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RISK MANAGEMENT

ICMAP-STAGE V

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What is Risk

- Is a measure of uncertainty.
- In any business process uncertainty is about achievement of objectives.
- May involve positive and negative consequences.
- Positive risks are know as "opportunities' and negative simply as "risks".

Where does risk comes from

Risk comes from environmental factors including ;

1. Economic environment.
2. Government Regulation.
3. Competition.
4. Stakeholders-suppliers-employees-shareholders.
5. Technology.

Risk Analysis

- Identification of risk,
- measurement of risk,
- Prioritizing risks,
- Selecting alternative for risk response.

Inherent Risk

- Risk inherent in any account balance or group of transactions without considering internal controls.

Risk Classifications

- Strategic Risks "long term risks, due to decisions taken by BOD"
- Operational Risks. "due to people, products, processes"
- Contractual Inadequacy Risks. "inadequate contacts"
- Political Risks "political actions of a country"
- Stakeholders Risks. "Poor relationship with stakeholders"
- Events Risks "floods, IT failure, H&S issues, legal action, loss of key employees and suppliers that delay or damages business operations "
- Interest Rate Risk. "floating interest rates"

Commonly found Risk Factors

- Subjective Factors-Complexity of entity, fast changes in technology, integrity of management, rapid changes in processes etc.
- Historical Factors- GP rates reduction, Liquidity of assets, exchange rate parity USD/PKR, Employee turnover rates etc.
- Calculated Factors- time since last audit, delays in completion of projects, initiation of projects etc.

Method for Identifying Risks

- Analogies to past events.
- Prior history of entity.
- Industry Surveys.
- Past experience.
- Application of risk assessment procedures.

Risk Assessment Procedures

- The audit procedures performed to obtain an understanding of the entity and its environment, including the entity's internal control, to identify and assess the risks of material misstatement, whether due to fraud or error, at the financial statement and assertion levels. RAP includes followings;

1. Inquiries of Management
2. Analytical procedures.
3. Observation and
4. Inspection.

Risk Identification/Risk Assessment

- Recognizing risks and opportunities is “risk identification”. It means identification and classification of what risk and their characteristics are.
- Risk assessment is qualitative and quantitative evaluation of exposures arising from activities. It includes

1. Risk Identification.
2. Risk Measurement-measurement of possible consequences.
3. Risk Prioritization-how risks are related to each other.

Approaches for risk identification

- Exposure Analysis-It is identification of risks that could affect assets.
- Environmental analysis-it is identification of risk that could affect operations.
- Threat Scenarios- it is for specialized risks including frauds/disasters etc.

Risk Management

The process of determining whether and how much risk is acceptable and what actions should be taken. Following are the possible actions;

1. Avoid Risk: withdraw from the activity.
2. Diversify Risk: Spread it over many activities.
3. Share: Share with customers/suppliers, third parties.
4. Transfer:
5. Reduce Risk: apply internal controls.

Risk Measurement

- Risks that have high impact and high likelihood of occurrence:
  1. Contaminated Food entering in production process.
  2. Market share reducing due to new entrants.
- Risks that have high impact but less likelihood of occurrence:
  1. Non availability of suppliers.
  2. Damage to property due to fire or earthquake.
- Risks that have low impact and low likelihood of occurrence:
  1. Minor damage to property due to snowfall.
- Risks that have low impact and high likelihood of occurrence:
  1. Drivers involved in accidents.
  2. Production employees falling sick.

CASE I

- Suppose you have been working as a risk assessment manager at perfect Solutions, a renowned software developing firm of the country. Nowadays, you are engaged with other experts in developing a commercial software for sale and for the use of your company. It will take substantial time for development.
- Enumerate some significant risks and how the company may minimize the impact and likelihood of such risks.

Case 2-Identify risk of material misstatement

	2012	2011	2010
Gross profit percentage	35%	40%	40%
Inventory turnover days	120	105	78
Current ratio	1.5	2.4	2.6
Quick asset ratio	0.78	1.6	1.7
Times interest earned	0.91	1.67	2.1
Debtors turnover days	132	86	68

POSSIBLE RISKS

- Technical feasibility.
- Technical, financial resources may be inadequate.
- Estimates in computations are not adequate.
- Technological obsolescence.

Measure to minimize risks

- Look at the written agreements/approval for funding the product development project.
- Periodic review.
- Monthly comparison of actuals/budget.
- Recruitment of staff.
- Feedback from technical team.
- Estimate of market demand.

EXTERNAL AUDIT

Assurance engagements

- An engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

- The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria.

Assurance engagement risk

- The risk that the practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated.

Types of assurance engagements

there are two types of assurance engagement a practitioner is permitted to perform:

- a reasonable assurance engagement and
- a limited assurance engagement.

REASONABLE ASSURANCE ENGAGEMENT

- The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement4 as the basis for a positive form of expression of the practitioner's conclusion.

LIMITED ASSURANCE ENGAGEMENT

- The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

AUDITOR'S OBJECTIVE

In conducting an audit of financial statements, the overall objective of the auditor is:

- to **obtain reasonable assurance** **about whether the financial statements as a whole are free from material misstatement**, whether due to fraud or error, **to express an opinion** on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.
- The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to **reduce audit risk to an acceptably low level.**
- Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. E.g. express unqualified opinion when FS are materially misstated.
- Audit risk is a function of the risks of material misstatement and detection risk. i.e. it results from inherent/control/detection risk.

Risk of material misstatement

The risk that the financial statements are materially misstated prior to audit. This consists of two components, described as follows at the assertion level:

Inherent risk—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.

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

AUDIT RISK

- Risk that auditor will issue inappropriate report when financial statements are materially misstated.
- Audit risk is a function of the risks of material misstatement and detection risk.
- Detection risk means that auditor may not be able to detect material misstatements even after applying his/her audit procedures.
- The assessment of risks is based on audit procedures to obtain information necessary for that purpose and evidence obtained throughout the audit.
- The assessment of risks is a matter of professional judgment, rather than a matter capable of precise measurement.

AUDIT PLANNING

PLANNING AN AUDIT OF FINANCIAL STATEMENTS

Planning an audit involves establishing;

- the overall audit strategy for the engagement and
- developing an audit plan.

Why do planning?

- Helping the auditor to devote appropriate attention to important areas of the audit.
- Helping the auditor identify and resolve potential problems on a timely basis.
- Helping the auditor properly organize and manage the audit engagement so that it is performed in an effective and efficient manner.
- Assisting in the selection of engagement team members with appropriate levels of capabilities and competence to respond to anticipated risks, and the proper assignment of work to them.
- Facilitating the direction and supervision of engagement team members and the review of their work.

WHO NEEDS TO BE INVOLVED

- The engagement partner and other key members of the engagement team shall be involved in planning the audit

Preliminary Engagement Activities

- Performing procedures regarding the continuance of the client relationship and the specific audit engagement.
- Evaluating compliance with relevant ethical requirements, including independence.
- Establishing an understanding of the terms of the engagement

Preliminary Engagement Activities- why needed.

Performing these preliminary engagement activities enables the auditor to plan an audit engagement for which, for example;

- The auditor maintains the necessary independence and ability to perform the engagement.
- There are no issues with management integrity that may affect the auditor's willingness to continue the engagement.
- There is no misunderstanding with the client as to the terms of the engagement

- The auditor's consideration of client continuance and relevant ethical requirements, including independence, occurs throughout the audit engagement as conditions and changes in circumstances occur

ISQC 1 requires the firm to obtain information considered necessary in the circumstances before accepting an engagement with a new client, when deciding whether to continue an existing engagement, and when considering acceptance of a new engagement with an existing client.

The information gathered can be as follows:

- The integrity of the principal owners, key management and those charged with governance of the entity.
- Whether the engagement team is competent to perform the audit engagement and has the necessary capabilities, including time and resources.
- Whether the firm and the engagement team can comply with relevant ethical requirements.
- Significant matters that have arisen during the current or previous audit
- engagement, and their implications for continuing the relationship

PLANNING ACTIVITIES-1

- The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

AUDIT STRATEGY

In establishing the overall audit strategy, the auditor shall:

- Identify the characteristics of the engagement that define its scope.
- Ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required.
- Consider the factors that, in the auditor's professional judgment, are significant in directing the engagement team's efforts.
- Ascertain the nature, timing and extent of resources necessary to perform the engagement.

Planning Activities-2

Develop audit plan that states:

- The nature, timing and extent of planned risk assessment procedures.
- The nature, timing and extent of planned further audit procedures at the assertion level.
- The auditor shall update and change the overall audit strategy and the audit plan as necessary during the course of the audit

DOCUMENTATION

- The overall audit strategy;
- The audit plan.
- Any significant changes made during the audit engagement to the overall audit strategy or the audit plan, and the reasons for such changes.

Additional consideration in initial audit engagements

The auditor shall undertake the following activities prior to starting an initial audit.

- Performing procedures required by ISA 220 regarding the acceptance of the client relationship and the specific audit engagement.

- Communicating with the predecessor auditor, where there has been a change of auditors, in compliance with relevant ethical requirements

Planning process-Characteristics

- Planning is not a discrete phase of an audit, but rather a continual and iterative process that often begins shortly after (or in connection with) the completion of the previous audit and continues until the completion of the current audit engagement.
- The auditor may decide to discuss elements of planning with the entity's management to facilitate the conduct and management of the audit engagement.
- When discussing matters included in the overall audit strategy or audit plan, care is required in order not to compromise the effectiveness of the audit.

IDENTIFYING AND ASSESSING THE RISKS OF MATERIAL MISSTATEMENT THROUGH UNDERSTANDING THE ENTITY AND ITS ENVIRONMENT

OBJECTIVE

The objective of the auditor is to;

- **identify and assess the risks of material misstatement,** whether due to fraud or error, **at the financial statement and assertion levels**.

- This work (identify and assess) is done by **understanding the entity and its environment, including the entity's internal control.**

- This risk assessment helps auditor design and implement his/responses.

- Responses means **"audit procedures"**. The auditor will determine **"Nature, timing and extent"** of his/audit procedures based on risk assessment i.e. risk can be high, medium or low and audit procedures will change accordingly.

Audit assertions

- Assertions are Representations by management, explicit or otherwise, that are embodied in the financial statements.
- Auditors apply audit procedures to verify these assertions for each group of expenses and account balance.
- These assertions are regarding **recognition, measurement, presentation and disclosure** of the various elements of financial statements and related disclosures.

Audit assertions

Assertions may occur fall into the following three categories and may take the following forms.

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

Assertions about classes of transactions and events for the period under audit.

