirmation requests.
- Consideration of laws and regulations and remaining alert when performing the audit for instances of non-compliance with laws and regulations (or suspected noncompliance) which may have a material effect on the financial statements or that could have a fundamental effect on the operations of the client causing the business to cease trading or bring into question the entity's ability to continue as a going concern.
- Considering whether the going concern presumption is appropriate in the company's circumstances such as evaluating management's plans for future actions and whether the outcome of these plans is likely to improve the situation and whether such plans are feasible.
- If the auditor is auditing significantly unusual or highly complex transactions, they must apply professional scepticism because the nature of such transactions may give rise to material misstatement of the financial statements and hence will merit heightened attention by the auditor.

Evidencing professional scepticism

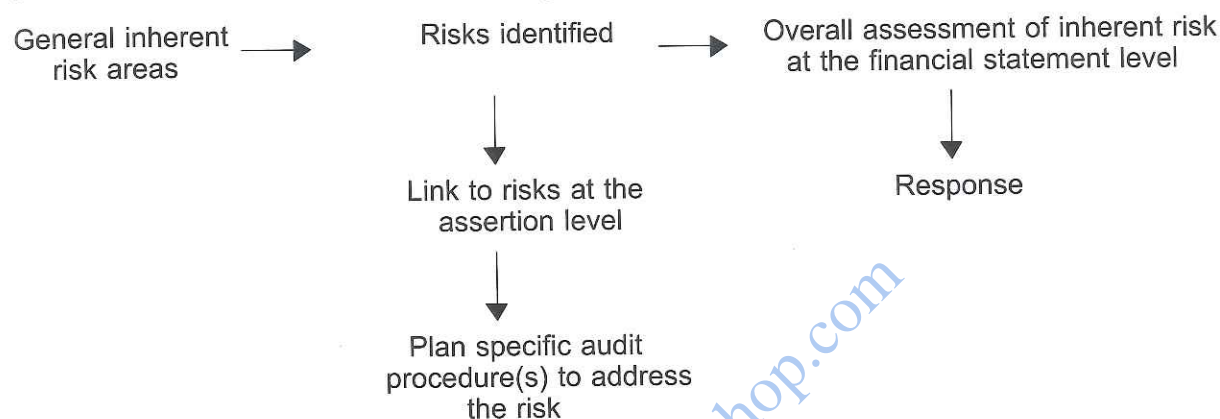
One of the main reasons that audit firms get criticised by professional bodies and regulators where professional scepticism is concerned is the lack of evidence proving that the auditor has applied professional scepticism when it comes to the file review. Where audit firms have documented certain points, it is often clear that the auditor is relying on past experience where the client's honesty and integrity is concerned and merely saying that because fraud/error was not noted in previous audits, then it can be assumed that the current year's audit will also not contain material misstatement due to fraud and/or error.

Care must also be taken by audit firms when they rebut the presumption that fraud in relation to revenue recognition is not applicable to the client. The presumption itself may be rebutted in cases where there may be a single type of simple revenue transaction (for example, leasehold revenue from a single-unit rental property). Management override of internal controls is also recognised as a significant risk in paragraph 31 to

Chapter 9 Determining the audit approach

9.1 Introduction

As discussed in Chapter 7 most audit systems approach the assessment of risk at the financial statement level and assertion level as illustrated in the following diagram:



The auditor's response to those assessed risks is guided by ISA 330 *The auditor's responses to assessed risks*.

9.2 Response to financial statement level risk

Paragraph 5 of ISA 330 requires the auditor to determine overall responses to address the risks of material misstatement at the financial statement level. Such responses may include:

- emphasising to the audit team the need to maintain professional scepticism in gathering and evaluating audit evidence;
- assigning more experienced staff or those with special skills or using experts;
- providing more supervision, or incorporating additional elements of unpredictability in the selection of further audit procedures to be performed; and
- making general changes to the nature, timing, or extent of audit procedures as an overall response.

The assessment of financial statement risk may also have a significant bearing on the choice of approach – that is, the relative emphases on substantive procedures (see Part II) and tests of controls (see section 4.9). In most audit systems, financial statement risk has a direct impact on the sample sizes for all substantive testing – the higher the risk, the larger the samples. This is looked at in more detail in Chapter 14.

