

2. Risk, Error and the Audit Process

Purpose of an audit

- To provide **reasonable assurance** that the FSs of the entity present (or do not present) a **T&F view** of the financial performance and financial position of the entity
- In practice, this means that the financial statements are **free of material errors**

Audit risk

- Audit risk: The risk of giving the wrong audit opinion (i.e. there is a material error, but the auditor did not claim that it was material; or, when it is not T&F, but the auditor claims it is)
- Audits provide a reasonable level of assurance
 - This means that even the best auditor cannot guarantee that their opinion is correct
 - Therefore, audit risk cannot be eliminated
- The aim of an audit is to reduce audit risk to an acceptable level

Engagement risk

- Engagement risk: Risk of negative consequences if the wrong audit opinion is given
 - Legal action – damages; loss of ability to conduct audits
 - Loss of reputation – inability to attract clients; lower audit fees due to lower reputation
- The lower level of audit risk, the lower the level of engagement risk

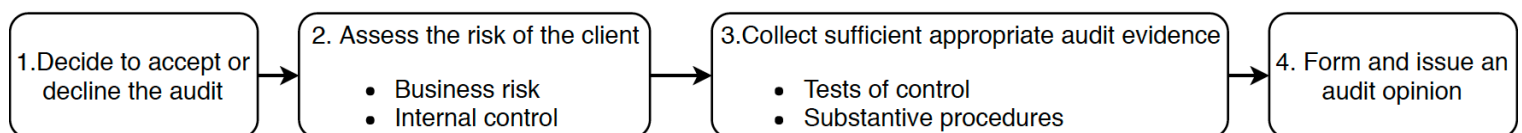
Risk and cost

- Reducing audit risk is a trade-off
 - It reduces engagement risk and the costs associated with it
 - It costs more money because it requires more resources (staff costs) to conduct better audits
- When designing an audit strategy, the auditor needs to assess when the benefits of reduced engagement risk are outweighed by the additional costs of more audit work

Audit efficiency and risk based auditing

- To reduce the audit risk at the lowest cost, the auditor should audit as efficiently as possible
- To achieve this, a risk based auditing approach is used
 - Determine which parts of the FSs are at most risk of material error
 - Concentrate the audit effort in those areas
- This is the approach that is legally mandated by Australian Auditing Standards (ASA)

The basic audit process



Audit engagement

- When an auditor is offered an audit engagement, the auditor has to decide whether to accept or decline it
- Reasons for declining:
 - Client is too risky (most common)
 - The auditor audits the client's competitors
 - The auditor does not have expertise in the client's industry (i.e. industry specialisation)
 - The auditor does not have enough staff
 - The fee is too low (most common)

Agreeing the Terms of Audit Engagements (ASA 210)

- The auditor should only accept an audit engagement if:
 - Management accepts its responsibility for the preparation of the FR and for the internal control system of the company
 - Management agrees to give the auditor access to all information and people that the auditor needs to conduct the audit

Engagement letter (ASA 210.10)

- The agreed terms of the audit engagement shall be recorded in an audit engagement letter or other suitable form of written engagement and shall include:
 - (a) The objective and scope of the audit of the FR
 - (b) The responsibilities of the auditor

Three major standards on audit quality control

<p><i>ASQC 1 Quality Control for Firms that Perform Audits and Reviews on Financial Reports and Other Financial Information, and Other Assurance Engagements</i></p> <p>Covers how to ensure high quality at an audit firm</p>	<p>Quality control in audit firms</p> <ul style="list-style-type: none">• The AUASB has issued a standard to force firms to establish internal quality control systems: ASCQ 1• This is not a standard on how to audit but a standard on how to control an audit firm <p>Objective of audit firm – to establish and maintain a system of quality control to provide it with reasonable assurance that:</p> <ul style="list-style-type: none">• The firm and its personnel comply with AUASB Standards, relevant ethical requirements, and applicable legal and regulatory requirements; and• Reports issued by the firm or engagement partners are appropriate in the circumstances <p>Elements of quality control</p> <ul style="list-style-type: none">• The firm shall establish and maintain a system of quality control that includes policies and procedures that address each of the following elements:<ul style="list-style-type: none">(a) Leadership responsibilities for quality within the firm(b) Relevant ethical requirements(c) Acceptance and continuance of client relationships and specific engagements(d) Human resources(e) Engagement performance(f) Monitoring <p>Requirements – For each of the six elements of control, the firm shall</p> <ul style="list-style-type: none">• Establish policies and procedures to ensure that element of control exists• Communicate these policies to all staff• Monitor and report on the effectiveness of and compliance with the policies• Document the policies and their communication and enforcement
<p><i>ASA 220 Quality Control for an Audit of a Financial Report and Other Historical Financial Information</i></p> <p>Covers how to ensure high quality on an audit</p>	<p>Engagement level quality control</p> <ul style="list-style-type: none">• ASQC1 covers general quality control measures for a whole audit firm• These general procedures need to be applied on each audit: ASA 220 <p>The engagement partner (EP)</p> <ul style="list-style-type: none">• Every audit is run by one EP<ul style="list-style-type: none">○ Plans the audit○ Manages the engagement team○ Consults with client management○ Forms the opinion○ Signs the audit report• Large audits may be assisted by other partners, but at the end, only one partner takes responsibility of the engagement <p>Leadership and ethics</p> <ul style="list-style-type: none">• The EP shall take responsibility for the overall quality on each audit engagement to which that partner is assigned• Throughout the audit engagement, the EP shall remain alert, through observation and making enquiries as necessary, for evidence of non-compliance with relevant ethical requirements by members of the engagement team• If matters come to the EP's attention through the firm's system of quality control or otherwise that indicate that members of the engagement team have not complied with relevant ethical requirements, the EP, in consultation with others in the firm, shall determine the appropriate action <p>Acceptance and continuation</p> <ul style="list-style-type: none">• The EP shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate

	<ul style="list-style-type: none"> • If the EP obtains information that would have caused the firm to decline the audit engagement had that information been available earlier, the EP shall communicate that information promptly to the firm, so that the firm and the EP can take the necessary action <p>Engagement teams</p> <ul style="list-style-type: none"> • The EP shall be satisfied that the engagement team, and any auditor's experts who are not part of the engagement team, collectively have the appropriate competence and capabilities to: <ul style="list-style-type: none"> (a) Perform the audit engagement in accordance with ASAs, relevant ethical requirements, and applicable legal and regulatory requirements; and (b) Enable an auditor's report that is appropriate in the circumstances to be issued <p>Engagement performance</p> <ul style="list-style-type: none"> • The EP shall take responsibility for: <ul style="list-style-type: none"> (a) The direction, supervision and performance of the audit engagement in compliance with ASA, relevant ethical requirements, applicable legal and regulatory requirements; and (b) The auditor's report being appropriate in the circumstances
<p><i>ASA 230 Audit Documentation</i></p> <p>Covers how to document an audit</p>	<p>Documentation</p> <ul style="list-style-type: none"> • Auditors need to document their work <ul style="list-style-type: none"> ○ Each individual document is called a workpaper ○ The complete set of workpapers is called an audit file • Documents can be stored on paper or in electronic form <p>Objective of documentation</p> <ul style="list-style-type: none"> • Audit documentation that meets the requirements of this Auditing Standard and the specific documentation requirements of other relevant ASA provides: <ul style="list-style-type: none"> (a) Evidence of the auditor's basis for a conclusion about the achievement of the overall objective of the auditor; and (b) Evidence that the audit was planned and performed in accordance with ASA and applicable legal and regulatory requirements <p>Additional purposes</p> <ul style="list-style-type: none"> • 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 in accordance with ASA 220.2 • 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 in accordance with ASQC • Enabling the conduct of external inspections in accordance with applicable legal, regulatory or other requirements <p>Requirements</p> <ul style="list-style-type: none"> • The auditor shall prepare audit documentation on a timely basis • The auditor shall prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand: <ul style="list-style-type: none"> (a) The nature, timing, and extent of the audit procedures performed to comply with the ASA and applicable legal and regulatory requirements (b) The results of the audit procedures performed, and the audit evidence obtained; and (c) Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgements made in reaching those conclusions • In documenting the nature, timing and extent of audit procedures performed, the auditor shall record: <ul style="list-style-type: none"> (a) The identifying characteristics of the specific items or matters tested (b) Who performed the audit work and the date such work was completed, and (c) Who reviewed the audit work performed and the date and extent of such review

	<ul style="list-style-type: none"> The auditor shall document discussions of significant matter with management, those charged with governance, and others, including the nature of the significant matters discussed and when and with whom the discussions took place If the auditor identified information that is inconsistent with the auditor's final conclusion regarding a significant matter, the auditor shall document how the auditor addressed the inconsistency <p>Audit file</p> <ul style="list-style-type: none"> The auditor shall assemble the audit documentation in an audit file and complete the administrative process of assembling the final audit file on a timely basis after the date of the auditor's report After the assembly of the final audit file has been completed, the auditor shall not delete or discard audit documentation of any nature before the end of its retention period
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Planning the audit

- Main risk assessment standard: *ISA 315 Identifying and Assessing the Risk of Material Misstatement through Understanding the Entity and its Environment* → it covers:
 - Audit Assertions
 - Business risk
 - Internal control

Audit assertions

- The information in an account or disclosure may contain many types of errors, e.g.:
 - Items being omitted
 - Items being entered into the wrong account
 - Non-existent items being included
 - Items being recorded at the wrong amount
- How can an auditor be sure that every possibility has been dealt with?
- Audit assertions are properties of:
 - An account balance,
 - A set of transactions,
 - A disclosure in the FSs,
 that must be true, for the account balance transaction or disclosure to be correctly stated
- In representing that the FR is in accordance with the applicable financial reporting framework, and other statutory reporting requirements, management of where appropriate those charged with governance implicitly or explicitly makes assertions regarding the recognition, measurement and presentation of classes of transactions and events, account balances and disclosures

Assertions, risk and errors

- Every error relates to one or more assertions of a particular account or disclosure
- Every risk that can cause an error must relate to one or more assertions
- To find all the errors, **every** assertion must be tested for **every** account and disclosure

Audit assertions

Assertions about classes of transactions and events, and related disclosures, for the period under audit – applicable for transactions in the income statement e.g. sales, purchases, payroll, depreciation expense)

Occurrences	Transactions and events that have been recorded or disclosed, have occurred and such transactions and events pertain to the entity
Completeness	All transactions and events that should have been recorded have been recorded, and all related disclosures should have been included in the FR have been included
Accuracy	Amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described
Cut-off	Transactions and events have been recorded in the correct accounting period
Classification	Transactions and events have been recorded in the proper accounts
Presentation	Transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable FRing framework

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