- Occurrence—transactions and events that have been recorded have occurred and pertain to the entity.
- Completeness—all transactions and events that should have been recorded have been recorded.
- Accuracy—amounts and other data relating to recorded transactions and events have been recorded appropriately.
- Cutoff—transactions and events have been recorded in the correct accounting period.
- Classification—transactions and events have been recorded in the proper accounts

ASSERTIONS ABOUT ACCOUNT BALANCES AT THE PERIOD END

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

ASSERTIONS ABOUT PRESENTATION AND DISCLOSURE

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

AUDIT PROCEDURES

Type of audit procedures are

- Inquiries
- Analytical procedures.
- Observation and inspection
- Computations and
- External confirmations.

AUDIT PROCEDURES

Inquiries of Management and Others within the Entity.

- It is usually directed towards people who are responsible for financial reporting.
- Inquiries can be directed towards those charged with governance may help the auditor understand the environment in which the financial statements are prepared.
- Inquiries directed toward internal audit personnel may provide information about internal audit procedures relating to the design and effectiveness of the entity's internal control and whether management has satisfactorily responded to findings from those procedures.
- Inquiries of employees involved in initiating, processing or recording complex or unusual transactions may help the auditor to evaluate the appropriateness of the selection and application of certain accounting policies.

- Inquiries directed toward in-house legal counsel may provide information about such matters as litigation, compliance with laws and regulations, knowledge of fraud or suspected fraud affecting the entity, warranties, post-sales obligations, arrangements.

- Inquiries directed towards marketing or sales personnel may provide information about changes in the entity's marketing strategies, sales trends, or contractual arrangements with its customers

Analytical procedure

- Analytical procedures performed as risk assessment procedures may identify aspects of the entity of which the auditor was unaware and may assist in assessing the risks of material misstatement in order to provide a basis for designing and implementing responses to the assessed risks.
- Analytical procedures performed as risk assessment procedures may include both financial and non-financial information, for example, the relationship between sales and square footage of selling space or volume of goods sold.
- Analytical procedures may help identify the existence of unusual transactions or events, and amounts, ratios, and trends that might indicate matters that have audit implications

- However, when such analytical procedures use data aggregated at a high level, the results of those analytical procedures only provide a broad initial indication about whether a material misstatement may exist.

Observation and Inspection

Observation and inspection may support inquiries of management and others, and may also provide information about the entity and its environment. Examples of such audit procedures include observation or inspection of the following;

- The entity's operations.
- Documents (such as business plans and strategies), records, and internal control manuals.
- Reports prepared by management (such as quarterly management reports and interim financial statements) and those charged with governance (such as minutes of board of directors' meetings).
- The entity's premises and plant facilities.

Identification and assessment of risk through collecting information on entity, its controls and environment

Why information to be collected

- Assessing risks of material misstatement of the financial statements.
- Determining materiality in accordance with ISA 320.
- Considering the appropriateness of the selection and application of accounting policies, and the adequacy of financial statement disclosures.
- Identifying areas where special audit consideration may be necessary, for example, related party transactions, the appropriateness of management's use of the going concern assumption, or considering the business purpose of transactions.
- Developing expectations for use when performing analytical procedures.
- Responding to the assessed risks of material misstatement, including
- designing and performing further audit procedures to obtain sufficient appropriate audit evidence.
- Responding to the assessed risks of material misstatement.
- Evaluating the sufficiency and appropriateness of audit evidence obtained, such as the appropriateness of assumptions and of management's oral and written representations

WHAT INFORMATION IS TO BE COLLECTED

- Relevant industry, regulatory, and other external factors including the applicable financial reporting framework.
- The nature of the entity, including its OPERATIONS, OWNERSHIP & GOVERNANCE STRUCTURE, INVESTMENTS MADE, HOW IT IS STRUCTURED.
- The entity's selection and application of accounting policies (policies should be appropriate to business be consistent with FRF and industry).
- The entity's objectives and strategies, and those related business risks that may result in risks of material misstatement.
- The measurement and review of the entity's financial performance.
- Entities' internal controls relevant to audit (design of controls and if they are implemented whole year).

- Entities Risk Assessment Process.
- The information system, including the related business processes, relevant to financial reporting, and communication.
- The auditor shall obtain an understanding of how the entity communicates financial reporting roles and responsibilities and significant matters relating to financial reporting,

Identifying and Assessing the Risks of Material Misstatement

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- Identify risk at financial statement level to provide a basis for designing and performing further audit procedures.
- Identify risk at assertion level for classes transaction, account balance and disclosures.
- Identify throughout the process by considering classes of transaction/account balances, disclosure.
- Assess if the identified risks relate more pervasively to the financial statements as a whole and potentially affect many assertions.
- Relate the identified risks to what can go wrong at the assertion level, taking account of relevant controls that the auditor intends to test.

EXTENT OF UNDERSTANDING REQUIRED

- It is matter of professional judgment for auditors.
- The auditor's primary consideration is whether the understanding obtained is sufficient to meet the objective.
- The depth of the overall understanding that is required by the auditor is less than that possessed by management in managing the entity.
- the auditor is not required to perform all of them for each aspect of that understanding.

INFORMATION REQUIRED

- Industry Factors. (The market and competition, including demand, capacity, and price competition, product technology and energy cost/supply)

  The industry in which the entity operates may give rise to specific risks of material misstatement arising from the nature of the business or the degree of regulation. For example construction industry where contract are of longer than one year and estimates for rev/cost are required for financial reporting.

INFORMATION REQUIRED

- Regulatory Factors. (financial reporting framework, legal and political environment). The auditor may consider;
  1. Accounting principles and industry-specific practices.
  2. Regulatory framework, legislation effecting operations.
  3. Taxation, government policies (monetary, Forex controls, tariff and trade policies, incentives etc).
  4. Environmental requirements affecting the industry and the entity's business.

INFORMATION REQUIRED- NATURE OF ENTITY

- Auditors collect information about structure, ownership and relationship between owners and other people.
- Complex structures often introduce issues that may give rise to risks of material misstatement. Such issues may include whether goodwill, joint ventures, investments, or special-purpose entities are accounted for appropriately.
- Information about ownership and relationship help understand related parties and if transactions with related party are accounted for appropriately.

NATURE OF ENTITY-EXAMPLES

Collect information on; Business operations-

1. Nature of revenue sources, products or services, and markets, including involvement in electronic commerce such as Internet sales and marketing activities.
2. Conduct of operations (for example, stages and methods of production, or activities exposed to environmental risks).
3. Alliances, joint ventures, and outsourcing activities.
4. Geographic dispersion and industry segmentation.
5. Location of production facilities, warehouses, and offices, and location and quantities of inventories.
6. Key customers/suppliers, incentive, R&D, related parties

- Investments and investment activities such as planned or recent acquisitions, investment /disposition in securities and capital investments.
- Financing activities such as Debt structure and related terms, including off-balance-sheet financing arrangements and leasing arrangements, derivatives.
- Financial reporting such as accounting principles and industry-specific practices, Revenue recognition practices, Accounting for fair values, Foreign currency assets, liabilities and transactions, Accounting for unusual or complex transactions (stock based transactions).

Information required
The Entity's Selection and Application of Accounting Policies

- The methods the entity uses to account for significant and unusual transactions.
- The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.
- Changes in the entity's accounting policies.
- Financial reporting standards and laws and regulations that are new to the entity and when and how the entity will adopt such requirements.

Information required *Objectives -Strategies-Business Risks*

- Industry developments (a potential related business risk might be, for example, that the entity does not have the personnel or expertise to deal with the changes in the industry).
- New products and services (a potential related business risk might be, for example, that there is increased product liability).
- New accounting requirements (a potential related business risk might be, for example, incomplete or improper implementation, or increased costs).
- Current and prospective financing requirements.
- Use of IT

INFORMATION REQUIRED
MEASUREMENT AND REVIEW OF THE ENTITY'S FINANCIAL PERFORMANCE

- Management and others will measure and review those things they regard as important.
- Performance measures, whether external or internal, create pressures on the entity.
- These pressures motivate management to take action to improve the business performance or to misstate the financial statements.
- Accordingly, an understanding of the entity's performance measures assists the auditor in considering whether pressures to achieve performance targets may result in management actions that increase the risks of material misstatement, including those due to fraud.

INFORMATION REQUIRED

EXAMPLES-PERFORMANCE MEASUREMENT

Includes both internal and external measures. Internal measures are given below;

- Key performance indicators (financial and non-financial) and key ratios, trends and operating statistics.
- Period-on-period financial performance analyses.
- Budgets, forecasts, variance analyses, segment information and divisional, departmental or other level performance reports.
- Employee performance measures and incentive compensation policies.
- Comparisons of an entity's performance with that of competitors.

Internal measures may highlight unexpected results or trends requiring management to determine their cause and take corrective action.

- Performance measures may also indicate to the auditor that risks of misstatement of related financial statement information do exist.

- For example, performance measures may indicate that the entity has unusually rapid growth or profitability when compared to that of other entities in the same industry.

- Such information, particularly if combined with other factors such as performance-based bonus or incentive remuneration, may indicate the potential risk of management bias in the preparation of the financial statements.

INTERNAL CONTROLS

- Internal control is designed, implemented and maintained to address identified business risks that threaten the achievement of any of the entity's objectives.
- The way in which internal control is designed, implemented and maintained varies with an entity's size and complexity.

Limitations of Internal Control

- Internal control, no matter how effective, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives.
- This is because of inherent limitation of internal controls . These include the realities that human judgment in decision-making can be faulty and that breakdowns in internal control can occur because of human error.
- Controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control.
- For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, edit checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

Components of internal controls

There are five components of internal controls;

- Control environment.
- The entity's risk assessment process.
- The information system, including the related business processes, relevant to financial reporting, and communication.
- Control activities and
- Monitoring of controls

Control environment.

- The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity.

- The control environment sets the tone of an organization, influencing the control consciousness of its people.

ELEMENTS OF CONTROL ENVIRONMENT-

- *Communication and enforcement of integrity and ethical values.*
- *Commitment to competence.*
- *Participation by those charged with governance and* Attributes of those charged with governance such as
  - Their independence from management, their e experience and stature,
  - The appropriateness of their actions, including the degree to which difficult questions are raised and pursued with management, and their interaction with internal and external auditors.
  - The extent of their involvement and the information they receive and the scrutiny of activities.

ELEMENTS OF CONTROL ENVIRONMENT-

- *Management's philosophy and operating style-characteristics such as*

1. *Approach for taking/managing risk,*
2. Attitudes and actions toward financial reporting.
3. Attitudes toward information processing and accounting functions and personnel

Elements of Control environment-

- *Organizational structure* – The framework within which an entity's activities for achieving its objectives are planned, executed, controlled, and reviewed.
- *Assignment of authority and responsibility* – Matters such as how authority and responsibility for operating activities are assigned and how reporting relationships and authorization hierarchies are established.
- *Human resource policies and practices* – Policies and practices that relate to, for example, recruitment, orientation, training, evaluation, counseling, promotion, compensation, and remedial actions.