A worked example of a standard schedule documenting the significant financial statement risks and the auditor's responses thereto, with extracts taken from the PCAS model file, is shown below.

Client: Manufacturing Company Limited	Prepared by: <i>aw</i>	Date: <i>10/3</i>	Ref: C8.2
Year end: 31 Dec 2010	Reviewed by: <i>JO</i>	Date: <i>11/3</i>	
File no: M0001			

FINANCIAL STATEMENT RISK ACTION PLAN

Ref	Risk	Response	Outcome Ref
1	<i>The company is reliant on a relatively small number of products. Technological advances could render the company's existing products obsolete very quickly. (PAF 1.1.2)</i>	<i>Discuss with directors as part of subsequent events review. (S2 Test11)</i>	<i>B6.1.1</i>
2	<i>In the past the directors have been very good at spotting opportunities in the market and have also moved out of older technologies at the right time. There is no guarantee that this will continue in the future. (PAF 1.1.2)</i>	<i>Discuss with directors as part of subsequent events review. (S2 Test 3)</i>	<i>B6.1.2</i>
3	<i>The directors are managing the business mainly by reference to the key performance indicators and are not using the management accounts to the full. This may result in focus on too narrow a range of indicators. (PAF 1.1.2)</i>	<i>Preliminary (C6.1) and final (B5.1) analytical reviews should identify any problem areas.</i>	<i>B6.1.3</i>
4	<i>The company's expansion plans are ambitious and, notwithstanding the company's good relationship with its bankers, could lead to financing problems. (PAF 1.1.2)</i>	<i>Discuss with directors as part of subsequent events review. (S2 test 2 & 3)</i>	<i>B6.1.4</i>
5	<i>What would happen if directors or key staff became ill or resigned? (PAF 1.1.2)</i>	<i>Discuss with directors as part of subsequent events review. (S2 test 2 & 3)</i>	<i>B6.1.5</i>

Note. Where a response to a financial statement level risk requires specific procedures to be undertaken at the assertion level this should be referenced to C8.3.

9.2.1 Interim audits

An interim audit is often used where the reporting timetable is particularly tight, as it enables the auditor to bring forward much of the detailed audit work to an earlier date, usually before the year end. This approach can be very efficient and cost effective – for example, by assisting the auditor in identifying significant matters at an early stage of the audit, and consequently resolving them with the assistance of management or developing an effective audit approach to address such matters.

However, the higher the risk of material misstatement, the more likely it is that the auditor may decide it is more effective to perform substantive procedures nearer, or at, the period end rather than at an earlier date, and so the timing of the audit work should be carefully considered at the planning stage.

If use is made of an interim audit, the auditor must consider what audit evidence is required for the remaining period. Paragraph 22 of ISA 330 requires the auditor to carry out further substantive procedures (and, where relevant, tests of control) to cover this period to provide sufficient audit evidence to support a conclusion on the whole accounting period.

A common problem when performing an interim audit is inefficiency. Many auditors do not spend enough time upfront planning the work needed at the interim and final stages, which tends to result in auditing everything twice. Balance sheet areas auditing at the interim stage should be 'rolled forward' and the work updated only. Profit and loss account testing should be mostly done at the interim stage. At the final stage, if samples have been apportioned between the two periods, the substantive testing still to be done should be limited, and use made of analytical procedures to provide the additional audit evidence needed.

9.3 Response to assertion level risk

Paragraph 6 of ISA 330 states: 'The auditor should design and perform further audit procedures whose nature, timing, and extent are responsive to the assessed risks of material misstatement at the assertion level'. The key purpose here is to provide a clear linkage between the risk assessment and the nature, timing, and extent of the auditor's further audit procedures.

9.3.1 Specifically identified risks

Many audit systems will contain a standard schedule to record in more detail the key risks identified at the assertion level by the risk assessment process and the auditor's proposed responses to them. A completed worked example of such a form, taken from the PCAS model file, is shown below. The equivalent schedule in the Kestrian system is B3(vii).