Control environment

- Relevant audit evidence on control environment may be obtained through a combination of inquiries and other risk assessment procedures such as corroborating inquiries through observation or inspection of documents.
- For example, through inquiries of management and employees, the auditor may obtain an understanding of how management communicates to employees its views on business practices and ethical behavior.
- The auditor may then determine whether relevant controls have been implemented by considering, for example, whether management has a written code of conduct and whether it acts in a manner that supports the code

- An active and independent board of directors may influence the philosophy and operating style of senior management.
- Control environment is affected by ability of those charged with governance to understand business, evaluate actions of management and financial reporting.
- It helps deter happening of fraud.
- The control environment in itself does not prevent, or detect and correct, a material misstatement. It may influence the auditor's evaluation of the effectiveness of other controls (for example, the monitoring of controls and the operation of specific control activities) and thereby, the auditor's assessment of the risks of material misstatement

GOING CONCERN –IAS 570

Going concern assumption

- An entity is going concern, when it is viewed as continuing in business for foreseeable future with no intention or necessity of liquidation, ceasing trading or seeking protection from creditors pursuant to laws and regulations.

- Accordingly, assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in normal course of business.

Going concern
Auditor's responsibility

- To obtain S&A audit evidence about APPROPRIATELNESS of management's use of going concern assumption in preparation of financial statements.
- To conclude if there are any material uncertainties about the entity's ability to continue as going concern, based on audit evidence obtained.
- To determine if management has performed an assessment of entity's ability to continue as going concern, if so evaluate and discuss with management.
- To remain alert throughout the audit for evidence that may cast significant doubt on ability of entity to continue as going concern.
- The assessment should of at least 12 months time from the year end date.

Going concern

- When events & conditions are identified which cast significant doubt on entity to continue as going concern, the auditor should obtain S&A audit evidence to DETERMINE IF MATERIAL UNCERTAINTY EXIST.

Factors indicating going concern problems

Financial

1. Net liability or net current liability position.
2. Negative operating cash flows.
3. Adverse key ratios.
4. Fixed term borrowing approaching maturity without realistic prospects of renewal or repayment.
5. Substantial Operating losses.
6. Arrears or discontinuance of dividends.
7. Inability to comply with terms of loan agreement.
8. Change from Credit to cash terms with suppliers.
9. Inability to obtain financing for essential new products development or other essential investments.

Factors indicating going concern problems

Operating

1. Loss of key management without replacement.
2. Loss of major market, franchise, license, or supplier.
3. Labor difficulties.

Other

1. Non compliance with capital or other statutory requirements.
2. Pending legal or regulatory proceedings against the company that may result in claims that unlikely to be satisfied.
3. Change sin regulations or government policy that is expected to adversely affect the entity.

PROCEDURES TO PERFORM TO DETERMINE IF MATERIAL UNCERTAINLY EXIST

- Requesting management to make as assessment of the entity's ability to continue as going concern, if they have not already done so.
- Review management plans for future action and cash flow forecasts.
- Consider any additional facts or information that have become available since management made its assessment.
- Seeking written representations from management regarding its plans for future actions and their feasibility.

Type of audit report

- If auditor consider that there is significant concern about the ability of company to continue as going concern and consider use to going concern assumption OKAY, the auditor would add emphasis of matter paragraph and disclosure to accounts.
- If disclosure are inadequate, the auditor would issue a qualified or adverse opinion, depending on the circumstances.
- If auditor disagree with basis of preparation of Financial statements, adverse opinion will be issued as effect of this disagreement will be pervasive.
- If FS are prepared on alternative basis (when going concern assumption is inappropriate), disclosure is necessary and unqualified report will be issued.

DRAFT MODIFICATION OF AUDIT REPORT

- Without qualifying our opinion we draw attention to note X to financial statements. The company incurred net loss of xxxx during the year under audit. As of this date, the company's current liabilities exceeded its current assets. These factors , along with the fact that operations of company have been substantially reduced in the recent past, company's ability to operate profitably is uncertain. Financing is also not available.

- Also mention that because of this significant doubt the company may not be able to recover its asset, pay liabilities in normal course of business.

RESPONSIBILITY OF MANAGEMENT FOR GOING CONCERN ASSUMPTION

- It is detailed in IAS 1.
- This standard requires management to make an assessment of an entity's ability to continue as going concern.
- If management becomes aware of material uncertainties casting doubt on entity's ability of continue as going concern, these must be disclosed.
- If financial statements are not prepared on going concern basis, management must disclose this fact and that what alternative method is used for FS preparation.

ISA 560, Subsequent Events

ADJUSTING AND NON ADJUSTING EVENTS

Auditors responsibilities (between reporting date & date of audit report)

- The audit procedures should be designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified and correctly accounted for.

Recommended audit procedures (to identify subsequent events)

The procedures should be performed as near as possible to the date of the auditor's report. These procedures are:

- Inquire into and consider effectiveness of procedures management has established to identify Sub events.
- Read minutes of meetings of shareholders, BOD, audit committees held after the period end.
- Enquire about matters discussed in the meetings for which minutes of meeting are not yet available.
- Review relevant accounting records and read the latest available FS (interim), budgets, cash flow forecast and other management reports.
- Make inquiry of entity's lawyers concerning litigations.
- Consider other information that comes from outside entity.
- Obtain formal MR about SE that are dated close to report.

Responsibly regarding SE after date of audit report

- The auditors do not have duty to carry out audit procedures in respect of subsequent events after the audit report has been issued.
- Instead management is responsible for bringing relevant matters arising before the financial statements are issued to members/auditors.
- If auditors become aware of an issue that necessitate revision of FS, they should encourage directors to revised FS upon which auditors will issued new audit report.
- If directors don't amend FS and audit report has been released to entity, the auditors should notify those charged with governance not to release FS.
- The auditors should seek legal advice and take steps to prevent reliance on the original report.

When FS are revised after original issuance of financial statements

- In case audited financial statements are already issued and revision of financial statement is required, the auditor should review the steps taken by management to ensure that anyone in receipt of the previously issued financial statements together with the auditors' report thereon is informed of the situation.

Audit report format when revised report is issued.

- If FS are revised, the auditor should issue a new report on the revised financial statements.
- The new auditors' report should include an emphasis of a matter paragraph referring to a note to the financial statements that more extensively discusses the reason for the revision of the previously issued financial statements and to the earlier report issued by the auditor.
- The new audit report should be dated not earlier than the date of approval of the revised financial statements.

- When after the financial statements are issued, the auditor becomes aware of fact which existed at the date of auditor's report, which if known a that date, may have caused the auditor to modify the auditor's report, the auditor should consider if financial statements need revision and should discuss the matter with management.
- If management does not revise financial statements or does not take any steps to let users know of the situation, then the auditor consider to take steps to prevent reliance of their report.
- The action taken will depend on auditor's legal rights. He/she may contact shareholders directly and seek legal advice.

WRITTEN REPRESENTATIONS

Written representations

- Written representation – A written statement by management provided to the auditor to confirm certain matters or to support other audit evidence.

- Written representations in this context do not include financial statements, the assertions therein, or supporting books and records.

Written representations

- The auditor shall request written representations from management with appropriate responsibilities for the financial statements and knowledge of the matters concerned.
- The auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework.
- Request written representation that it has provided the auditor with all relevant information and access as agreed in the terms of the audit engagement and
- all transactions have been recorded and are reflected in the financial statements

Written representations

- the auditor determines that it is necessary to obtain one or more written representations to support other audit evidence relevant to the financial statements or one or more specific assertions in the financial statements, the auditor shall request such other written representations.
- The date of the written representations shall be as near as practicable to, but not after, the date of the auditor's report on the financial statements.
- The written representations shall be in the form of a representation letter addressed to the auditor.

Requested Written Representations Not Provided

The auditor shall

- Discuss the matter with management
- Reevaluate the integrity of management and evaluate the effect that this may have on the reliability of representations (oral or written) and audit evidence in general; and
- Take appropriate actions, including determining the possible effect on the opinion in the auditor's report

QUESTION

- How the auditor would deal with a situation where he is in doubt as regards the reliability of the written representation provided by the management of the company?

Answer

- If there is inconsistency between one or more written representations and audit evidence is obtained from another source, the auditor may consider whether the risk assessment remains appropriate and, if not, revise the risk assessment and the nature, timing and extent of further audit procedures to respond to the assessed risk.

- If the matters relates to the competence, integrity, ethical values, diligence and commitment of management, the auditor may conclude that the audit cannot be conducted. In such a situation, the auditor may consider withdrawing from the engagement and if withdrawal is not possible, he may disclaim an opinion.

AUDIT ENGAGEMENT LETTER

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Audit engagement letter

Following are key components of audit engagement letter.

- The objective and scope of the audit of financial statements;
- The responsibilities of the auditor;
- The responsibilities of management;
- Identification of the applicable financial reporting framework for the preparation of the financial statements;
- Reference to the expected form and content of any reports to be issued by the auditor and;
- A statement that there may be circumstances in which a report may differ from its expected form and content.
- Other matters (Fee/dispute resolution, transmittal, upload on website etc)

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Change in terms of engagement

- An auditor may agree to a change in the terms of engagement provided there is a reasonable justification for doing so.

CIRCUMSTANCES WHEN MANAGEMENT MAY REQUEST THE AUDITOR TO CHANGE THE TERMS OF AN AUDIT ENGAGEMENT

- Change in circumstances affecting the need for the service.
- A misunderstanding as to the nature of an audit as originally requested.
- A restriction on the scope of an audit engagement, whether caused by management or caused by other circumstances

FACTORS TO BE CONSIDERED BY THE AUDITOR BEFORE ACCEPTING THE CHANGE IN TERMS OF ENGAGEMENT

- Justification provided for changing the terms of engagement
- The information in respect of which the change is requested by the management and
- Legal or contractual implications of the change.

STEPS THAT THE AUDITOR CAN TAKE, IF HE/SHE IS UNABLE TO AGREE TO A CHANGE IN TERMS OF ENGAGEMENT

If the auditor is unable to agree to a change in the terms of the audit engagement and is not permitted by management to continue the original engagement, the auditor shall:

- Withdraw from the audit engagement where possible under applicable law or regulation; and
- Determine whether there is any obligation, either contractual or otherwise, to report the circumstances to other parties, such as those charged with governance, owners or regulators.

OTHER KEY CONCEPTS

(Audit skepticism, professional judgment, Sufficient and appropriate audit evidence, audit evidence is persuasive rather then conclusive)

WHY AUDITOR CAN NOT GIVE ABSOLUTE ASSURANCE

Reasonable assurance is less than absolute assurance. Reducing assurance engagement risk to zero is very rarely attainable or cost beneficial as a result of factors such as the following:

- The use of selective testing.
- The inherent limitations of internal control. ☺
- The fact that much of the evidence available to the assurance practitioner is persuasive rather than conclusive.
- The use of professional judgment in gathering and evaluating evidence and forming conclusions based on that evidence.
- In some cases, the characteristics of the subject matter when evaluated or measured against the identified criteria.

AUDIT SKEPTICISM

Audit skepticism is an attitude of professional skepticism which means that

a) the auditor should recognize the fact that circumstances may exist that may cause the financial statements to be materially misstated. Consequently, he/she should make a critical assessment with a questioning mind of the validity of audit evidence obtained.
b) He/she should remain alert to audit evidence that contradicts or brings into question the reliability of documents and responses to inquiries and the reliability of other information obtained from management and those charged with governance
c) He/She should remain alert that there can be conditions that may indicate possible fraud

AUDIT SKEPTICISM

Maintaining professional skepticism throughout the audit is necessary if the auditor is to reduce the risks of:

- Overlooking unusual circumstances.
- Over generalizing when drawing conclusions from audit observations.
- Using inappropriate assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof.

PROFESSIONAL JUDGMENT

- Professional judgment is essential to the proper conduct of an audit.
- Professional judgment is necessary in particular regarding decisions about;
  1. Materiality and audit risk.
  2. The nature, timing and extent of audit procedures used to verify management assertions and gather audit evidence.
  3. Evaluating whether sufficient appropriate audit evidence has been obtained, and whether more needs to be done to achieve the objectives of the auditor.
  4. Drawing conclusions based on the audit evidence obtained, (for example, assessing the reasonableness of the estimates made by management in preparing the financial statements)

PROFESSIONAL JUDGEMENT

- The exercise of professional judgment in any particular case is based on the facts and circumstances that are known by the auditor.
- Consultation on difficult or contentious matters during the course of the audit, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm, assist the auditor in making informed and reasonable judgments.
- Professional judgment can be evaluated based on whether the judgment reached reflects a competent application of auditing and accounting principles and is appropriate in the light of, and consistent with, the facts and circumstances that were known to the auditor up to the date of the auditor's report.

Sufficient and Appropriate Audit Evidence”.

- The sufficiency and appropriateness of audit evidence are interrelated.
- Sufficiency is the measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the auditor’s assessment of the risks of misstatement (the higher the assessed risks, the more audit evidence is likely to be required) and also by the quality of such audit evidence (the higher the quality, the less may be required).
- Appropriateness is the measure of the quality of audit evidence; that is, its relevance and its reliability in providing support for the conclusions on which the auditor’s opinion is based.

SITUATIONS THAT RESTRICT AUDITOR'S ABILITY TO OBTAIN SUFFICIENT APPROPRIATE AUDIT EVIDENCE

The auditor's inability to obtain sufficient appropriate audit evidence may arise from:

- Circumstances beyond the control of the entity.
- Circumstances relating to the nature or timing of the auditor's work.
- Limitations imposed by management.

Examples-Circumstances beyond control of entity

- The entity's accounting records have been destroyed.
- The accounting records of a significant component have been seized indefinitely by governmental authorities

EXAMPLE-CIRCUMSTANCES RELATING TO NATURE OR TIMING OF AUDITOR'S WORK

- The timing of the auditor's appointment is such that the auditor is unable to observe the counting of the physical inventories.

- The auditor determines that performing substantive procedures alone is not sufficient, but the entity's controls are not effective.

- The entity is required to use the equity method of accounting for an associated entity, and the auditor is unable to obtain sufficient appropriate audit evidence about the latter's financial information to evaluate whether the equity method has been appropriately applied

EXAMPLE-LIMITATIONS IMPOSED BY MANAGEMENT

- Management prevents the auditor from observing the counting of the physical inventory.

- Management prevents the auditor from requesting external confirmation of specific account balances.

Audit evidence is persuasive rather then conclusive-reasons

- The auditor gathers evidence on a test basis (the sample may or may not be representative).
- People make mistakes (both client and auditor).
- Documents could be forged (increasingly easy with digital technology)
- The client's personnel may not always tell the truth.

THE TERM 'PERVASIVE EFFECTS ON THE FINANCIAL STATEMENTS

Pervasive is a term used to describe the effects of misstatement on the financial statements or the possible effects thereon if any misstatement remains undetected due to the auditor's inability to obtain sufficient appropriate audit evidence.

Pervasive effects on the financial statements are those that, in the auditor's judgments:

- are not confined to specific elements, account or items of the financial statements,
- if so confined, represent or could represent a substantial proportion of the financial statements or
- in relation to disclosures, are fundamental to user's understanding of the financial statements.

AUDIT PROCEDURES

- INVENTORY
- ACCOUNTS RECEIVABLES.
- ACCOUNTS PAYABLES.
- CASH & BANK.
- SALES
- PURCHASES

- (Separate material containing details is distributed for each of above item)

RELATED PARTIES

Related parties

A related party is a person or entity that is related to the entity that is preparing its financial statements (referred to as the 'reporting entity') [IAS 24.9]

a) A person or a close member of that person's family is related to a reporting entity if that person

- has control or joint control over the reporting entity;
- has significant influence over the reporting entity; or
- is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

An entity is related to a reporting entity if any of the following conditions applies

- The entity and the reporting entity are members of the same group.
- One entity is an associate or joint venture of the other entity.
- Both entities are joint ventures of the same third party.
- One entity is a joint venture of a third entity and the other entity is an associate of the third entity.
- The entity is a post-employment defined benefit plan for the benefit of employees of either the reporting entity or an entity related to the reporting entity,
- The entity is controlled or jointly controlled by a person identified in (a).

Disclosures-Related parties

Regardless of whether there have been transactions between a parent and a subsidiary, an entity must disclose the name of its parent and, if different, the ultimate controlling party.

Disclose key management personnel compensation in total and for each of the following categories: [IAS 24.17]

- short-term employee benefits
- post-employment benefits
- other long-term benefits
- termination benefits
- share-based payment benefits

DISCLOSURES

1. If there have been transactions between related parties, disclose the nature of the related party relationship as well as information about the transactions and outstanding balances necessary for an understanding of the potential effect of the relationship on the financial statements.
2. These disclosure would be made separately for each category of related parties and would include
   - the amount of the transactions
   - the amount of outstanding balances, including terms and conditions and guarantees
   - provisions for doubtful debts related to the amount of outstanding balances
   - expense recognized during the period in respect of bad or doubtful debts due from related parties

EXAMPLES TRANSACTIONS THAT ARE DISCLOSED IF THEY ARE WITH A RELATED PARTY

- purchases or sales of goods
- purchases or sales of property and other assets
- rendering or receiving of services
- leases
- transfers of research and development
- transfers under license agreements
- transfers under finance arrangements (including loans and equity contributions in cash or in kind)
- provision of guarantees or collateral
- commitments to do something if a particular event occurs or does not occur in the future
- settlement of liabilities on behalf of the entity or by the entity on behalf of another party

Examples of transactions indicating existence of related parties

- Transactions with abnormal terms of trade such as unusual prices, interest rates, guarantees or repayment terms.
- Transactions with lack apparent logical business reason.
- Transactions in which substance differs from form.
- High volume or significant transactions with certain customers and suppliers as compared to others.
- Unrecorded transactions such as receipt or provision of management services at no cost.

Audit procedures to ensure completeness of related party transactions

- Review prior year working papers for names of known related parties.
- Review the entity's procedures for identification of related parties.
- Inquire as to the affiliation of those charged with governance and officers with other entities.
- Review shareholder records to determine names of principal shareholders or obtain list of principal shareholders from share register.
- Review minutes of meetings of shareholders and those charged with governance.
- Review register of director's interests.
- Inquire other auditors currently involved in the audit or predecessor auditors as to their knowledge of RP.
- Review income tax records and information supplied to regulatory agencies.

- Review material investment transactions during the audit period to determine whether the nature and extent of investments during the period create related parties .
- Review contracts and agreements with key management or those charged with governance.
- Review significant contracts re-negotiated by the entity during the period.
- Review of internal auditor's report
-

Indicators of influence exerted by related party

- Significant transactions are referred to the related party for final approval
- There is little or no debate among management and those charged with governance regarding business proposals initiated by the related party
- Transactions involving the related party (or a close family member of the related party) are rarely independently reviewed and approved.
- The related party has vetoed significant business decisions taken by management or those charged with governance.

Examination of identified related party transactions

Usually limited amount of audit evidence is available for related party transactions. E.g. parent company might ask to book royalty etc. considering this, the auditor consider performing following audit procedures;

- Confirming the terms and amount of the transactions with the related party.
- Inspecting information in possession of the related party.
- Confirming or discussing information with persons associated with the transactions such as lawyers, banks, guarantors and agents.

Test Question

- Platinum Limited (PL) is a key supplier of raw materials to Zinc Limited (ZL). PL has filed a suit against ZL for breach of terms of an agreement. The amount claimed by PL is Rs. 10 million.

- ZL has disclosed it as a contingent liability in the draft financial statements for the year ended 31December 2011. However, ZL is striving for an out of court settlement and recent correspondence indicates that PL is likely to agree and settle the dispute for 50% of the amount claimed by them.

Required:

- Describe the audit procedures that ZL's auditor should perform in the above situation. Also discuss the impact, if any, of the above procedures on the audit report.

Materiality in Planning and Performing an Audit
ISA 320

Materiality in context of audit

- Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, are expected to influence the economic decisions of users taken on the basis of the financial statements.

- Judgments about materiality are made in light of surrounding circumstances, and are affected by the **size or nature** of a misstatement, or **combination of both**.

- **Materiality and audit risk are considered throughout the audit**

Materiality in context of audit

The auditor would assume that the users;

- Have a reasonable knowledge of business and economic activities and accounting and a willingness to study the information in the financial statements with reasonable diligence.
- Understand that financial statements are prepared, presented and audited to levels of materiality.
- Make reasonable economic decisions on the basis of the information in the financial statements.

MATERIALITY IN CONTEXT OF AUDIT

The concept of materiality is applied by the auditor

- In planning the audit (for identifying and assessing the risks of material misstatement/determining nature time and extent of risk assessment procedures)

- In performing the audit (for determining the nature, timing and extent of further audit procedures)

- In evaluating the effect of identified misstatements on the audit and of uncorrected misstatements on the financial statements and

- In forming the opinion in the auditor's report.

AUDITOR'S OBJECTIVE

In conducting an audit of financial statements, the overall objective of the auditor is:

- to **obtain reasonable assurance** **about whether the financial statements as a whole are free from material misstatement**, whether due to fraud or error, **to express an opinion** on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.
- The auditor obtains reasonable assurance by obtaining sufficient appropriate audit evidence to **reduce audit risk to an acceptably low level.**
- Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. E.g. express unqualified opinion when FS are materially misstated.
- Audit risk is a function of the risks of material misstatement and detection risk. i.e. it results from inherent/control/detection risk.

Relationship between audit risk and materiality

- There is an inverse relationship between materiality and the level of audit risk.