<http://www.pbookshop.com>

Chapter 14 Sampling and error evaluation

14.1 Sampling

ISA 530 *Audit sampling* applies in all circumstances where a sample is taken from the population for testing in order to form an audit opinion. In certain circumstances, 100 per cent of the population will be tested; this does not constitute audit sampling. Audit sampling is a method of identifying a number of items within the population that can be tested in order to provide sufficient assurance that any material error in the population will be identified. Crucially, paragraph 8 of the ISA requires all items in the sample to have a chance of selection. However, this need not be an equal chance of selection.

Consistency is a crucial aspect when considering sampling. The auditor must ensure that the sampling method adopted by the firm is applied in every case where sampling is appropriate.

All audit systems will have their own methodology to determine sample sizes. An example methodology is detailed below. It is important to remember that sampling should be utilised wherever possible. A common pitfall that many firms fall into is to test the entire population in too many cases. This can frequently result in overauditing, but can also result in a more serious problem. For example, when testing for receipt of cash after date for debtors, the whole population is considered – that is, all cash received from the period end to the date of the test. A conclusion is then drawn along the lines that say 60 per cent of the debtors have been paid after the period end and, therefore, the results are reasonable. However, this ignores the fact that the sample represented 100 per cent of the population and, therefore, if only 60 per cent have been paid, the potential error is 40 per cent: an issue that must be addressed.

14.2 Determining sample sizes

The basis of determining sample sizes in this example uses the following parameters:

- the monetary value of the population;
- the overall level of materiality set for the audit, or if applicable, sector-specific materiality (see section 6.3);
- a calculated risk factor (inherent risk); and
- the identification of high value and key items.

By selecting the sample size using the combination of the first three items above, the auditor is using the assessments made at the planning stage of the audit to determine the size of the audit sample.

We saw in section 6.5, that tolerable misstatement (or error) is the application of performance materiality to a particular sampling procedure. This example assesses tolerable error by multiplying materiality by a numerical risk factor which represents a combination of the overall inherent risk for the audit and the assertion level risk for the item being tested. Hence, the lower the figure of performance materiality, the larger the sample will be.

This sampling method expects the auditor to identify high value and key items separately for testing. These items are considered sufficiently important to justify selecting all of them. High value items will be identified as transactions that are higher than performance materiality, i.e. tolerable error. Key items are other balances or transactions that are identified as significant in the particular circumstance of the test being carried out. The judgment of the auditor is required in assessing whether or not an item is a 'key' item for these purposes. No absolute definition of key items is possible.

The value of the population being tested will relate specifically to the test being carried out. For example, when undertaking existence testing on fixed assets, the population would be the net book value of the assets. However, when undertaking tests on additions, the value of the population will be the value of the additions in the period.

This sampling method also requires testing of 'the residual population'. The residual population is the value of the population after deducting the value of the high value and key items.

When determining the number of items from a residual population that need to be tested, the auditor should consider the materiality and risk. In addition, consideration needs to be given to the method of obtaining audit evidence. If a test is purely substantive, then a higher sample size will be required than if the testing also includes extensive analytical review and/or tests of control, in which case the number of substantive tests that need to be undertaken will be reduced.

Having identified a method that can be used to determine sample sizes, it must then be applied consistently. The audit working papers must incorporate details of how the sample size was selected. In addition, they must also contain details of how the ultimate sample was selected from the population.

Various means are available for selecting the chosen sample from a population. High value and key items will already have been identified. The sample selected from the residual population should be selected so as to cover fairly the whole of the population being tested.

This will involve the use of random, systematic or judgmental means of selection. The auditor should try to avoid the selection of a block of items as this is prone to bias and fails to consider the whole population adequately. The working papers should reflect where the sample was selected from and how the items were selected for testing.

Although sample sizes should feel right judgmentally, it is not sufficient to determine the size of a sample without recording the logic. Furthermore, once the sample size has been selected, it is essential that it is not changed. The only exception one would expect to see is where errors have been identified, and so the sample size has been increased to reduce these. In too many cases where the auditor is under time pressure, the sample size is reduced for no other reason than lack of time. This is dangerous. Where the time pressure results from the test that has been designed being difficult to carry out, then – instead of reducing the sample size – the auditor should consider whether there is an alternative test that can be applied to satisfy the required objective.