- This relationship is considered by an auditor in determining the nature, timing and extent of audit procedures

Determining Materiality

- Determining materiality involves the exercise of professional judgment.
- A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole.
- Factors that may affect the identification of an appropriate benchmark include the following:
  1. The elements of the financial statements (for example, assets, liabilities, equity, revenue, expenses.
  2. Whether there are items on which the attention of the users of the particular entity's financial statements tends to be focused.
  3. The nature of the entity, where the entity is in its life cycle, and the industry and economic environment in which the entity operates.

Determining Materiality

4. The entity's ownership structure and the way it is financed (for example, if an entity is financed solely by debt rather than equity, users may put more emphasis on assets, and claims on them, than on the entity's earnings)
5. The relative volatility of the benchmark.

- Examples of appropriate benchmarks depending on the circumstances of the entity, include categories of reported income such as profit before tax, total revenue, gross profit and total expenses, total equity or net asset value.

- Determining a percentage to be applied to a chosen benchmark involves the exercise of professional judgment.

Determining Materiality

- The auditors may, in planning the work, **intentionally** set the acceptable materiality level at a lower level than is intended to evaluate the results of audit.

- This is done to reduce likelihood of undiscovered misstatements and to provide the auditors with a margin of safety when evaluating the effect of misstatement during the audit.

Materiality Levels for Classes of Transactions, Account Balances or Disclosures.

Factors that indicate the existence of one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could be expected to influence the economic decisions of users taken. This may include the following;

- Whether laws or the financial reporting framework affect users' expectations regarding the measurement or disclosure of certain items (e.g. related party transactions)
- The key disclosures in relation to the industry in which the entity operates (for example, research and development costs for a pharmaceutical company).
- Whether attention is focused on a particular aspect of the entity's business that is separately disclosed in the financial statements (for example, a newly acquired business).

PERFORMANCE MATERIALITY

- This means the amount set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.
- Performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level or levels for particular classes of transactions, account balances or disclosures.
- Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated.

MATERIALITY REVISION AS THE AUDIT PROGRESSES

Materiality for the financial statements may need to be revised as a result of ;

- a change in circumstances that occurred during the audit (for example, a decision to dispose of a major part of the entity's business),
- Change in the auditor's understanding of the entity and its operations as a result of performing further audit procedures.

For example, if during the audit it appears as though actual financial results are likely to be substantially different from the anticipated period-end financial results that were used initially to determine materiality for the financial statements as a whole, the auditor revises that materiality.

AUDIT SAMPLING

WHAT IS AUDIT SAMPLING

- the application of an audit procedure to less than 100 percent of the items within an account balance or class of transactions for the purpose of evaluating some characteristic of the balance or class of transactions.

- Sampling is key to an effective and efficient audit .

- Without application of sampling techniques and audit can become inefficient because of utilization of more time and wastage of efforts on insignificant matters.

- Without application of sampling techniques, the audit may become ineffective as the results of audit work may not be termed adequate.

Tolerable error

- TE means the maximum error (misstatement) in a population that the auditor is willing to accept and still conclude that audit results are achieved.
- TE is a monetary amount set by the auditor in respect of which the auditor seeks to obtain an appropriate level of assurance that the monetary amount set by the auditor is not exceeded by the actual misstatement in the population.
- TE needs to be defined in advance what constitutes and error.
- TE will be either control deviations **(No)** when performing tests of control or **amount** of misstatements when performing substantive procedures.
- TE is considered at planning stage. It is related to auditor's judgment of materiality.
- The smaller the tolerable error, the greater the sample size need to be.
- Larger samples are made when errors are expected as against when no errors are expected.

Tolerable error (for controls) determination factors

- Auditor's understanding of the business, in particular, risk assessment procedures undertaken to obtain an understanding of internal control.
- Changes in personnel or in internal controls
- The results of audit procedures applied in prior periods and
- The results of other audit procedures

IMPORTANT SAMPLING PRINCIPLES

- In determining sample size the auditor should consider whether sampling risk is reduced to an acceptably low level.
- In determining sample size, consider if sampling risk is reduced to acceptably low level.
- Select sample items in such a manner that they can be expected to be representative of the population.
- If sample is small, auditor risk giving inappropriate opinion. (sampling risk)
- If sample is too large, it increase time and effort for audit.
- the auditor should consider the risk of material misstatement on the entire population.
- Sample results should be projected to the population.
- Items that cannot be audited should be treated as misstatements or deviations in evaluating sample results.

Attribute Sampling for Tests of Controls

- Determine the objective of the test
- Define the attributes and deviation conditions
- Define the population to be sampled
- Specify:
  - The tolerable deviation rate
  - The estimated population deviation rate
- Determine the sample size

Planning

- Select the sample
- Test the sample items

Performance

- Evaluate the sample results

Evaluation

- Document the sampling procedure

Documentation

AUDIT SAMPLING METHODS

- SYSTEMETIC SAMPLING. (Sampling units in population is divided by the sample size to determine sample interval.
- BLOCK SAMPLING/STRATIFICATION. (population is divided into different blocks of items which have common attributes e.g. basis of their value. Then from different blocks, items are selected on random or systematic basis.

SAMPLING AND NON SAMPLING RISK

- Sampling risk is the risk that the auditor's conclusion based on a sample may be different from the conclusion if the entire population were subjected to the same audit procedure .

- Non sampling risk is the risk that the auditor may reach an erroneous conclusion for any reason not related to sampling risk.

STRATIFICATION

- Audit efficiency may be improved as the auditor has stratified a population by dividing it into discrete sub-populations which have an identifying characteristic. The stratification reduces the variability of items within each stratum and therefore allow sample size to be reduced without a proportional increase in sampling risk .

- Other ways by which population may be stratified are by product, customers, geographically, terms of sales, cash advances etc.

EXAMPLES

When the expected rate of deviation has increased such that this increase is unacceptable to you as an auditor.

Then

If the expected rate of deviation is unacceptably high, it means that controls are not operating effectively and the auditor cannot place reliance on controls, accordingly the auditor do not perform the test of controls.

EXAMPLES

- You expect that the amount of misstatements has decreased from Rs. 300,000, to Rs. 200,000, whereas the monetary amount in respect of which you need an appropriate level of assurance is increased by Rs. 50,000

Then

- **A decrease in the amount of misstatements and increase in the monetary amount in respect of which the auditor requires an appropriate level of assurance will decrease the sample size as both the factor will reduce the audit risk. Hence the sample size of the test of details will decrease**.

Statistical sampling

- The sample size is determined scientifically and not arbitrarily.
- It quantifies the risk inherent in testing-that the sample may be unrepresentative of the population and hence undetected material errors may be contained in accounts.
- The auditor needs to define in advance, tolerable error, acceptable tolerable error and level of confidence to determine sample size.
- Confidence level is dependent upon the auditor's evaluation of internal control system.
- Confidence level refers to degree of assurance required that the total errors in the accounts do not exceed maximum amount of error regarding as acceptable and therefore is not material

STATISTICAL SAMPLING

- The auditor can justify the size of sample and the time spent on audit. He is forced to plan his audit testing more systematically than is generally the case with judgmental sampling.
- Interpretation of results is more objective and expressed in quantitative terms.
- Helps give precise information to the client.

JUDGMENTAL SAMPLING

- Based on experience and professional judgment, the auditor design sample and sample size.
- In this approach, human judgment play important role.
- This judgment may vary from person to person and it is likely that the sample is biased.
- Items are not selected on random basis, therefore it is not possible logically to extrapolate results of any test on sample to the population.
- The conclusions are difficult to justify.

CIRCUMSTANCES WHEN AUDITOR MAY DECIDE TO EXAMINE ENTIRE POPULATION

- when the population constitutes a small number of large value items.
- when there is a significant risk and other means do not provide sufficient appropriate audit evidence; or
- when the repetitive nature of a calculation or other process performed automatically by an information system makes a 100% examination cost effective

EXAMPLES-IMPACT ON SAMPLE SIZE

- An increase in auditor's assessment of inherent risk-INCREASE
- An increase in auditor's assessment of control risk-INCREASE
- In increase in auditors required confidence level-INCREASE
- An increase in tolerable error the auditor is willing to accept-DECREASE
- In increase in the amount of error the auditor expects to find in the population-INCREASE
- Stratification of population when appropriate-DECREASE
- An increase in expected rate of deviation from the prescribed control procedure-INCREASE
- An increase in the auditor's expected reliance on accounting and internal control system-INCREASE

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External confirmations

Reliability of audit evidence

- the reliability of audit evidence is influenced by its source and by its nature, and is dependent on the individual circumstances under which it is obtained.
- Audit evidence is more reliable when it is obtained from independent sources outside the entity.
- Audit evidence obtained directly by the auditor is more reliable than audit evidence obtained indirectly or by inference.
- Audit evidence is more reliable when it exists in documentary form, whether paper, electronic or other medium.
- ISA requires that the auditor obtain more persuasive audit evidence the higher the auditor's assessment of risk. To do this, the auditor may increase the quantity of the evidence or obtain evidence that is more relevant or reliable, or both.

Definitions

External confirmation – Audit evidence obtained as a direct written response to the auditor from a third party (the confirming party), in paper form, or by electronic or other medium

Positive confirmation request – A request that the confirming party respond directly to the auditor indicating whether the confirming party agrees or disagrees with the information in the request, or providing the requested information.

Negative confirmation request – A request that the confirming party respond directly to the auditor only if the confirming party disagrees with the information provided in the request.

WHEN TO USE NEGATIVE CONFIRMATION

- Negative confirmations provide less persuasive audit evidence than positive confirmations. Accordingly, the auditor shall not use negative confirmation requests as the sole substantive audit procedure to address an assessed risk of material misstatement at the assertion level unless all of the following are present

When to use negative confirmation

- The auditor has assessed the risk of material misstatement as low and has obtained sufficient appropriate audit evidence regarding the operating effectiveness of controls relevant to the assertion.

- The population of items subject to negative confirmation procedures comprises a large number of small, homogeneous account balances, transactions or conditions;

- A very low exception rate is expected; and

- The auditor is not aware of circumstances or conditions that would cause recipients of negative confirmation requests to disregard such requests.

The auditors may not circulate director confirmations when…..

- Accounts receivables are immaterial to the financial statements;
- The response rate is not expected to be adequate;
- The responses are not expected to be reliable;
- Inherent and control risk in aggregate are assessed at low level.
- Audit evidence expected to be gathered through other substantive procedures (e.g. analytical procedures) is sufficient to reduce the audit risk to an acceptable level.
- Management requests not to send the confirmation and auditor after satisfying himself from the reason and explanation given by the management

THE AUDITORS CONSIDER FOLLOWINGS FOR DESIGNING CONFIRMATION REQUESTS

- Assertions being addressed through the direct confirmation.
- Form of the external confirmation requests (i.e. positive or negative or combination of both)
- Prior experience on the audit of similar engagements.
- The nature of the information being confirmed.
- The intended respondent.
- Type of information respondents will be able to confirm readily.

Alternate procedures if customer does not reply to request for confirmation

- Check receipt from customers after balance sheet date.
- When there is no receipt from customers after balance sheet date, the auditor should consider the following audit procedures:
    - Verify validity of purchase orders, if any.
    - Verify goods dispatched note other & documents duly acknowledged by the customers.
- Obtain explanations for invoices remaining unpaid, if any, after subsequent one have been paid.
- Examine sales near the period end to provide audit evidence about cutoff assertion.

Direct communication with entity's legal council

Letter of general inquiry

- Under this method, a letter of general inquiry requests the entity's legal counsel to inform the auditor:
  1. of any litigation and claims that the counsel is aware
  2. an assessment of the outcome of the litigation and claims, and
  3. an estimate of the financial implications, including costs involved.

Direct communication with entity's legal council

Letter of specific inquiry

This method is used when it is unlikely that the entity's external legal counsel will respond appropriately to a letter of general inquiry. A letter of specific inquiry includes:

- a list of litigations and claims;
- where available, management's assessment of the outcome of each of the identified litigation and claims and its estimate of the financial implications, including costs involved; and
- A request that the entity's external legal counsel to:
  1. Confirm the reasonableness of management's assessments and
  2. Provide the auditor with further information if the list is considered by the entity's external counsel to be incomplete or incorrect.

Direct communication with entity's legal council

Meeting with legal counsel

- In certain circumstances, the auditor also may judge it necessary to meet with the entity's external legal counsel to discuss the likely outcome of the litigation or claims. This may be the case where:

- the auditor determines that the matter is a significant risk.
- the matter is complex.
- there is disagreement between management and the entity's external legal counsel.

Ordinarily such meetings require management's permission and are held with a representative of management in attendance.

Situation when debtors confirm a balance which is different from confirmation request

- A response that indicates a difference between information requested to be confirmed and information provided by the confirming party is termed as exception.
- The exception may be on account of TIMING DIFFERENCE OR MISSTATEMENT.
- In case of timing differences, the auditor will need to reconcile the amount confirmed by the confirming party and the amount sent for confirmation
- If the amount cannot be reconciled, the auditor is required to evaluate whether it is <u>indicative of a fraud or deficiency or deficiencies in the entity's internal control over financial reporting.</u>
- In either case, the auditor will consider whether he needs to revise his risk assessment and audit procedures.

Frauds & Errors

- Fraud involves incentive or pressure to commit fraud, a perceived opportunity and some rationalization of the act

AUDITOR'S RESPONSIBILITY

- An auditor conducting an audit in accordance with ISA obtains reasonable assurance that FS are as a whole free from material misstatements, whether due to fraud or error.

- When obtaining reasonable assurance, an auditor maintains attitude of professional skepticism throughout the audit and considers potential for management override of controls.

- Auditor plans audit with expectation of misstatements due to fraud

- He also recognizes the fact that audit procedures that are effective for detecting errors may not be appropriate in the context of an identified risk of material misstatement due to fraud

Management's responsibility

- Primary responsibility for prevention and detection of fraud rest with both charged with governance and management.
- It is important that management place strong emphasis on fraud prevention which may reduce opportunities for fraud and fraud deterrence which could persuade people not to commit fraud because of likeliness of detection/punishment.
- This involves creating culture of honesty and ethical behavior
- Such culture is based on strong set of core values and is communicated and demonstrated by management and leads employees how business is conducted.

Characteristics of management fraud

Two types of intentional misstatements are relevant to auditor;

- These are from fraudulent financial reporting. This involves intentional misstatement including omissions of amounts or disclosures to deceive users.

- Misstatements resulting from misappropriation of assets. This is often accompanied by false or misleading records in order to conceal the fact that assets are missing or have been pledged without proper authorization.

Situations indicating existence of fraud.

- Financial stability or profitability is threatened by economic, industry or entity's operating conditions.
- Excessive pressure exist on management to meet requirements, financial targets (sales/profitability) or expectation of third parties.
- Information available indicates that personal financial situation of management is threatened by entity's financial performance.
- The nature of industry or entity's operations provide opportunities to engage in fraudulent financial reporting.
- There are ineffective monitoring of management.
- There are complex or unstable organizational structure.
- Internal controls components are deficient.
- Adverse employee/entity relationship.
- Inadequate internal controls over assets.

Situations indicating existence of fraud.

- Significant transaction, that are outside the normal course of business or that otherwise appear to be unusual .
- Management has not discussed the nature of and accounting for such transactions with those charged with governance of the entity and there is inadequate documentation.
- Management is placing more emphasis on the need for a particular accounting treatment than on the underlying economics of the transaction
- Transactions that involve non-consolidated related parties, including special purpose entities and have not been properly reviewed or approved by those charged with governance of the entity.
- The transactions involve previously unidentified related parties or parties that do not have the substance or the financial strength to support the transaction without assistance from the entity under audit.

Management fraud by overriding of controls (common fraud techniques)

- Recording fictitious journal entries, particularly close to end of FY to manipulate operating results.
- Inappropriately adjusting assumptions and changing judgments used to estimate account balances.
- Omitting, advancing or delaying recognition in the FS of events and transactions that have occurred during the year
- Concealing or not disclosing facts that could effect amounts recorded in FS.
- Engaging in complex transactions that are structured to misrepresent financial position or performance of the entity.
- Altering records and terms related to significant and unusual transactions.

Responsive audit procedures

- Obtain understanding of entity's financial reporting process and controls over journal entries and adjustments.
- Evaluate design of controls over journal entries and other adjustments whether they have been implemented.
- Make inquiries of individuals in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments.
- Determine timing of testing and
- Identify and select journal entries and other adjustments for testing.

Procedures to identify risk of misstatements due to fraud

- Make inquiries of Management and obtain understanding of how people charged with governance exercise oversight of management processes and monitor internal controls.

- Consider whether one or more fraud risk factors are present

- Consider any unusual or unexpected relationship that have been identified while performing analytical procedures.

- Consider other information that may be helpful in identifying risks.

General principles

- Although responsibility for detection and prevention of fraud rest with management, the auditor should plan his work with reasonable expectation of detecting material fraud and error.
- The auditor therefore assess risk that fraud or error may cause the FS to contain material misstatements and should inquire management as to any instance of fraud or error already discovered. (see representation letter).
- During course of audit, if a fraud suspicion arise, then auditor should carry out such additional procedures that either confirm or dispel such suspicion.

General principles

- If auditor is unable to confirm or dispel his doubt then he should either take legal advice or withdraw from engagement.
- If management is involved in fraud then he should reconsider validity of all representations made by management.
- The auditor should communicate to the management on timely basis and not wait till end or issuance of audit report.
- If fraud or error goes amiss and it is proved after issuance of audit report, the auditor can only be held liable if he is proved to be "negligent" in carrying our his work.

Discussion question

- The BOD has appointed Mr. Smart as new CEO whole remuneration is based on performance (bonus/stock options
- Smart is seasoned executive and is very good fried of the chairman of Board.
- Since his joining, he has proved to be main decision maker and Board appears to be relying considerably on him and less interested in day to day operations of the company.
- Board's main concern is growth in net earnings for the next year, which Mr. Smart believes to be minimum 30%.
- There are number of instances of lack of segregation of duties and Mr. Smart being cost conscious, has allowed the situation to continue.
- There is big layoff plan and employees are expecting it.
- Mr. Smart introduced skill development program for to management personals.

AUDIT DOCUMENTATION

AUDIT DOCUMENTATION

Audit documentation should provides;

- Evidence of the auditor's basis for a conclusion about the achievement of the overall objective of the auditor; and

- Evidence that the audit was planned and performed in accordance with ISAs and applicable legal and regulatory requirements

- The preparation of working papers is an integral part of the auditor's responsibilities.

If audit work is not documented….it is considered not done

- In audit – you can never prove anything to have been done unless you document it…

- How to document – attach supports, use work programs and then sign them off, write work done, index, cross reference and tick marks etc.

- How to document-always check that there is a complete referenced set of financial statements available in file, which is referenced and linked with the working papers.

PURPOSE

- Assisting the engagement team to plan and perform the audit.
- Assisting members of the engagement team responsible for supervision, to direct and supervise the audit work and to discharge their review responsibilities.
- Enabling the engagement team to be accountable for its work.
- Retaining a record of matters of continuing significance to future audits.
- Enabling the conduct of quality control reviews and inspections.
- Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements.

Factors to be considered while determining form, content and extent of working papers

- The nature of the audit procedures to be performed;
- The identified risks of material misstatement;
- The extent of judgment required in performing the work and evaluating the results;
- The significance of the audit evidence obtained;
- The nature and extent of exceptions identified;
- The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained; and
- The audit methodology and tools used.

Criteria for preparing audit working papers

- A person with no previous connection with audit should be in position to review WP and ascertain what work was performed and how the conclusions were reached.
- FS should be supported by schedules for analytical review.
- WP should contain comparative figures and record of all adjustments leading to final figures.
- WP should be crossed referenced to avoid duplications.
- WP should specify source of data.
- WP should specify client name, WP title, period covered, name of person who has prepared it and date of preparation.
- WP should spell out description of work performed and conclusions reached.
- WP should be initialed and dated by staff. (prepare/review)
- WP should be reviewed and initialed by job incharge.

WP OWNERSHIP

WP are property of the auditors.

Auditors may decide to give extract from WP to the entity.

WP are not substitute for entity's accounting reocrds.

Documents included in working papers

- Audit programs, analytical schedules, working sheets.
- Information concerning org structure/legal structure.
- Risk assessment documentation (information concerning industry, environment and relevant legislation.
- Evidence of auditor's understanding of entity's accounting and internal controls system.
- Evidence of auditor's consideration of work of internal auditors/other experts, degree of reliance.
- Record of nature, timing and extent of audit procedures applied.
- Copies of communication with other auditors/experts etc.
- Audit engagement letter
- Management representation letter,
- Management Letter.
- Financial statements/audit report

AUDIT PROCEDURES

AUDIT PROCEDURES

- Auditing procedures are methods and techniques used by the auditor to gather and evaluate audit evidence.

- In selecting a procedure, the auditor must take care to balance the potential effectiveness of the procedure in meeting specific objectives against the cost of performing the procedure

TYPES OF AUDIT PROCEDURES

- **Analytical procedures:**

  Involve comparing recorded accounting data with historical information, budget expectations or external benchmarks

- **Inspecting**.

  Involves careful scrutiny or detailed examination of documents and records, and physical examination of tangible resources and this procedure is used extensively in auditing

TYPES OF AUDIT PROCEDURES

TRACING:

Involves inspecting documents created when transactions were executed and determines that information from the documents was properly recorded in the accounting records.

VOUCHING:

Involves selecting entries in the accounting records and inspecting the documentation that served as the basis for the entries, so as to determine the propriety and validity of the recorded transactions.

TYPES OF AUDIT PROCEDURES

CONFIRMING:

Is a form of inquiry that enables the auditor to obtain information directly from an independent source outside the entity in writing, and where the auditor controls the mailing of the inquiry.