14.3 The evaluation of errors

The investigation and evaluation of errors encountered during audit testing is a vital part of the audit. Errors should always be followed up. In no circumstances should they simply be ignored.

When an error occurs, there are two specific questions that need to be addressed, namely:

- Could other errors exist elsewhere within the population?
- Is it possible that the error could be material to the accounts?

If the answer to both of these questions is yes, then additional audit work must be carried out. It is important to remember that the second question is asking whether it is possible, not whether it is likely. In normal circumstances, therefore, some additional work must be carried out whenever an error is encountered. The work can be directed specifically to help the auditor answer both of those questions. Alternatively, it may be appropriate to extend the sample size in order to determine whether the level of error encountered is typical of the population as a whole.

If the method of sampling identified above has been utilised, then the level of error in the population of high value and key items will already have been fully evaluated. Therefore, any increased audit work will be within the 'residual population'.

Where the increased work identifies a certain level of error within the population, it would usually be appropriate to extrapolate that level of error over the residual population. This, combined with the errors found in the high value and key items tested, will give the most likely level of error in the entire population. Consideration must be given to whether this level of error is likely to produce material misstatement within the accounts. The actual and the extrapolated error should be recorded on the summary of unadjusted errors on the audit file (see Part III Chapter 41).

14.4 Projecting the value of errors

There are two main statistical methods of projecting the value of total errors in a population – the ratio method and the difference method. The ratio method may be more appropriate where the amount of error in a transaction is related closely to its size – that is, the bigger the transaction, the bigger the error. The difference method may be more appropriate where the size of the transaction would make no difference to the amount of the error – that is, the error is of a constant amount. The basis of each calculation has been set out below.

14.4.1 The ratio method

This method takes the value of the error found and multiplies it by the population value divided by the value of the sample to obtain the projected error in a population.

$$\text{Error in population} \times \frac{\text{Population value}}{\text{Total value of sample}} = \text{Projected error in population}$$

14.4.2 The difference method

This method takes the error found in the sample and multiplies it by the number of items in the population divided by the number of items in the sample to give the projected error in the population.

$$\text{Error in population} \times \frac{\text{Population value}}{\text{Number in sample}} = \text{Projected error in population}$$

Where information about the nature of errors is not known, the ratio method is normally the most appropriate method to use.

Because the projected error is unlikely to be the same as the actual error in a population, it will be necessary to consider judgmentally whether or not a material error in the accounts is likely. If it is considered that it might be material, the following options are available to the auditor:

- a) to request the client to investigate the errors and the potential for further errors;
- b) to extend the audit test again and gain a more precise conclusion;
- c) to perform alternative procedures (if possible); or
- d) to qualify the audit opinion on the grounds of uncertainty.

If action (a) is chosen, then it should be noted that paragraph 7 of ISA 450 *Evaluation of misstatements identified during the audit* requires the auditor to perform additional audit procedures to determine whether misstatements remain. This was guidance in the old ISA and was always considered to be best practice. It is now a mandatory requirement.

Action (d) should be the last option, which should only be taken after establishing that it was not possible to form a conclusion from any of the other methods. However, it is essential that the effects of any errors found in the audit tests are resolved. It is not acceptable to leave an error position 'open'; a conclusion about its impact on the individual area being tested and on the accounts as a whole must be drawn. If errors are left unresolved and their effect on the accounts not properly assessed, it is not possible to assess whether the audit opinion given is in fact reasonable.

Alternatively, an error is frequently described as being an 'anomaly' or as being 'isolated' as a justification for not extending testing. It should be noted that paragraph 13 of ISA 530 considers anomalies to be 'extremely rare', and yet they are remarkably prevalent on audit files! The same paragraph requires the auditor to obtain, 'a high degree of certainty that such a misstatement or deviation is not representative of the sample ... by performing additional audit procedures', yet this is rarely done and documented on the file. The absence of such evidence again casts doubt on the reasonableness of the audit opinion.