COUNTING:

Involves the physical counting of tangible resources (such as the amount of cash or inventory on hand) and accounting for all pre-numbered documents.

TYPES OF AUDIT PROCEDURES

OBSERVING:

Pertains to watching or witnessing the performance of some activity or process such as the manner in which cash is safeguarded, or the care taken by the entity in counting inventory.

RE-PERFORMING:

Includes checking calculations and reconciliations made by the entity such as the amounts calculated for depreciation and accrued interest, and verifying the accuracy of totals on supporting schedules and reconciliations

CLASSIFICATION OF AUDIT PROCEDURES

CLASSIFICATION OF AUDIT PROCEDURES

- Auditing procedures are usually classified by purpose into the following categories:

– tests of control to obtain an understanding of the internal control structure.

– substantive procedures

TESTS OF CONTROLS

- Are made to provide evidence about the effectiveness of the design and operations of internal control structure policies and procedures.
- Assume, for example, that the control procedure provides for depositing cash in the bank daily.
- The auditor can test the effectiveness of the control by observing actual deposits being made or by inspecting duplicate deposit slips.

Substantive procedures

- Provide direct evidence as to the fairness of management's financial statement assertions.

- This category of auditing procedure consists of:

– analytical procedures
– tests of details of transactions
– tests of details of balances

Substantive procedures

- Analytical procedures involve the use of comparisons to assess fairness, e.g. a comparison of an account balance with the previous year's balance or a budgeted amount.

- Tests of details of transactions involve examining support for the individual debits and credits posted to an account.

- Tests of details of balances involve examining support for the closing balance directly.

ANALYTICAL PROCEDURES

NATURE & PURPOSE OF ANALYTICAL PROCEDURES (AP)

- AP include studying significant ratios, trends and other statistics.
- It is based upon the expectations that relationship among data exist and continue in absence of known conditions to the contrary.
- It provides audit evidence as to completeness, accuracy and validity of data produced by the accounting system.
- Its purpose is to understand the business and reveal possible misstatements in financial statements.
- AP are helpful in planning, execution and completion states of audit.

AP AT PLANNING STAGE

- AP are carried out at this stage to:

  1. Understand the business.
  2. Identify potential risk in business by indicating aspects of business of which auditors were not aware before.

- AP use financial and non financial information.

- Non financial information used include number of employees, volume of goods produced etc.

AP AT EXECUTION STAGE

AP are carried out at this stage to:

1. Reduce the detailed testing of transactions and balances in certain areas without increasing detection risk.

2. To quickly react to anomalies disclosed by the comparisons and tailoring detailed tests accordingly.

AP AT COMPLETION STATE OF AUDIT

- Form an overall conclusion as to whether the financial statements as whole are consistent with the auditor's understanding of the entity.
- Corroborate the conclusions formed through other procedures performed during the audit of individual components of financial statements.
- Identify previously unrecognized risk of material misstatement, in such circumstances, the auditor may;

1. Revise auditor's assessment of risk of material misstatements.
2. Modify responsive audit procedures.

WHEN AP IDENTIFY SIGNIFICANT FLUCTUATIONS OR RELATIONSHIPS, THE AUDITORS SHALL;

- Investigate such differences. Fluctuations can be investigated in the following manner;
  1. Inquiring of management and obtaining appropriate audit evidence relevant to management responses. These audit evidences can be obtained by taking into account the auditor's understanding of the entity and its environment and with other audit evidence obtained during the course of audit.
  2. Performing other audit procedures when; the management is unable to provide an explanation or the explanation together with the audit evidence obtained is not considered adequate.

AUDIT RISK

AUDIT RISK

- Audit risk is the risk that the auditor gives an inappropriate audit opinion when the financial statement is materially misstated.

- In setting the desired audit risk, auditors seek an appropriate balance between the costs of an incorrect audit opinion and the costs of performing the additional audit procedures necessary to reduce audit risk

AUDIT RISK COMPONENTS
INHERENT RISK

- Is the possibility that a material misstatement could occur in an assertion, either individually or when aggregated with other misstatements, assuming there are no related controls?

- Inherent risk may be greater for some accounts or transactions than for others.

AUDIT RISK COMPONENTS
INHERENT RISK

- The existence of related parties, foreign exchange dealings and other complicated contracts can constitute an inherent risk in some entities.

- Inherent risk exists independently of the audit of financial statements and thus auditors cannot change the actual level of inherent risk

AUDIT RISK COMPONENTS
CONTROL RISK

- Is the risk that a material misstatement could occur in an assertion, either individually or when aggregated with other misstatements, and not be prevented, detected, or corrected on a timely basis by the entity's internal control structure?

- Control risk is a function of the effectiveness of the internal control structure as good controls reduce risk

AUDIT RISK COMPONENTS
DETECTION RISK

- Is the risk that an auditor's substantive procedures will not detect any material misstatements that exist in an assertion, either individually or when aggregated with other misstatements?
- Detection risk is a function of the effectiveness of substantive procedures and their application by an auditor and thus is fundamental to the amount of audit work undertaken

AUDIT RISK COMPONENTS
DETECTION RISK

- Unlike inherent and control risk, the actual level of detection risk is controllable by the auditor through:

– appropriate planning, direction, supervision and review.

– variation in the nature, timing and extent of audit procedures.

– effective performance of the audit procedures and evaluation of their results

Relationship among risk components

- An auditor's objective is to achieve an acceptably low level of audit risk, as is practicable.

- While recognizing the cost of performing audit procedures, there is an inverse relationship between the assessed levels of inherent and control risks and the level of detection risk that the auditor can accept.

Relationship among risk components

- Thus, if inherent and control risks are assessed as being low, the auditor can tolerate a higher level of detection risk

- Auditors, although unable to control inherent risk (IR) and control risk (CR), can assess these risks and design substantive procedures to produce an acceptable level of detection risk, thus reducing the audit risk to an accept.

QUANTIFIED AUDIT RISK MODEL

- The audit risk model provides a framework for auditors to follow in responding to these assessed risks through their choice of audit procedures;

- The audit risk model expresses the relationship among the audit risk (AR) components as follows:

  $AR = IR \times CR \times DR$

That is, Audit risk = Inherent risk ×Control risk × detection risk

QUANTIFIED AUDIT RISK MODEL

- Assume the auditor has made the following risk assessments for a particular transaction class or account balance — that IR and CR both equal Detection risk (DR) can be determined by solving the model for DR as follows:

- DR = AR(.05)/IR(.5.) × CR(.5) = 20%

- Given that the aim is to hold the overall audit risk to a specified level, the higher the assessed levels of inherent risk and control risk, the lower will be the acceptable level of detection risk

NON QUANTIFIED RISK MODEL

- Auditors may use non-quantified expressions for risk.
- Is consistent with the quantified audit risk model, in that the acceptable levels of detection risk are inversely related to the assessments of inherent and control risks.
- If an auditor's assessment of control and inherent risks are both high, then the acceptable level of detection risk will generally have to be very low.

- That is, the risk that the auditor's substantive procedures will not detect material misstatements will need to be low — which means more substantive testing by the auditor.

CODE OF ETHICS

FUNDAMENTAL PRINCIPLES

While acting in public interest, it is mandatory on professional accountants to comply with code of ethics which is applicable on all professional accountants.

It is accountant's responsibility to work in public interest and not just in interest of their client or employer.

The code of ethics establishes **fundamental principles of professional ethics** and provides conceptual framework that professional accountants apply to ;

- **Identify threats** to compliance with fundamental principles,
- Evaluate significance of threats identified and
- **Apply safeguards**, when necessary, to eliminate threats or reduce them to acceptably low level.

Fundamental principles of professional ethics

A professional accountant shall comply with the following fundamental principles:

- Integrity
- Objectivity
- Professional Competence and due care
- Confidentiality
- Professional Behavior.

INTEGRITY

- Integrity means-to be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness.

- A professional accountant shall not knowingly be associated with reports, returns, communications or other information where the professional accountant believes that the information:

(a) Contains a materially false or misleading statement;

(b) Contains statements or information furnished recklessly; or

(c) Omits or obscures information required to be included where such omission or obscurity would be misleading.

Objectivity

- The principle of objectivity imposes an obligation on all professional accountants not to compromise their professional or business judgment because of bias, conflict of interest or the undue influence of others.

Professional competence and due care

The principle of professional competence and due care imposes the following obligations on all professional accountants:

- To maintain professional knowledge and skill at the level required to ensure that clients or employers receive competent professional service;
- To act diligently in accordance with applicable technical and professional standards when providing professional services.
- Diligence encompasses the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.
- A professional accountant shall take reasonable steps to ensure that those working under the professional accountant's authority in a professional capacity have appropriate training and supervision.
- This principle can be grouped in two phases of "attainment of professional competence" and "maintenance of professional competence"

Confidentiality

The principle of confidentiality imposes an obligation on all professional accountants to refrain from:

- Disclosing outside the firm or employing organization confidential information acquired as a result of professional and business relationships without proper and specific authority or unless there is a legal or professional right or duty to disclose; and
- Using confidential information acquired as a result of professional and business relationships to their personal advantage or the advantage of third parties.

A professional accountant shall maintain confidentiality, including in a social environment, being alert to the possibility of inadvertent disclosure, particularly to a close business associate or a close or immediate family member.

CONFIDENTIALITY

- A professional accountant shall take reasonable steps to ensure that staff under the professional accountant's control and persons from whom advice and assistance is obtained respect the professional accountant's duty of confidentiality.
- The need to comply with the principle of confidentiality continues even after the end of relationships between a professional accountant and a client or employer.
- When a professional accountant changes employment or acquires a new client, the professional accountant is entitled to use prior experience. The professional accountant shall not, however, use or disclose any confidential information either acquired or received as a result of a professional or business relationship

CONFIDENTIALITY

The following are circumstances where professional accountants are or may be required to disclose confidential information or when such disclosure may be appropriate:

- Disclosure is permitted by law and is authorized by the client or the employer;
- Disclosure is required by law, for example Production of documents or other provision of evidence in the course of legal proceedings; or Disclosure to the appropriate public authorities of infringements of the law that come to light;
- There is a professional duty or right to disclose, when not prohibited by law (A) to comply with the quality review of a member body or professional body; (B)to respond to an inquiry or investigation by a member body or regulatory body; (C) to protect the professional interests of a professional accountant in legal proceedings; (D) or to comply with technical standards and ethics requirements.

PROFESSIONAL BEHAVIOR

- The principle of professional behavior imposes an obligation on all professional accountants:

  1. To comply with relevant laws and regulations and
  2. Avoid any action that the professional accountant knows or should know may discredit the profession.

- In marketing and promoting themselves and their work, professional accountants shall not bring the profession into disrepute. Professional accountants shall be honest and truthful and not:
  1. Make exaggerated claims for the services they are able to offer, the qualifications they possess, or experience they have gained; or
  2. Make disparaging references or unsubstantiated comparisons to the work of others.

Threats to compliance with fundamental principles

- A threat can compromise, or could be perceived to compromise, a professional accountant's compliance with the fundamental principles.
- Threats may be created by a broad range of relationships and circumstances.
- A circumstance or relationship may create more than one threat that may affect compliance with more than one fundamental principle.

THREATS FALL INTO ONE OR MORE OF THE FOLLOWING CATEGORIES

- Self Interest Threat.
- Self Review Threat.
- Advocacy Threat.
- Familiarity Threat.
- Intimidation Threat.

SELF INTEREST THREAT

the threat that a financial or other interest will inappropriately influence the professional accountant's judgment or behavior. Examples include;

- A member of the assurance team having a direct financial interest in the assurance client.
- A firm having undue dependence on total fees from a client.
- A member of the assurance team having a significant close business relationship with an assurance client.
- Firm concerned about possibility of losing a significant client.
- A member of the audit team entering into employment negotiations with the audit client.
- A firm entering into a contingent fee arrangement relating to an assurance engagement.
- A professional accountant discovering a significant error when evaluating the results of a previous professional service performed by a member of the professional accountant's firm.

Self review threat

the threat that a professional accountant will not appropriately evaluate the results of a previous judgment made or service performed by the professional accountant, or by another individual within the professional accountant's firm or employing organization, on which the accountant will rely when forming a judgment as part of providing a current service. Examples include;

- A firm issuing an assurance report on the effectiveness of the operation of financial systems after designing or implementing the systems.

- A firm having prepared the original data used to generate records that are the subject matter of the assurance engagement.

SELF REVIEW THREAT (CONTINUED)

- A member of the assurance team being, or having recently been, a director or officer of the client.

- A member of the assurance team being, or having recently been, employed by the client in a position to exert significant influence over the subject matter of the engagement.

- The firm performing a service for an assurance client that directly affects the subject matter information of the assurance engagement. A self-review threat may be created when a firm provides internal audit services to a financial statement audit client

ADVOCACY THREAT

the threat that a professional accountant will promote a client's or employer's position to the point that the professional accountant's objectivity is compromised. Examples are:

- The firm promoting shares in an audit client.
- A professional accountant acting as an advocate on behalf of an audit client in litigation or disputes with third parties.

FAMILIARITY THREAT

the threat that due to a long or close relationship with a client or employer, a professional accountant will be too sympathetic to their interests or too accepting of their work. Examples include:

- A member of the engagement team having a close or immediate family member who is a director or officer of the client.
- A member of the engagement team having a close or immediate family member who is an employee of the client who is in a position to exert significant influence over the subject matter of the engagement.
- A director or officer of the client or an employee in a position to exert significant influence over the subject matter of the engagement having recently served as the engagement partner.
- A professional accountant accepting gifts or preferential treatment from a client, unless the value is trivial or inconsequential.
- Senior personnel having a long association with the assurance client.

INTIMIDATION THREAT

the threat that a professional accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the professional accountant. Examples include:

- A firm being threatened with dismissal from a client engagement.
- An audit client indicating that it will not award a planned non assurance contract to the firm if the firm continues to disagree with the client's accounting treatment for a particular transaction.
- A firm being threatened with litigation by the client.
- A firm being pressured to reduce inappropriately the extent of work performed in order to reduce fees.
- A professional accountant feeling pressured to agree with the judgment of a client employee because the employee has more expertise on the matter in question.
- A professional accountant being informed by a partner of the firm that a planned promotion will not occur unless the accountant agrees with an audit client's inappropriate accounting treatment.

SAFEGUARDS

- Safeguards that may eliminate or reduce threats to an acceptable level.
- Professional accountant shall exercise judgment to determine how best to deal with threats that are not at an acceptable level, whether by applying safeguards to eliminate the threat or reduce it to an acceptable level or by terminating or declining the relevant engagement.
- Safeguards fall into two broad categories:
  - ✓ Safeguards created by the profession, legislation or regulation; and
  - ✓ Safeguards in the work environment.

SAFEGUARDS IN WORK ENVIRONMENT

- In the work environment, the relevant safeguards will vary depending on the circumstances. It comprise

1. Firm-wide safeguards
2. Engagement-specific safeguards

Firm wide safeguards-examples

- Policies and procedures to implement and monitor quality control of engagements.
- Documented internal policies and procedures requiring compliance with the fundamental principles.
- Policies and procedures that will enable the identification of interests or relationships between the firm or members of engagement teams and clients.
- Using different partners and engagement teams with separate reporting lines for the provision of non-assurance services to an assurance client.
- Timely communication of a firm's policies and procedures, including any changes to them, to all partners and professional staff, and appropriate training and education on such policies and procedures.
- A disciplinary mechanism to promote compliance with policies and procedures.

ENGAGEMENT-SPECIFIC SAFEGUARDS

- Having a professional accountant who was not a member of the assurance team review the assurance work performed or otherwise advise as necessary.
- Rotating senior assurance team personnel.
- Involving another firm to perform or re-perform part of the engagement.

IMPORTANT PROVISIONS FROM CODE OF CORPORATE GOVERNANCE -2012

Muhammad Aamir, ACA, ACMA

AUDIT COMMITTEE

- The Audit Committee should comprise of not less than three members from among the directors of a listed company.
- The Code 2012 requires that the members of the Audit Committee should be from the non-executive directors of the company.
- The chairman of the Audit Committee must be an independent director who is not the chairman of the board.
- The board shall satisfy itself that at least one member of the audit committee has relevant financial skills/expertise and experience
- The secretary of Audit Committee shall either be the Company Secretary or Head of Internal Audit. However, the CFO shall not be appointed as the secretary to the Audit Committee.
- For hiring external auditor, audit committee suggest name and BOD recommends name for AGM.

Audit committee meetings & internal audit function

- The Audit Committee of a listed company shall meet at least once every quarter of the financial year. These meetings shall be held prior to the approval of interim results of the listed company by its Board of Directors and before and after completion of external audit. A meeting of the Audit Committee shall also be held, if requested by the external auditors or the Head of Internal Audit.
- Qualification introduced for Head of IA. The removal of Head of IA is with the approval of the Board only upon recommendation of the Chairman of the Audit Committee
- The internal audit function may be outsourced by a listed company to a professional services firm or be performed by the internal audit staff of the holding company. In the event of outsourcing the internal audit function, the company shall appoint or designate a fulltime employee other than the CFO, as Head of Internal Audit, to act as coordinator between the firm providing internal audit services and the board.

OTHER PROVISIONS

- The internal audit function of a listed company must be independent from the management/directors of a listed company. Therefore, a director cannot be appointed, in any capacity, in the internal audit function .
- There is no particular provision in the Code 2012 that restricts an individual of foreign nationality to assume the position of an officer/head of internal audit of a company listed in Pakistan.
- Only statutory auditors appointed to conduct the annual audit of a listed company can carry out a limited scope review of the company's half-yearly accounts.

OTHERS

- In terms of the requirements of the Code 2012, the Audit Committee or the board of directors can only approve the duly reviewed or audited accounts in case of second quarter and annual accounts respectively.
- The requirement for the auditors to initial the financial statements has been introduced .
- This is to ensure that only the accounts duly reviewed or audited are presented for the approval of the Audit Committee and the board.
- The CEO and the CFO are mandated to present to the Audit Committee and the board, annual accounts (both separate and consolidated) and second-quarter (only separate/stand-alone) reviewed and initialed by external auditor, for the purposes of identification, and as such, the responsibility of preparation of financial statements rests with the management in accordance with provisions of the Companies Ordinance, 1984.

Penalty for misconduct

- No listed company shall appoint or continue to retain any person as an auditor, who has been found guilty of professional misconduct, by the Commission or by a Court of Law, for a period of three years unless a lesser period is determined by the Commission.
- In case a firm has been appointed as an auditor, and if any of its partners has been held guilty of professional misconduct, the firm shall only be eligible for appointment as an auditor provided a written confirmation is given by the firm to all the stock exchanges of the country and the Commission with a copy to ICAP to the effect that such a partner shall not be engaged in the audit of any listed company for the specified period.

WHAT IS "PROFESSIONAL MISCONDUCT"

A person appointed as an auditor shall be guilty of "professional misconduct" if he/she;

- fails to report a material misstatement or fact known to him and non-disclosure of which may render the financial statements misleading or disclosure of which is necessary in his professional capacity.
- fails to obtain sufficient information to warrant the expression of an opinion.
- makes a statement which is misleading, or deceptive.
- incites any one to commit a criminal offence, or helps or encourages anyone in planning or execution of a criminal offence which is committed.
- agrees with anyone to prevent or obstruct the course of justice by concealing, destroying or fabricating evidence by a misleading statement which he knows to be untrue;

WHAT IS "PROFESSIONAL MISCONDUCT

- Deceives any person, either by making a statement, which he knows to be false, or by suppressing matters relevant to a proper appreciation of its significance.
- expresses his opinion on financial statements of any business or enterprise in which he, his firm or a partner in his firm has substantial interest.
- is penalized under any of the provisions of the Companies Ordinance, 1984 in relation to his function as an auditor of a listed company.
- is guilty of any other act which is determined as professional misconduct by the Commission in relation to his function as an auditor of a listed company

Effect on appointment of auditors because of providing prohibited services

- No Listed company shall, appoint or continue to retain any person as an auditor who is engaged by the company to provide services that are prohibited.

- listed company shall also not appoint or continue to retain any person as an auditor, if a person associated with the auditor is, or has been, at any time during the preceding three months engaged as a consultant or advisor or to provide any services that are prohibited.

LIST OF PROHIBITED SERVICES (APPLICABLE ON LISTED COMPANIES ONLY)

- Preparing financial statements, accounting records and accounting services;
- Financial information technology system design and implementation, significant to overall financial statements;
- Appraisal or valuation services for material items of financial statements;
- Acting as an Appointed Actuary within the meaning of the term defined by the Insurance Ordinance, 2000;
- Actuarial advice and reviews in respect of provisioning and loss assessments for an insurance entity;
- Internal audit services related to internal accounting controls, financial systems or financial statements;
- Human resource services relating to executive recruitment or Work performed (including secondments) where management decision will be made on behalf of a listed audit client

LIST OF PROHIBITED SERVICES (APPLICABLE ON LISTED COMPANIES ONLY)

- Legal Services;
- Management functions or decisions;
- Corporate finance services, advice or assistance which may involve independence threats such as promoting, dealing in or underwriting of shares of audit clients.
- Any exercise or assignment for estimation of financial effect of a transaction or event where an auditor provides litigation support services as identified in paragraph 9.187 of Code of Ethics for Chartered Accountants.
- Share Registration Services (Transfer Agents) and;
- Any other service(s) which the Council with the prior approval of the Securities & Exchange Commission of Pakistan, may determine to be a "prohibited service"